STATE+LOCAL TAX

INSIGHTS

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FACTOR REPRESENTATION: IS IT UNCONSTITUTIONAL FOR A STATE TO HAVE IT BOTH WAYS?

By Mitchell A. Newmark and William T. Pardue

A state cannot include income in the apportionable base and then exclude the receipts and related factors that generated that very same income from the apportionment formula. Factor representation is not only a matter of being fair, it is mandated by the U.S. Constitution.

Factor representation ensures that the property, payroll and/or sales factors of a state's apportionment formula include the amounts that are attributable to the generation of that income which a state included in its apportionable base. For example, in the case of a gain realized by a corporation from the sale of a business that operated outside the United States, if the gain is included in apportionable income, the sales factor should include the receipts from the sale. Factor representation can be accomplished either by: (1) including the gain in the apportionable income base and including the receipts in the sales factor; or (2) excluding the gain from the apportionable income base and excluding the receipts from the sales factor. States that include the income in the base

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and exclude the receipts from the sales factor are trying to have it both ways by not matching the income base with the factors related to the production of that same income. The result of the mismatch will almost always be an overstatement of the income apportioned to that state.

Despite the importance of factor representation, a number of state legislatures have enacted statutory apportionment formulas in which the factors do not match the apportionable income base. For example, Minnesota excludes sales of capital assets from its sales factor, but it has no statute providing for their mandatory exclusion from the apportionable income base.[1] The result is a violation factor representation. States have the option of either matching the income in the base with the factors that contributed to the generation of that income or excluding income from the base when it is too difficult to determine the matching factors.

Factor representation should not be confused with what is frequently referred to as "factor relief." Factor relief can be necessary when a state's normal allocation and apportionment formula does not fairly represent the taxpayer's business activity in that state.[2] In such a case, an alternative apportionment formula could be utilized in order to provide relief from the unfair application of the state's normal apportionment formula.

U.S. Constitutional Requirement of Factor Representation

Justice Stevens' Dissent in *Mobil Oil Corp. v. Vermont*

U.S. Supreme Court Justice John Paul Stevens explained factor representation in his dissenting opinion in *Mobil Oil Corp. v. Vermont*.[3] That case involved Mobil Oil's challenge to Vermont's treatment of dividend income that Mobil Oil received from subsidiaries and affiliates conducting business outside of the United States.[4] The majority opinion held that Vermont was not precluded from taxing foreign-source dividend income received by a non-domiciliary corporation.[5]

States have the option of either matching the income in the base with the factors that contributed to the generation of that income or excluding income from the base when it is too difficult to determine the matching factors.

Specifically, the Vermont apportionable income computation for Mobil Oil (which was organized under the laws of New York and headquartered in New York) included foreign-source dividend income.[6] However, the factors that created the dividend income, namely the payroll, property and sales of the subsidiaries and affiliates that were conducting business outside of the United States, were not included in the computation of Mobil Oil's apportionment formula.[7] Vermont refused to grant Mobil Oil's request for factor representation.[8]

An apportionment formula is fair under the external consistency test when the factor or factors used in the formula actually reflect a reasonable sense of how the income being apportioned was generated.

The majority of Justices declined to rule on the factor representation issue on the basis that Mobil Oil expressly did not challenge the formula in its briefs and, instead, only challenged inclusion of the foreign sourced dividend income in its apportionable income base.[9]

After concluding that the factor representation issue was sufficiently before the Court, Justice Stevens wrote in his dissenting opinion that:

> [u]nless the sales, payroll, and property values connected with the production of income by the payor corporations are added to the denominator of the apportionment formula, the inclusion of earnings attributable to those corporations in the apportionable tax base will inevitably cause Mobil's Vermont income to be overstated.[10]

The Majority Opinion in *Container Corp. of America v. Franchise Tax Board*

Only three years later, the U.S. Supreme Court majority saw the wisdom of Justice Stevens' explanation of factor representation and so commented in *Container Corp. of America v. Franchise Tax Board*.[11] Although the Court did not make a formal endorsement of factor representation, it spent several pages of the opinion discussing the constitutional requirements for apportionment formulas.[12] As explained by the Court, a state must apply an apportionment formula that is fair under the Due Process Clause and the Commerce Clause under *both* an internal consistency test and an external consistency test.[13] An apportionment formula is fair under the internal consistency test when the formula, if applied by every jurisdiction, would not result in more than all of the unitary business' income being taxed.[14] An apportionment formula is fair under the external consistency test when the factor or factors used in the formula actually reflect a reasonable sense of how the income being apportioned was generated.[15]

The U.S. Supreme Court placed additional limits on apportionment formulas.[16] For example, the Court stated that

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- "Nexus as Applied to the Energy Industry"
  Craig B. Fields and Richard C. Call

May 14
Annual West Coast State + Local Tax Update
Morrison & Foerster, San Francisco, California
- See ad on page 8

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"State Corporate Income Apportionment Key Fundamentals"
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COST 2013 Spring Audit Session / Income Tax Conference
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  Open Weaver Banks

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- Eric J. Coffill, Craig B. Fields and Philip M. Tatarowicz

September 22 – 25
2013 Institute of Professionals in Taxation (IPT) Credits and Incentives (C&I) Symposium
Dallas, Texas
- "SEC v. ACC"
  Philip M. Tatarowicz

September 30 – October 2
IPT Sales Tax Symposium
Monterey, California
- "Sourcing of Services and Nexus?"
  James P. Kratochvill

November 19
New Jersey Society of CPAs Multistate Tax Conference
Edison, New Jersey
- Paul H. Frankel and Mitchell A. Newmark

an apportionment formula may not result in discrimination against interstate or foreign commerce (under the Commerce Clause) and may not be distortive (under the Due Process and Commerce Clauses).[17] The U.S. Supreme Court reminded states that it "will strike down the application of an apportionment formula if the taxpayer can prove 'by clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportions to the business transacted in that State' or has led to a grossly distorted result."[18]

External Consistency and Factor Representation

A lack of factor representation in an apportionment formula causes the formula to fail the test for external consistency. Take the example of Vermont's apportionment formula in *Mobil Oil* wherein Vermont included the dividends received from non-United States subsidiaries and affiliates in the apportionable income base of a foreign corporate taxpayer, but did not include any of the property, payroll or sales of those same affiliates in Mobil Oil's apportionment factors.[19] To be valid under the external consistency test, the apportionment formula must include factors that reflect a reasonable sense of how the income was generated.[20] As the factors in Vermont's apportionment formula excluded all of the inputs that created the dividends that were apportioned, the factors did not reflect the generation of the income by the non-United States subsidiaries and affiliates. Therefore, Vermont's formula employed in *Mobil Oil* fails the external consistency test from *Container Corp*.[21] Factor representation is an important aspect of ensuring that an apportionment formula satisfies the constitutional test for external consistency. A formula lacking factor representation does not meet the U.S. Supreme Court's requirements for apportionment formulas.[22]

The Difficulty of Apportionment Is No Defense for Denial of Factor Representation

The U.S. Supreme Court has explained the requirements for apportionment formulas in depth and put states on notice that a formula will be struck down if it does not meet constitutional requirements.[23] States that rely upon the purported difficulty of creating a perfect apportionment formula as a defense for adopting formulas that do not provide factor representation are misguided. Perhaps Justice Stevens said it best when he explained that if it was too difficult for Vermont to determine how to arrive at the correct apportionment factors, Vermont could simply exclude the dividend income from the apportionable base.[24] Although apportionment is not an exact science, the defects created by failing to provide for factor representation can be easily remedied. A taxing authority can either include the factors that contributed to the generation of any income included in the apportionable base or, if it proves too difficult to ascertain those factors, the taxing authority can exclude that income from the apportionable base. Both scenarios result in factor representation.

States that rely upon the purported difficulty of creating a perfect apportionment formula as a defense for adopting formulas that do not provide factor representation are misguided.

State Courts Requiring Factor Representation

Some state courts have recognized the constitutional requirement of factor representation and have invalidated attempts by taxing authorities to deny factor representation. For example, Rhode Island included the distributions from partnerships not conducting business in the State in the corporate taxpayer's apportionable income base but excluded the factors of those same partnerships from the apportionment formula.[25] The Rhode Island Supreme Court correctly held that the exclusion of proportionate property, payroll and sales factors from the apportionment equation while including the income from those same partnerships was "manifestly inequitable."[26] Further, the court stated that the State had a "duty" to employ an alternative apportionment formula to remedy the denial of factor representation.[27]

Some state courts have recognized the constitutional requirement of factor representation and have invalidated attempts by taxing authorities to deny factor representation.

Similarly, the Wisconsin Court of Appeals held that an apportionment formula that lacked factor representation was invalid under the Due Process and Commerce Clauses of the U.S. Constitution, as well as State law.[28] Specifically, with respect to a foreign corporate taxpayer, Wisconsin included income from dividends, interest and royalties paid by AT&T's subsidiaries in AT&T's apportionable income base, but excluded the subsidiaries' significant property from AT&T's property factor.[29] Thus, the State sought to deny factor representation.

The court stated that factor representation was important and explained that the State's argument for excluding the real and tangible personal property of the subsidiaries that paid income to AT&T "ignore[d] the nature of [a] unitary business" as the "bulk" of the real and tangible personal property used in the operation of the unitary business was owned by those subsidiaries.[30] Further, the court correctly rejected the State's argument that the apportionment statute defines the property factor as only including the real and tangible personal property of the "taxpayer" rather than that of AT&T and its subsidiaries.[31] The court stated that "[t]he inconsistency of the department's position is immediately apparent" due to the State's attempt to deny factor representation.[32] The court held that the State's apportionment formula failed the external consistency test under the U.S. Constitution because "the apportionment formula used by the department does not reflect a reasonable sense of how [AT&T's] income is generated and taxes value earned outside the borders of Wisconsin" due to its lack of factor representation.[33]

States Not Requiring Factor Representation

Some states have denied factor representation. Minnesota, for example, included royalties, dividends and interest from a corporate taxpayer's subsidiaries that operated outside of the United States in the taxpayer's apportionable income base, but failed to include the matching factors from those very same subsidiaries in the apportionment formula.[34] The Minnesota Supreme Court upheld the computation of the apportionment formula on the basis that, by definition, the apportionment factors included the property, payroll and sales of the "taxpayer."[35] The court stated that the subsidiaries that were operating outside of the United States were not taxpayers and could not be included in the apportionment formula.[36] The court further held that the discrepancy in tax resulting from the denial of factor representation was "within the 'acceptable margin of error,' and certainly does not approach the disparity the Supreme Court of the United States [has] found constitutionally unacceptable."[37]

A similar result occurred in Pennsylvania where the State included the value of the corporate taxpayer's subsidiary corporations, both in and out of Pennsylvania, in the computation of the apportionable capital base while excluding the factors representing the capital stock value of those same subsidiaries from the apportionment formula, thereby denying factor representation.[38] Despite noting the "inherent rationality of factor representation in apportionment" and that "Pennsylvania's scheme for taxation of foreign business franchises may be less than ideal and, absent statutory fairness adjustment, unconstitutional in some applications," the majority in the Supreme Court of Pennsylvania affirmed the denial of factor representation.[39]

The court reasoned that formulating an apportionment formula was difficult and that a taxpayer must establish a baseline to determine whether the discrepancy in tax from the denial of factor representation rises to an unconstitutional level under the external consistency test.[40] The court explained that by failing to establish an appropriate baseline upon which to base fair apportionment as compared with the State's method, the taxpayer failed to prove unconstitutionality.[41] However, there is no constitutional requirement to provide a baseline in the external consistency test.[42] As Justice Stevens explained in *Mobil Oil*, the answer is to either exclude the capital stock value of the subsidiaries from the apportionable base or include the factors that led to the creation of that value in the apportionment formula.[43]

States that exclude from the factor the values that represent the generation of the income by statute should exercise their duty to apply alternative apportionment to situations that would otherwise result in a denial of factor representation…

States Have a Choice But Cannot Have It Both Ways

If income or value is included in the apportionable income or value base of a corporation, then the factors connected to the generation of that income or value must be included in the apportionment formula.[44] States can either: (1) include amounts in the base *and* the apportionment formula; or (2) exclude amounts from the base *and* the apportionment formula. As the Rhode Island Supreme Court explained, states that exclude from the factor the values that represent the generation of the income by statute should exercise their duty to apply alternative apportionment to situations that would otherwise result in a denial of factor representation when that very same income is included in the apportionable base.[45] ■

1 Minn. Stat. § 290.191(5)(a) (2010); Minn. Stat. § 290.17 (2010). *See also, e.g.*, Fla. Stat. § 220.15(5)(a) (2011) (excluding interest, dividends, rents, royalties and gross receipts derived from securities from the sales factor); Fla. Stat. § 220.13 (2012) (providing no express exclusion for the interest, dividends, rents, royalties or gross receipts derived from securities from the apportionable income base); S.C. Code Ann. § 12-6-2280(c) (2007) (excluding sales of tangible personal property to the U.S. government from the sales factor); S.C. Code Ann. § 12-6-2252(a) (2007) (providing no express exclusion for the sales of tangible personal property to the U.S. government from the apportionable income base).

2 *See, e.g.*, Uniform Division of Income for Tax Purposes Act § 18; Fla. Stat. § 220.152 (2013); N.J. Stat. Ann. § 54:10A-8 (2013); and N.Y. Tax Law § 210(8) (2012).

3 *Mobil Oil Corp. v. Vt.*, 445 U.S. 425, 449 (1980) (Stevens, J., dissenting).

4 *Id.* at 427.

5 *Id.* at 449.

6 *Id.* at 427.

7 *Id.* at 460 (Stevens, J., dissenting).

8 *Id.*

9 *Id.* at 441 n. 15 (stating that "[a]ppellant, we reiterate took this appeal on the assumption that Vermont's apportionment formula was fair").

10 *Id.* at 461 (Stevens, J., dissenting).

11 *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 168 n.5 (1983).

12 *Id.* at 169-70 (citations omitted).

13 *Id.*

14 *Id.* at 169.

15 *Id.*

16 *Id.* at 169-70.

17 *Id.* at 170-71.

18 *Id.* at 170 (quoting *Hans Rees' Sons, Inc. v. N.C.ex rel Maxwell*, 283 U.S. 123, 135 (1931); *Norfolk & W. R. Co. v. State Tax Comm'n*, 390 U.S. 317, 326 (1968); and *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 274 (1978)).

19 *Mobil Oil Corp.*, 445 U.S. at 427.

20 *Container Corp.*, 463 U.S. at 169.

21 *Id.*

22 *Id.* at 170.

23 *Id.*

24 *Mobil Oil Corp.*, 445 U.S. at 462 (Stevens, J., dissenting).

25 *See, e.g., Homart Dev. Co. v. Norberg*, 529 A.2d 115 (R.I. 1987)

26 *Id.* at 121.

27 *Id.*

28 *Am. Tel. & Tel. Co. v. Wis. Dep't of Revenue*, 422 N.W.2d 629, 636 (Wisc. App. 1988).

29 *Id.* at 631.

30 *Id.* at 632.

31 *Id.*

32 *Id.*

33 *Id.* at 636.

34 *NCR Corp. v. Comm'r of Revenue*, 438 N.W.2d 86, 87-88 (Minn. 1989), cert. denied, 493 U.S. 848 (1989).

35 *Id.* at 91 (citing to Minn. Stat. § 290.19 (1980), current version at Minn. Stat. § 290.191 (2010)).

36 *Id.*

37 *Id.* at 93 (citations omitted).

38 *Unisys Corp.* v. *Commonwealth*, 812 A.2d 448, 450 (Pa. 2002), cert. denied, *Unisys v. Pa. Bd. of Fin. & Revenue*, 540 U.S. 812 (2003).

39 *Id.* at 465-66.

40 *Id.* at 462.

41 *Id.*

42 *Container Corp.*, 463 U.S. at 169-70 (citations omitted).

43 *Mobil Oil Corp.*, 445 U.S. at 462 (Stevens, J., dissenting).

44 *Standard Oil Co. v. Peck*, 342 U.S. 382, 384-85 (1952) (explaining that "[t]he rule which permits taxation by two or more states on an apportionment basis precludes taxation of all of the property by the state of the domicile") (citing *Union Refrigerator Transit Co. v. Ky.*, 199 U.S. 194 (1905)).

45 *Homart Dev. Co.*, 529 A.2d at 121.

EXPANDED CALIFORNIA SALES AND USE TAX EXCLUSIONS FOR ADVANCED MANUFACTURING PROJECTS

By Eric J. Coffill and Leslie J. Lao

Introduction

Recent California legislation expanded the existing sales and use tax exclusion authority of the California Alternative Energy and Advanced Transportation Financing Authority, known as "CAEATFA," to include advanced manufacturing projects. In this article, we identify and analyze CAEATFA's general statutory authority to grant such exclusions. Then, we examine the recent expansion of CAEATFA's powers pursuant to 2012 legislation, including significant amendments to CAEATFA's existing authority. Finally, we summarize the application process, program requirements and post-approval process related to CAEATFA's sales and use tax exclusion program.

Through five renewable energy programs, CAEATFA offers financial assistance in the form of revenue bonds, loan guarantees, loan loss reserves, insurance and–the focus of this article–California sales and use tax exclusions.

CAEATFA was established in 1980 in an effort to support the financing of facilities in California that generate new and renewable energy sources, develop clean and efficient distributed generation and demonstrate the economic feasibility of new technologies.[1] Through five renewable energy programs, CAEATFA offers financial assistance in the form of revenue bonds, loan guarantees, loan loss reserves, insurance and–the focus of this article–California sales and use tax exclusions ("STE").[2] Public agencies, local government, non-profit and public and private entities are all eligible to receive financial assistance from CAEATFA.[3] Legislation is pending to clarify that an out-of-state or overseas entity can apply for the STE with CAEATFA if that entity commits to, and demonstrates that, it will be opening a California manufacturing facility.[4]

Since CAEATFA was established in 1980, the California Legislature has expanded CAEATFA's general authority to grant the STE in California....

CAEATFA's Former "Green" Tax Exclusions Under S.B. 71

Since CAEATFA was established in 1980, the California Legislature has expanded CAEATFA's general authority to grant the STE in California, with the first major change occurring in 2010. Senate Bill 71 ("S.B. 71"), enacted in 2010 as an urgency statute, expanded the scope of projects eligible for CAEATFA's consideration under the existing categories of "alternative source" and "advanced transportation" technologies.[5] By amending the statutory definitions of "project" and "alternative source," S.B. 71 allowed CAEATFA to authorize financing for projects that promote the manufacturing of alternative, or "green," energy and transportation technologies. As a result of S.B. 71, the STE became available for purchases of tangible personal property utilized for the design, manufacture, production or assembly of alternative source products, components or systems.[6] "Alternative source" was redefined to incorporate the "application of cogeneration technology, as defined in Section 25134; the conservation of energy; or the use of solar, biomass, wind, geothermal, hydroelectricity under 30 megawatts, or any other source of energy, the efficient use of which will reduce the use of fossil and nuclear fuels."[7] Other eligible alternative source projects involved "advanced electric distributive generation technology . . . or energy storage technologies and their component materials."[8] Thus, S.B. 71 was implemented as the Advanced Transportation and Alternative Source Manufacturing Sales and Use Tax Exclusion Program ("S.B. 71 Program").

Last year, Governor Brown signed Senate Bill 1128, which enables CAEATFA to authorize the STE for purchases of tangible personal property for "advanced manufacturing" projects.

Under the S.B. 71 Program, many approved companies can and did receive significant benefits in the form of the STE. For example, First Solar, a solar photovoltaic manufacturer, saved more than $3 million in sales and use taxes on the purchase of almost $40 million in tangible personal property for its facility in Santa Clara, California.[9] Tesla Motors, an electric vehicle manufacturer, saved more than $23 million in sales and use taxes for $292 million in tangible personal property purchased for its manufacturing facilities in the California cities of Fremont, Hawthorne, Palo Alto and Menlo Park.[10] Solyndra, a highly publicized solar photovoltaic manufacturer, received savings of approximately $34 million in sales and use taxes on the purchase of $381,776,000 in tangible personal property for its manufacturing facility in Fremont, California.[11]

CAEATFA's New "Advanced Manufacturing" Tax Exclusion Under S.B. 1128

The most recent expansion of CAEATFA's tax exemption authority occurred in 2012. Last year, Governor Brown signed Senate Bill 1128 ("S.B. 1128"), which enables CAEATFA to authorize the STE for purchases of tangible personal property for "advanced manufacturing" projects.[12] "Advanced manufacturing," as defined by S.B. 1128, includes manufacturing processes that improve existing, or create entirely new materials, products and processes through the use of science, engineering, or information technologies, high-precision tools and methods, a high-performance workforce and innovative business or organizational models.[13] Advanced manufacturing projects may involve a variety of industries, such as microelectronics, advanced materials, integrated computational materials engineering, nanotechnology, additive manufacturing or industrial biotechnology.[14]

S.B. 1128 imposes a new annual maximum amount of $100 million in STE to be awarded for projects related to alternative energy sources, advanced transportation technologies and advanced manufacturing.

S.B. 1128 further provides two broad "catch-all" categories of projects that are considered to promote the utilization of advanced manufacturing:

1. Systems that result from substantive advancement, whether incremental or breakthrough, beyond the current industry standard, in the production of materials and products. These advancements include improvements in manufacturing processes and systems that are often referred to as "smart" or "intelligent" manufacturing systems, which integrate computational predictability and operational efficiency; and
2. Sustainable manufacturing systems and manufacturing technologies that minimize the use of resources while maintaining or improving cost and performance.[15]

In addition to allowing CAEATFA to grant the STE to advanced manufacturing companies, S.B. 1128 presents two noteworthy changes to the existing STE program. First, S.B. 1128 imposes a new annual maximum amount of $100 million in STE to be awarded for projects related to alternative energy sources, advanced transportation technologies and advanced manufacturing.[16] (The prior CAEATFA statutory structure simply allowed CAEATFA staff to provide the Legislature with 20-day notice prior to making additional approvals once the "soft cap" of $100 million in STE per year was exceeded.)[17] Remember, however, this annual limitation applies to the amount of actual STE granted for all projects under the S.B. 71 Program, not to the value of the tangible personal property to be purchased. Thus, there would appear to be little cause for concern that this new annual limit would materially affect CAEATFA's ability to provide the STE to projects that otherwise qualify for the STE program.

Companies thinking about securing financial assistance for advanced manufacturing projects would be wise to begin the application process for the STE soon.

Second, while not totally clear, S.B. 1128 might have eliminated the compliance provision–discussed below–that requires the individual or entity to transfer title of qualified property to CAEATFA for purposes of reconveyance in order to receive the STE. The California State Board of Equalization has issued guidance titled Green Manufacturing and Advanced Manufacturing Exclusion, which provides that *purchases* of tangible personal property by a participating party for eligible projects involving alternative energy sources, advanced transportation technologies and advanced manufacturing will not be subject to sales and use taxes.[18] There is no mention of the title transfer requirement set forth in the existing CAEATFA statute. Until further guidance is issued, it appears S.B. 1128 has significantly simplified the process by which an individual or entity can receive the STE from CAEATFA.

CAEATFA's authority granted by S.B. 1128 will remain effective until July 1, 2016.

CAEATFA's authority granted by S.B. 1128 will remain effective until July 1, 2016.[19] On July 2, 2016, S.B. 1128 will expire and CAEATFA's authority under S.B. 71 will be reinstated. In other words, advanced manufacturing projects will only be eligible for exclusion from sales and use taxes for the next three years. Accordingly, companies thinking about securing financial assistance for advanced manufacturing projects would be wise to begin the application process for the STE soon.

Overview of the Application Process

CAEATFA has yet to implement S.B. 1128 as a formal STE program. On February 6, 2013, CAEATFA requested comments from interested parties regarding how to structure an STE program that effectively accommodates advanced transportation, as well as how to establish eligibility criteria for advanced manufacturing projects.[20] Comments are being sought on a wide range of items, such as what constitutes a "high-performance workforce" and what is considered a "substantive advancement" in manufacturing capability,

ANNUAL STATE + LOCAL TAX WEST COAST UPDATE

May 14, 2013
8:00 a.m. – 12:30 p.m.
San Francisco, CA

Special Guest Panelist:
Carl Joseph, Counsel, Multistate Tax Affairs, will provide insights and be available for Q&A.

Topics to be discussed include:

- Hot Topics and Issues in California
- SALT Litigation and Other Developments Nationally
- Issues and Developments in the State Taxation of E-Commerce
- Elective Apportionment and Multistate Tax Compact Challenges
- Current California Property Tax Issues

Speakers:
Eric Coffill, Holly Hyans, Thomas H. Steele, Andres Vallejo, Peter Kanter, James P. Kratochvill, Scott Reiber and Kirsten Wolff

CLE and CPE is pending.

For additional information contact Lauren Max at lmax@mofo.com.

technology or performance as that language is set forth in S.B. 1128. Until formal guidance is issued, likely through the regulatory process in mid-2013, it is unclear precisely what type of project qualifies as "advanced manufacturing," or whether CAEATFA will accept applications under S.B. 1128 in the interim. However, it is reasonable to assume CAEATFA will model the application process along the lines of its existing process for applications to the S.B. 71 Program.

Project applications for the S.B. 71 Program may be submitted at any time and are accepted by CAEATFA on an ongoing basis. CAEATFA staff review the project applications and, in our experience, have been very open to working with applicants throughout the application process. Staff evaluate each application in terms of the extent to which the project's anticipated benefits to California will exceed the projected costs of sales and use taxes.

Staff typically consider the following criteria in its evaluation of a project:

- The extent to which the project develops manufacturing facilities, or purchases equipment for manufacturing facilities, located in California;
- The extent to which the anticipated benefit to California from the project equals or exceeds the projected benefit to the participating party from the STE;
- The extent to which the project will create new, permanent jobs in California;
- To the extent feasible, the extent to which the project, or the product produced by the project, results in a reduction of greenhouse gases, a reduction in air or water pollution, an increase in energy efficiency or a reduction in energy consumption, beyond what is required by any federal or state law or regulation;
- The extent of unemployment in the area in which the project is proposed to be located; and
- Any other factors CAEATFA deems appropriate.[21]

An application will not be deemed complete without the submission of an application fee. The application fee is an amount equal to five tenths of one percent of the total purchase price of tangible personal property identified in the application, not to exceed $10,000, and with a minimum fee of $250.[22]

Staff ultimately make a recommendation to the CAEATFA Board, which must approve each application. The CAEATFA Board is composed of five members: the Director of Finance; the Chairperson of the State Energy Resources Conservation and Development Commission; the President of the Public Utilities Commission; the Controller; and the Treasurer, (who also serves as the chairperson of CAEAFTA). The Board considers each application at the first Board meeting occurring at least 60 calendar days after receipt of a completed application.[23] If the Board approves an application, the applicant will receive a written Notification Letter and a certified copy of the CAEATFA Board resolution.[24] Within 30 days of Board approval, the approved applicant must execute the Master Regulatory and Title Conveyance Agreement, which indicates agreement to the conveyance and reconveyance requirement.[25] Financial assistance in the form of the STE is subject to the timely execution of this agreement.

The approved applicant has three years from the date of Board approval to complete 100% of the purchases of tangible personal property.[26] At least 25% of the purchases must be made within one year of Board approval, although an alternative agreement may be reached with the Board.[27] As mentioned in greater detail above, after each purchase of tangible personal property, the applicant may need to convey title of such property to CAEATFA pursuant to a transaction agreement identifying the property and location of purchase. Each conveyance is subject to payment of a portion of the overall administrative fee, which amounts to four tenths of one percent of the total purchase price of the property, not to exceed $350,000, and with a minimum fee of $15,000.[28] CAEAFTA has ten days to reconvey title to the applicant. A final transaction agreement will terminate the arrangement between CAEATFA and the approved applicant.

CAEATFA has approved 52 projects in the alternative energy and advanced transportation industries and has granted $51,678,686 in STE for purchases of qualified property worth more than $1 billion.

Conclusion

Advanced manufacturing companies that may potentially benefit from CAEATFA's amended STE program should carefully watch developments in this area and consider participating in the current process to establish parameters for that program. While S.B. 1128 has not yet been implemented as a formal STE program, there can be little doubt that S.B. 1128 possesses the same potential for success as the S.B. 71 Program. Since the enactment of the S.B. 71 Program, CAEATFA has approved 52 projects in the alternative energy and advanced transportation industries and has granted $51,678,686 in STE for purchases of qualified property worth more than $1 billion.[29] The private entities receiving the STE are incredibly diverse and include companies in the areas of electric vehicle manufacturing, solar photovoltaic manufacturing, landfill gas capture and production, biogas capture and production, demonstration hydrogen fuel production, electric vehicle battery manufacturing and biomass processing and fuel production. Of those companies that received financial assistance under the S.B. 71 Program, 41 projects are still active as of March 1, 2013.[30] With S.B. 1128's recent expansion of CAEATFA's authority to approve the STE for projects in the advanced manufacturing industry, one can surely expect that an even greater number of companies will reap the benefits of CAEATFA's STE program in the upcoming years. ■

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1 California Alternative Energy and Advanced Transportation Financing Authority Act § 2, 2012 Cal. Stat. ch. 677 (effective Jan. 1, 2013) (Senate Bill 1128) ("S.B. 1128").

2 California Alternative Energy and Advanced Transportation Financing Authority, 2011 Annual Report to the California State Legislature, *available at* http://www.treasurer.ca.gov/caeatfa/annual/2011.pdf.

3 Cal. Pub. Res. Code § 26003(a)(6)(A) (2013) (as amended by Sec. 5, S.B. 1128, Laws 2012).

4 A.B. 1422 authored by the Assembly Committee on Jobs, Economic Development and the Economy, clarifies the statutory term "participating party," as used by CAEATFA for purposes of the STE, applies to both an in-state entity and an entity located outside California, including overseas, if the entity commits to, and demonstrates that it will be opening a manufacturing facility in California. This issue was brought to the Committee's attention by an economic development corporation that was trying to use the STE program to attract a business to California and was informed that business would not be eligible for the STE. The bill is intended only as a clarification of existing law. *California Alternative Energy and Advanced Transportation Financing Authority, Participating Party: Hearing on A.B. 1422* (Ca. 2013).

5 California Alternative Energy and Advanced Transportation Financing Authority Act § 4, 2010 Cal. Stat. ch. 10 (amended 2012) (Senate Bill 71) ("S.B. 71").

6 Cal. Pub. Res. Code § 26003(g) (2010) (as amended by Sec. 1, S.B. 71, Laws 2010).

7 Cal. Pub. Res. Code § 26003(c)(1) (2010) (as amended by Sec. 1, S.B. 71, Laws 2010).

8 Cal. Pub. Res. Code § 26011.8(b)(2) (2010) (as amended by Sec. 2, S.B. 71, Laws 2010).

9 *CAEATFA Report of SB 71 Sales and Use Tax Exclusion (STE) Financing Applications Considered and Approved*, Cal. State Treasurer's Office (Apr. 1, 2013), *available at* http://www.treasurer.ca.gov/caeatfa/sb71/applicants/considered.pdf.

10 *Id.*

11 *Id.* Unfortunately, Solyndra has since filed for bankruptcy. *See* Voluntary Petition for Chapter 11, In re Solyndra LLC, No. 11-12799 (Bankr. Del. Sept. 6, 2011), *available at* https://www.solyndra-info.com/CourtFilings.aspx.

12 S.B. 1128 § 5, 2012 Leg., Reg. Sess. (Cal. 2012).

13 Cal. Pub. Res. Code § 26003(a)(1)(A) (2013) (as amended by Sec. 5, S.B. 1128, Laws 2012).

14 *Id.*

15 Cal. Pub. Res. Code § 26003(a)(1)(B)(i)-(ii) (2013) (as amended by Sec. 5, S.B. 1128, Laws 2012).

16 Cal. Pub. Res. Code § 26011.8(h) (2013) (as amended by Sec. 12, S.B. 1128, Laws 2012).

17 Cal. Pub. Res. Code § 26011.8(h) (2010) (as amended by Sec. 2, S.B. 71, Laws 2010).

18 *Green Manufacturing and Advanced Manufacturing Exclusion*, Cal. State Bd. of Equalization, http://www.boe.ca.gov/sutax/gme.htm (emphasis added) (last visited Apr. 17, 2013).

19 Cal. Pub. Res. Code § 26011.8(j) (2013) (as amended by Sec. 12, S.B. 1128, Laws 2012).

20 Request for Proposal Number CAEATFA 05-12, Cal. State Treasurer's Office (Feb. 6, 2013), *available at* http://www.treasurer.ca.gov/caeatfa/rfp_0512.pdf.

21 Cal. Pub. Res. Code § 26011.8(d)(1)-(6) (2010) (as amended by Sec. 2, S.B. 71, Laws 2010).

22 *S.B. 71 Sales and Use Tax Exclusions–Frequently Asked Questions*, California Alternative Energy and Advanced Transportation Financing Authority (Aug. 20, 2012), *available at* http://www.treasurer.ca.gov/caeatfa/sb71/faq.pdf.

23 *Id.*

24 *Post CAEATFA Board Approval of STE Application: Applicant's Procedures*, Cal. State Treasurer's Office (Aug. 15, 2012), *available at* http://www.treasurer.ca.gov/caeatfa/sb71/applicants/procedures.pdf.

25 *Id.*

26 Cal. Code of Regs. tit. 4, § 10035(c)(1).

27 *Id.*

28 Cal. Code of Regs. tit. 4, § 10036(b).

29 *CAEATFA Report of SB 71 Sales and Use Tax Exclusion (STE) Financing Applications Considered and Approved*, Cal. State Treasurer's Office (Apr. 1, 2013), *available at* http://www.treasurer.ca.gov/caeatfa/sb71/applicants/considered.pdf.

30 *Id.*

REDEFINING "BUSINESS INCOME": WHAT RECENT DECISIONS BY THE OREGON AND PENNSYLVANIA SUPREME COURTS TELL US ABOUT THE STATE OF BUSINESS INCOME

By R. Gregory Roberts and Rebecca M. Ulich

On the surface, recent decisions by the Oregon and Pennsylvania Supreme Courts in *Crystal Communications, Inc. v. Department of Revenue*, *CenturyTel, Inc. v. Department of Revenue* and *Glatfelter v. Commonwealth* appear to continue the trend of adverse court decisions and narrowing interpretations of what constitutes "nonbusiness income."[1] However, despite the courts' holdings that the gains involved in the appeals constituted apportionable business income, the decisions are somewhat narrow and the analyses applied by the courts provide valuable guidance for taxpayers that may pursue nonbusiness income claims in the future.

In this article, we begin with an analysis of the Oregon Supreme Court's decisions in *Crystal* and *CenturyTel*, as well as the Pennsylvania Supreme Court's decision in *Glatfelter* and conclude by providing a framework for approaching nonbusiness income claims in both states, as well as in other states with similar statutes.

Analysis of Business Income in Oregon

Overview of Oregon's Allocation and Apportionment Provisions

Like many states, Oregon has adopted the Uniform Division of Income for Tax Purposes Act ("UDITPA") to govern the determination, allocation and apportionment of income.[2] Although most taxpayers are subject to the UDITPA apportionment provisions, financial institutions and public utilities are specifically excluded from the UDITPA provisions. For those types of entities, the statute provides that:

> [i]f a taxpayer has income from business activity as a financial organization or as a public utility . . . which is taxable both within and without this state . . . the determination of net income shall be based upon the business activity within the state, and the Department of Revenue shall have power to permit or require either the segregated method of reporting or the apportionment method of reporting, under rules and regulations adopted by the department, so as fairly and accurately to reflect the net income of the business done within the state.[3]

Although the statute does not specify an apportionment formula or establish a method to allocate income, the Oregon Department of Revenue ("Department") promulgated regulations providing that "[t]he definitions of 'business income,' . . . [and] 'nonbusiness income' . . . contained in [Oregon's UDITPA statute] *and the related rules are by this reference incorporated herein.*"[4] Thus, for financial institutions and public utilities, "business income" is defined only pursuant to a regulation that incorporates both the UDITPA statutory definition and the Department's regulatory definition of "business income."

Under Oregon's UDITPA statute, business income is defined as "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, the management, use or rental, and the disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."[5] The Oregon Supreme Court has held that this definition encompasses both a transactional test and a functional test.[6]

Additionally, a Department regulation provides that "business income" includes "[g]ain or loss from the sale, exchange or other disposition of real or tangible or intangible personal property . . . if the property while owned by the taxpayer was used in the taxpayer's trade or business" (the "Business Income Rule").[7]

Crystal Communications, Inc. v. Department of Revenue

In *Crystal*, the taxpayers were non-resident shareholders of Crystal Communications, Inc. ("Crystal"), an Oregon S corporation.[8] Crystal provided cellular telecommunications services in rural areas of Oregon and was subject to tax as a public utility.[9] In 1999, Crystal sold all of its assets, distributed the gain from the sale of its assets to its shareholders and ceased all business operations.[10] The majority of the proceeds from the sale of Crystal's assets were attributable to intangible assets, which consisted primarily of a license from the Federal Communications Commission to operate wireless telecommunications services in rural areas of Oregon (the "FCC License").[11] On its Oregon tax return, Crystal classified the gain from the sale of the FCC License as nonbusiness income that was allocable to Florida.[12] The Department issued an assessment reclassifying the gain as apportionable business income.[13]

CenturyTel, Inc. v. Department of Revenue

CenturyTel, Inc. ("CenturyTel") was a Louisiana corporation that provided both wireless and wireline telecommunications services in multiple states, including Oregon.[14] CenturyTel was subject to tax in Oregon as a public utility.[15] In 2002, CenturyTel sold all of the stock of its wireless service subsidiary and the parties elected to treat the sale as a deemed sale of assets under Internal Revenue Code Section 338(h)(10).[16] For federal income tax purposes, the sale was treated as a deemed liquidation of assets and a cessation of its business.[17] CenturyTel continued to provide wireline telecommunications services after the sale and it used the majority of the gain to finance the acquisition of wireline assets.[18] On its Oregon tax return, CenturyTel classified the gain as nonbusiness income, allocable to Louisiana.[19] The Department reclassified the gain as apportionable business income.[20]

The Oregon Supreme Court's Decisions

In both *Crystal* and *CenturyTel*, the Oregon Supreme Court affirmed the Tax Court's decisions and held that the gains were properly classified as business income.[21]

Although Crystal and CenturyTel both acknowledged that their respective gains would qualify as business income under the Business Income Rule, they asserted that the rule was invalid because: (i) the functional test provided for a liquidation exception and, as Crystal's sale of assets was pursuant to a liquidation of its business and as CenturyTel's sale was treated as a deemed sale of assets and a liquidation, their gains were, therefore, nonbusiness income; and (ii) the rule exceeded the scope of Oregon's UDITPA statutory definition of "business income."

In reaching its decision in *Crystal*, the court clarified that the issue was not whether the gain at issue was business income under Oregon's UDITPA provisions or whether the Business Income Rule exceeded the scope of the UDITPA statutory definition of "business income."[22] Rather, because the Department's regulations incorporated apparently conflicting definitions of "business income" for financial institutions and public utilities, the court explained that the issue before the court was whether the Department had reasonably interpreted its regulation and whether the court could harmonize the two apparently conflicting definitions.[23]

To harmonize the two definitions, the court looked to the California Supreme Court's decision in *Hoechst Celanese Corp. v. Franchise Tax Board*.[24] In *Hoechst*, the California Supreme Court determined that income from the reversion of surplus pension plan assets was business income.[25] In analyzing the functional test, the California Supreme Court explained that the relevant inquiry was on the income-producing property and its relationship to the taxpayer's business operations.[26] After conducting a lengthy statutory construction analysis, that court determined that income is business income under the functional test if the taxpayer's "acquisition, control and use of the property contribute materially to the production of the taxpayer's business income."[27] Because Hoechst created the pension plan to retain its employees and attract new employees, funded the plan with its business income and exercised control over the plan through various appointments of trustees and managers, the court concluded that the pension plan assets contributed materially to Hoechst's production of business income via their effect on Hoechst's labor force.[28] Therefore, the acquisition, management and disposition of the pension plan assets were held to be integral parts of Hoechst's business operations.[29]

The court concluded that *Hoechst* was a plausible interpretation of the functional test in the statutory UDITPA definition and that the reasoning of *Hoechst* was inconsistent with a liquidation exception.[30] By interpreting the Oregon statutory UDITPA definition consistently with *Hoechst* (*i.e.*, with no liquidation exception), the court concluded that the Department reasonably gave effect to both provisions.[31] In holding that the Department's interpretation was reasonable, the court noted that it did not need to decide whether the UDITPA statute includes gains from the liquidation of a business.[32] The court then emphasized again that the question was not what the UDITPA statutory definition of "business income" means in a case arising under UDITPA, but rather whether the Department reasonably interpreted the two definitions of business income in a way that gave effect to both the statutory and regulatory definitions.[33]

The court also rejected the argument that the Department's interpretation of "business income" for financial institutions and public utilities violated the Uniformity Clause of the Oregon Constitution as premature because the court has "not yet determined whether, for businesses subject to UDITPA, the functional test does or does not reach income realized during the course of liquidating a business."[34] The court further stated that "[u]ntil we decide that issue, we have no occasion to decide whether any difference in treatment would run afoul of the Uniformity Clause of the Oregon Constitution."[35]

Analysis of Business Income in Pennsylvania

Nonbusiness Income in Pennsylvania

Prior to 2001, Pennsylvania's definition of "business income" followed the UDITPA definition and provided that:

> "[b]usiness 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.[36]

Pursuant to this pre-2001 definition, the Pennsylvania Supreme Court, in *Laurel Pipe Line Co. v. Commonwealth*, recognized a liquidation exception to the functional test and held that the gain from the sale of an idle pipeline, which constituted the liquidation of a discrete aspect of Laurel's business operations, was nonbusiness income.[37] The court emphasized that the functional test required that "the acquisition, management, *and disposition* of the property constitute integral parts of the taxpayer's *regular* trade or business operations" to be considered business income.[38] The court found that the disposition of the pipeline was a liquidation of that portion of Laurel's business and that the unprofitable pipeline was not an integral part of Laurel's regular trade or business.[39] In reaching its decision, the court noted that distributing the gain to stockholders, as opposed to reinvesting the gain, evidenced that the sale of the pipeline was a partial liquidation, even though the company continued to operate a separate, independent pipeline.[40]

Following *Laurel*, the Pennsylvania Supreme Court, in *Canteen Corp. v. Pennsylvania* and *Pennsylvania v. Osram Sylvania, Inc.*, held that gain from the sale of a subsidiary that was treated as a deemed asset sale under Internal Revenue Code Section 338(h)(10) was nonbusiness income because the subsidiary was deemed to have liquidated its assets and distributed the proceeds to its stockholder.[41]

In 2001, the Pennsylvania legislature amended the definition of business income to provide that:

> "[b]usiness 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 *either* the acquisition, the management *or* the disposition of the property constitutes an integral part of the taxpayer's regular trade or business operations. *The term includes all income which is apportionable under the Constitution of the United States.*[42]

Glatfelter v. Commonwealth

In the first decision interpreting Pennsylvania's amended definition of business income, the Pennsylvania Supreme Court in *Glatfelter* held that, pursuant to the plain language of the 2001 amendments to the State's definition of business income, the gain from Glatfelter's disposition of 25% of its Delaware timberlands was properly classified as business income.[43]

Glatfelter Pulpwood Company ("Glatfelter") was a Maryland corporation that was headquartered in Pennsylvania.[44] Glatfelter was a wholly owned subsidiary of a Pennsylvania corporation ("Parent") that manufactured specialty papers and engineered products in Pennsylvania and elsewhere.[45] Glatfelter's sole business activity was to procure pulpwood from either company owned timberland or on the open market from third parties, for its Parent's specialty paper manufacturing operations.[46] In connection with its pulpwood procurement activity, Glatfelter owned timberland in Delaware, Maryland, Pennsylvania and Virginia to hedge against risks of potential future declines in pulpwood or potential rising costs of pulpwood in the open market.[47] In 2004, as part of a "Timberland Divestiture Plan," Glatfelter sold approximately 25% of its Delaware timberland.[48] Glatfelter distributed the net proceeds from the sale to its Parent, who used the entire amount to pay debt and to make distributions to its shareholders.[49]

Based on *Laurel Pipe Line Co. v. Commonwealth*, Glatfelter argued that the gain resulted from a partial liquidation of its business and, thus, was properly classified as nonbusiness income.[50] Alternatively, Glatfelter argued that the gain was not taxable by Pennsylvania under the multiformity and unrelated asset doctrines because the Timberland Divestiture Plan constituted a separate and distinct business that was unrelated to its Pennsylvania business operations of supplying pulpwood to its Parent.[51] Finally, Glatfelter argued that taxation of the gain violated the Due Process and Commerce Clauses of the U.S. Constitution because it resulted in taxation of 142% of the gain.[52]

The Pennsylvania Supreme Court's Decision in *Glatfelter*

In finding that the gain was business income, the Pennsylvania Supreme Court noted that its holding was "controlled by the text of the statutory definition of business income."[53] Therefore, the court explained that, in the 2001 amendment, "[t]he General Assembly chose to employ the disjunctive conjunctions 'either/or' in this definition, and its meaning is clear and unambiguous," that "[f]or a gain from the sale of property to be classified as business income, the acquisition **or** the management **or** the disposition of that property must constitute an integral part of the taxpayer's business operations."[54] Thus, as the court found that the parties' stipulations established that the acquisition and the management of the property were integral parts of its regular business, the court did not find the need to reach the issue of whether the disposition of the property was also an integral part of the taxpayer's regular business operations.[55]

The court also rejected Glatfelter's multiformity argument.[56] An exclusion of the gain from Pennsylvania corporate net income tax may be claimed when the gain results from: (i) a separate business outside of Pennsylvania (the "multiformity doctrine"); or (ii) an asset or assets that were unrelated to the exercise of the taxpayer's franchise or conduct in the state (the "unrelated asset doctrine"). The court determined that its case law "revealed a consistent attempt to allocate to Pennsylvania that fair share of value or income reflective of activity here and to exclude value or income not contributing to the exercise of the Pennsylvania franchise."[57] In analyzing Glatfelter's claims, the court explained that determinations under the multiformity and unrelated asset doctrines are "highly dependent upon factual consideration[s], rendering each case 'unique.'"[58] Noting that Glatfelter grew, harvested and sold pulpwood from its Delaware timberland to benefit its Parent, a Pennsylvania corporation, in the manufacture and sale of products in Pennsylvania, the court concluded that Glatfelter's timberland was integrally related to its business activities in Pennsylvania and did not become an "unrelated asset" merely because a decision was made to sell the property.[59] Therefore, the court held that neither the multiformity nor the unrelated asset doctrine applied.[60]

Finally, the court found that imposition of tax on 142% of the gain from the sale of the timberland was not unconstitutional.[61] In reaching its decision, the court noted that the U.S. Supreme Court has held that "even if the state in which an enterprise earned specific income can be ascertained by geographical accounting, another state is not barred from imposing a tax on an appropriate portion of that income, if the enterprise involved was a multi-state unitary business" and that "the application of an apportionment formula does not offend the Commerce Clause merely because in certain instances it results in double taxation of the same income."[62] Thus, because the court found that Glatfelter operated as a unitary whole, the court held that taxation on 142% of the gain was constitutional.[63]

Insights

Although the courts in *Crystal*, *CenturyTel* and *Glatfelter* held that the gains in question were business income, the analyses applied by the courts nevertheless provide some hope to taxpayers doing business in either state that may have large capital gains.

Oregon

In Oregon, the Oregon Supreme Court emphasized that its opinions in *Crystal* and *CenturyTel* were limited to interpreting the definition of business income for financial institutions and public utilities.[64] The court made it clear that it did not decide whether: (i) the gain was business income under Oregon's statutory UDITPA definition; (ii) the Business Income Rule exceeded the scope of Oregon's statutory UDITPA definition; or (iii) there is a liquidation exception to the functional test under Oregon's UDITPA definition.[65]

Because of the regulatory regime adopted by the Department, in analyzing the definition of "business income" applicable to financial institutions and public utilities, the court was forced to harmonize two apparently inconsistent provisions (the UDITPA statute and the Business Income Rule). The court will not be charged with the same task when interpreting the definition of business income pursuant to Oregon's statutory UDITPA provisions. For other business corporations, the only questions will be whether the gain is business income under the state's statutory UDITPA definition and whether the Business Income Rule exceeds the statute.

Although the Oregon Tax Court and Oregon Supreme Court will likely look to *Hoescht* and *Jim Beam Brands Co. v. Franchise Tax Board* for guidance, the California decisions relied solely on the language of California's UDITPA definition of business income and, despite having a regulation similar to Oregon's Business Income Rule, did not provide an analysis of whether the regulation exceeded the scope of the statute.[66] Further, by ignoring the nature of the transaction, the California courts' interpretation of the functional test is: (i) inconsistent with the plain language of the statute; and (ii) so broad that it essentially converts the functional test into a constitutional, unitary business requirement. By focusing solely on the relationship of an asset to a taxpayer's business, California ignores the plain language of the functional test, which requires that the "acquisition, management, and disposition" of an asset be *integral* to the taxpayer's *regular* business operations. The plain language of the statute, therefore, establishes that the nature of the transaction is relevant. Moreover, the Oregon legislature's intent to preserve the definition of business income, and to not adopt a constitutional standard, is evidenced by the legislature's enactment of a statute that does not define "business income" to mean all income apportionable under the U.S. Constitution.[67]

Additionally, by limiting its decisions to the interpretation of Oregon's UDITPA provisions, the Oregon Supreme Court rejected the broad decisions of the Oregon Tax Court and declined to decide whether there is a liquidation exception to the functional test under Oregon's statutory UDITPA definition of business income.[68] The Tax Court in *Crystal*, despite rejecting the argument that the Business Income Rule should be construed under UDITPA principles when being applied by incorporation, nevertheless provided a detailed analysis of the functional test under UDITPA and determined that there was no liquidation exception.[69] Although this analysis and conclusion were dicta in *CenturyTel*, the Tax Court cited to its finding in *Crystal* that there was no liquidation exception to the functional test.[70] By narrowing its opinion, the Oregon Supreme Court rejected the Tax Court's analysis under the UDITPA provisions regarding the liquidation exception.

Pennsylvania

Although the Pennsylvania Supreme Court held that the gain in *Glatfelter* was business income, the court clarified the effect of the 2001 amendments and its analysis provides a framework for taxpayers pursuing nonbusiness income claims in the future.[71]

First, by basing its holding on the plain language of the 2001 amendments to the definition of business income, the court effectively held that the 2001 amendments were a change in law and not merely a clarification of existing law.[72] Second, although the court essentially held that there is no liquidation exception to the functional test, the court's decision does not render *Laurel*, *Canteen* or *Osram* obsolete.[73] Instead, under the amended definition of business income, if the acquisition or the management of an asset is found not to be integral to the taxpayer's regular business operations, then the analysis in *Laurel* remains relevant in analyzing whether the disposition of the property is an integral part of a taxpayer's regular business operations.

Third, the court decided *Glatfelter* based on the plain language of the transactional and amended functional tests and not on the statutory language providing that business income includes "all income which is apportionable under the Constitution of the United States."[74] This is significant because, based on the court's finding that Glatfelter was operating as a unitary business, the court conceivably could have found that the gain was business income based on the constitutional provision alone. By not relying on this provision, the court properly gave meaning to the transactional and functional tests that remain in the statutory definition of business income.

Finally, the court's decision establishes that the multiformity and unrelated asset doctrines remain viable options for taxpayers going forward. Although the court held that the multiformity and unrelated asset doctrines were not applicable in *Glatfelter*, the court held that these doctrines were not applicable based on the particular facts and circumstances of the transactions in *Glatfelter*.[75] ■

1 *Crystal Commc'ns, Inc. v. Dep't of Revenue,* 353 Or. 300 (Or. 2013); *CenturyTel, Inc. v. Dep't of Revenue*, 353 Or. 316 (Or. 2013); *Glatfelter Pulpwood Co. v. Commonwealth*, 61 A.3d 993 (Pa. 2013). For a detailed discussion regarding national developments in nonbusiness income, please see R. Gregory Roberts and Rebecca M. Ulich, *To Be Or Not To Be: Nonbusiness Income*, Morrison & Foerster LLP's State + Local Tax Insights, Summer 2012.

2 Ore. Rev. Stat. § 314.605, *et. seq.* (2013).

3 Ore. Rev. Stat. § 314.280 (2013).

4 Or. Admin. R. 150-314.280-(B) (emphasis added).

5 Ore. Rev. Stat. § 314.610(1) (2013).

6 *See*, *e.g.*, *Willamette Indus., Inc. v. Dep't of Revenue*, 15 P.3d 18 (Or. 2000).

7 Or. Admin. R. 150-314.610(1)-(B)(2).

8 *Crystal Commc'ns*, 353 Or. at 306.

9 *Id.*

10 *Id.* at 307.

11 *Id.*

12 *Id.*

13 *Id.*

14 *CenturyTel*, 353 Or. at 317.

15 *Id.*

16 *Id.* at 317-18.

17 *Id.* at 318.

18 *Id.*

19 *Id.*

20 *Id.* at 318-19.

21 *Crystal Commc'ns*, 353 Or. at 315; *CenturyTel*, 353 Or. at 320. The analysis set forth in *Crystal* was simply adopted in *CenturyTel. CenturyTel*, 353 Or. at 320.

22 *Crystal Commc'ns*, 353 Or. at 308-9.

23 *Id.*

24 *Id.* at 310 (citing *Hoechst Celanese Corp. v. Franchise Tax Bd.*, 22 P.3d 324 (Cal. 2001)).

25 *Hoechst*, 22 P.3d 324, 337.

26 *Id.* at 340.

27 *Id.*

28 *Id.* at 343.

29 *Hoechst*, 22 P.3d 324 (Cal. 2001). Although *Hoechst* did not decide whether there was a liquidation exception to the functional test, based on the analysis in *Hoechst*, the California Court of Appeal found that California does not recognize the liquidation exception. *Jim Beam Brands Co. v. Franchise Tax Bd.*, 133 Cal. App. 4th 514 (2005).

30 *Crystal Commc'ns*, 353 Or. at 313.

31 *Id.*

32 *Id.*

33 *Id.* at 313-14.

34 *Id.* at 314.

35 *Id.*

36 72 P.S. § 7401(3)2.(a)(1)(A) (effective until 2001).

37 *Laurel Pipe Line Co. v. Commonwealth*, 642 A.2d 472 (Pa. 1994).

38 *Id.* at 475 (emphases in original).

39 *Id.*

40 *Id.*

41 *Canteen Corp. v. Pa.*, 818 A.2d 594, 600 (Pa. Commw. Ct. 2003), *aff'd*, 854 A.2d 440 (Pa. 2004); *Commonwealth v. Osram Sylvania, Inc.*, 863 A.2d 1140 (Pa. 2004).

42 72 P.S. § 7401(3)2.(a)(1)(A) (statutory changes highlighted). In the 2001 Act implementing the statutory changes, the legislature noted that its intent in amending the definitions of business and nonbusiness income was to clarify existing law. Act of June 22, 2001, P.L. 353, No. 23, § 25.

43 *Glatfelter*, 61 A.3d at 1004.

44 *Id.* at 996-97.

45 *Id.* at 997.

46 *Id.*

47 *Id.*

48 *Id.*

49 *Id.*

50 *Id.* at 999 (citing *Laurel Pipeline Co. v. Commonwealth*, 642 A.2d 472 (Pa. 1994)).

51 *Glatfelter*, 61 A.3d at 1003.

52 *Id.*

53 *Id.*

54 *Id.* (emphases in original).

55 *Id.*

56 *Id.*

57 *Id.* at 1006 (quoting *Commonwealth v. ACF Indus., Inc.*, 271 A.2d 273 (Pa. 1970)) (internal quotations omitted).

58 *Glatfelter*, 61 A.3d at 1006. The Pennsylvania courts have established three general principles to determine whether a multiformity business exists. First, if a multistate business conducts its operations in such a way that some or all of its operations outside Pennsylvania are independent of and do not contribute to the business operations within Pennsylvania, the outside activity may be excluded. *See ACF Industries*, 271 A.2d at 280. Second, in applying the first principle, the focus should be on the relationship between the Pennsylvania activity and the activities outside of Pennsylvania, and not on the common relationships between the business activity and the central corporate structure. *Id.* Third, multiformity treatment is not appropriate for manufacturing, wholesaling or retailing activities of a single enterprise, but it is appropriate for a truly divisionalized business conducting disparate activities with each division internally integrated with respect to manufacturing and selling. *Id.*

59 *Glatfelter*, 61 A.3d at 1007.

60 *Id.*

61 *Id.* at 1014.

62 *Id.* at 1009.

63 *Id.* at 1014.

64 *Crystal Commc'ns*, 353 Or. at 300; *CenturyTel*, 353 Or. at 316.

65 *Id.*

66 *See Hoechst*, 22 P.3d 324; *Jim Beam Brands Co.*, 133 Cal. App. 4th 514.

67 *See* Ore. Rev. Stat. § 314.605.

68 *Crystal*, 353 Or. at 300; *CenturyTel*, 363 Or. at 316.

69 *Crystal Commc'ns, Inc. v. Dep't of Revenue*, T.C. 4769 (Or. T.C., July 19, 2010).

70 *Id.*

71 *Glatfelter*, 61 A.3d at 1000.

72 *Id.*

73 *Id.*

74 *Id.* at 999.

75 *Id.* at 1006.