

Tennessee Appeals Court Decision on Unitary Business Clarifies Limits on State's Authority to Tax

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Summary by **taxanalysts**

Michael D. Sontag and Stephen J. Jasper of Bass, Berry & Sims PLC analyze the recent decision by the Tennessee Court of Appeals in *Blue Bell Creameries LP v. Chumley* and conclude that the court gave real meaning to the constitutional limits on a state's authority to tax and provided additional clarity on appropriate standards for those limits.

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News Analysis

Perhaps no area of state tax law is as murky as the line between out-of-state income a state can subject to tax and out-of-state income a state is prohibited from taxing under the commerce and due process clauses of the U.S. Constitution. These constitutional limits have been frequently litigated over the past several decades, with courts across the country -- including several decisions by the U.S. Supreme Court -- articulating, discussing, and applying the unitary business principle as the controlling standard for deciding whether out-of-state income can be subjected to state taxation.

Under the unitary business principle, a state is constitutionally prohibited from taxing income earned out of state unless the income arises from a business activity that is unitary with a taxpayer's in-state activity. Although this unitary business principle is fairly easy to articulate, the results of its application in a given case have been extremely difficult to predict, with courts typically basing their decisions on the facts of each case and without recognizing or applying clear standards other than statements of general factors that should be considered.

In the September 29 decision by the Tennessee Court of Appeals in *Blue Bell Creameries LP v. Chumley*, the court once again addressed this difficult issue and ultimately determined that a holding company was not unitary with its operating subsidiary. (For the opinion, see *Doc 2009-21729 [PDF]* or *2009 STT 189-18*.) In reaching this decision, the court gave real meaning to the constitutional limits on a state's authority to tax and provided some additional clarity on the appropriate standards for determining in future cases whether those limits have been surpassed.

Background

The income at issue in *Blue Bell Creameries* was \$119,909,317 in capital gain, which the taxpayer's operating company had received as a result of its parent holding company's redemption of some stock that had been contributed to the taxpayer as part of a complicated

corporate reorganization. The taxpayer, a limited partnership domiciled in Texas, was created as part of the reorganization and was engaged in the business of producing, selling, and distributing ice cream in several states, including Tennessee. Before the reorganization, the taxpayer's predecessor engaged in this same line of business, and both parties agreed that the operation of the ice cream business was controlled, managed, and conducted by the taxpayer's predecessor before the reorganization and by the taxpayer after the reorganization. Although the manner in which it held its interests changed as a result of the reorganization, the parent holding company, a Delaware corporation, continued to own the vast majority of interests in the taxpayer both before and after the reorganization.

In its Tennessee franchise and excise tax returns, the taxpayer reported the gain from the stock redemption as nonbusiness earnings allocated 100 percent to the taxpayer's commercial domicile outside Tennessee. The Tennessee Department of Revenue disputed this characterization and assessed franchise and excise taxes based on its treatment of the gain as business earnings properly included in the taxpayer's apportionable business income subject to Tennessee's excise tax. The taxpayer filed litigation disputing the treatment of the gain as business earnings and arguing that Tennessee's assessment of taxes on the capital gain was an unconstitutional assessment on out-of-state earnings. The trial court ruled for the taxpayer, finding the assessment unconstitutional.

The Appellate Court's Decision

On appeal, the DOR argued that the trial court's decision was incorrect and that the capital gain was properly subject to Tennessee taxation because the redemption of the stock giving rise to the gain was undertaken as part of a unitary business involving both the taxpayer and the holding company. The Court of Appeals disagreed, finding the taxpayer and holding company were not part of a unitary business and the tax on the capital gain, therefore, was unconstitutional.

In reaching its decision, the Court of Appeals considered whether the facts of the case reflected the "three hallmarks of a unitary relationship" the U.S. Supreme Court has previously recognized for these purposes: centralization of management, functional integration, and economies of scale. Considering the centralization of management factor, the appeals court noted there was no dispute that the parent holding company owned the taxpayer. Nevertheless, as the court pointed out, unity of ownership alone does not mandate a finding that there is a unitary relationship. Instead, the more significant inquiry is the extent of control the relevant entities have over each other's business activities.

Addressing this inquiry, the court acknowledged there was some overlap in the management of the holding company and the taxpayer, including a corporate officer common to both companies. Despite this, the court found that the holding company did not exert sufficient control over the taxpayer's activities in Tennessee to support a finding of centralized management. In fact, as the court reiterated, the parties had agreed that the operation of the ice cream business -- which was the only relevant business activity conducted in Tennessee -- was controlled, managed, and conducted by the taxpayer and the taxpayer's predecessor, not by the holding company. The Court of Appeals, therefore, found there was not sufficient centralization of management to find a unitary relationship between the holding company and the taxpayer.

Looking to the functional integration factor, the court found there were no benefits resulting

from the corporate reorganization or stock redemption that contributed to the taxpayer's operations or on which the taxpayer relied in performing its operations so as to justify a determination that the holding company and taxpayer were functionally integrated. Against this finding, the DOR argued that the parent company, as a pure holding company, had "no reason to exist" without the taxpayer's operations and, thus, the holding company was necessarily functionally integrated with the taxpayer. The court disagreed, stating that although "holding companies are not automatically separate businesses from their subsidiaries, [it does] not adopt the Department's assertion that holding companies are never separate businesses."

In other words, whether holding companies and their operating subsidiaries are unitary must be determined based on the same functional integration analysis that would apply in any other circumstances, under which there must be a substantial interrelationship or interdependence for two entities to be considered functionally integrated. The court found there was no such interrelationship or interdependence on the facts of the *Blue Bell Creameries* case, even though the holding company clearly received income from the operations of the taxpayer's business. As the court stated, the taxpayer's contribution of the income it earned from the ice cream making operations to the holding company, without more, is insufficient to prove functional integration because the taxpayer can "add to the riches" of the holding company while maintaining its status as a discrete business enterprise.

Regarding the economies of scale factor, the appeals court found there was no evidence that the holding company provided any "central services" to the taxpayer that undermined the taxpayer's operational independence. To support this finding, the court once again emphasized that the taxpayer and the taxpayer's predecessor were responsible for controlling, managing, and conducting the operations of the ice cream business, not the holding company. Accordingly, the court found there were insufficient economies of scale -- or centralized management and functional integration -- to find the taxpayer and holding company were part of a unitary business.

After finding the taxpayer and holding company were not part of a unitary business, the appeals court went on to hold that the capital gain at issue also failed to satisfy the operational function test. As the court explained, the U.S. Supreme Court created the operational function test in recognition that, in some circumstances, an asset can be part of a unitary business conducted in a taxing state -- and, therefore, subject to tax in that state -- even if a unitary relationship does not exist between the payer and payee of that asset. Rejecting that possibility in *Blue Bell Creameries*, the court found that the funds the taxpayer received in the form of the capital gain at issue were not operational, but rather were distributed to the taxpayer's partners. Consequently, the Court of Appeals held that, under both the operational function test and the unitary business principle, Tennessee was constitutionally prohibited from taxing the capital gain.


Practitioner's Comment

The Tennessee appeals court's decision in *Blue Bell Creameries* is important for several reasons. First, it is another reminder of the real limits that the commerce clause and the due process clause impose on a state's ability to tax out-of-state income, even in circumstances in which the taxpayer has some activities within the taxing state. Even more importantly, the court's decision provides some additional, clear guidance that can be used to determine in future cases whether those limits have been surpassed.

First, as the court recognized throughout its decision, a key fact in determining whether a unitary business exists is what entity actually controls the business activities and operations conducted in the taxing state. If those operations are controlled, managed, and conducted by a separate entity out of state or are funded by income created out of state, a court will likely find a unitary business exists. If, however, the operations conducted within the taxing state are actually controlled by the taxpayer with a presence in the taxing state -- and not by the out-of-state entity or income the state is seeking to tax -- there is likely no unitary relationship.

Second, the court's decision expressly recognizes that the corporate relationship between two entities -- including the fact that one entity may be owned by another -- is not controlling when determining whether those entities have a unitary relationship. Further, the court directly addressed and rejected the suggestion that a relationship between a holding company and its operating subsidiary is either always unitary or never unitary. Instead, the determination must be made based on the actual interrelationship, interdependence, and other relevant factors in each case.

In a point similar to the one just discussed, the court's decision in *Blue Bell Creameries* makes it clear that a unitary relationship will not be found simply because an operating subsidiary generates income that is received by a holding company. As the court's decision recognizes, even in these circumstances, there must be a substantial contribution and dependency between the two entities for a unitary relationship to exist.

Finally, the court's application of the operational function test in *Blue Bell Creameries* is, by itself, significant. Following the U.S. Supreme Court's decision in *MeadWestvaco Corp. ex rel. Mead Corp. v. Illinois Dept. of Revenue*, 128 S. Ct. 1498 (U.S. 2008), it is unclear whether the operational function test continues to be an independently sufficient basis to allow a state to tax out-of-state income. (For the opinion, see [Doc 2008-8409 \[PDF\]](#) or [2008 STT 74-1](#) ) The Tennessee Court of Appeals' application of the operational function test in *Blue Bell Creameries* suggests that, at least in Tennessee, the test continues to be a valid basis for finding constitutional taxation of out-of-state income.

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189-18 .

MeadWestvaco Corp. ex rel. Mead Corp. v. Illinois Dept. of Revenue, 128 S. Ct. 1498 (U.S. 2008); for the opinion, see *Doc 2008-8409 [PDF]* or *2008 STT 74-1* .

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