

Corporate Net Income Tax - Nonbusiness Income, Fair Apportionment and Unrelated Asset Arguments Rejected

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In a recent 4-3 decision, Pennsylvania's Commonwealth Court rejected the Glatfelter Pulpwood Company's request to exclude from its Corporate Net Income Tax base the extraordinary gain on its sale of Delaware timberland pursuant to a plan by which the company sought to dispose of most of its timberland holdings (362 F.R. 2007, May 4, 2001). The timberland was part of holdings the company had used to generate 25% of the pulpwood it sold to its parent, a paper manufacturing company. The subsidiary company historically had made pulpwood acquisitions on the open market to provide the other 75% of its parent's pulpwood requirements. The court refused to grant relief on three basic grounds.

Nonbusiness Income

First, the court rejected the company's argument for "nonbusiness income" treatment. Similar to many other states, in Pennsylvania "nonbusiness income" is income other than "business income," which 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 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.

The company had made only inconsequential sales of timberland prior to adopting its "Timberland Divestiture Plan." Although a series of sales were made under the Plan, the court majority agreed with the company that the sale of Delaware timberland was not a "transaction ... in the regular course of [Glatfelter's] ... business" – referring to the first part of the "business income" definition, traditionally called the "Transactional Test."

However, the court's majority did conclude that the sale met the second part of the "business income" definition – known as the "Functional Test." Here, the majority believed the management and disposition of the Delaware timberland were an integral part of the company's business. The majority distinguished the Pennsylvania Supreme Court's 1994 decision in *Laurel Pipe Line Company v. Board of Finance and Revenue*, 537 Pa. 205, 642 A.2d 472 on the basis that Laurel had liquidated a distinct part of its pipeline holdings, while Glatfelter continued its business and, in the majority's eyes, did not liquidate a part of its business.

Had the majority viewed the sale as part of a liquidation, it would have needed to address changes made by Act 23 of 2001 – after *Laurel* was decided – which changed the wording of the Functional Test from the conjunctive to the disjunctive, and added the “apportionable under the Constitution” catchall language to the “business income” definition. A footnote in the majority opinion, however, suggests that the changes would likely yield a different result if facts similar to *Laurel* again come before the court.

Since the three dissenters did not write a dissenting opinion, it is not possible to know whether they disagreed with the majority’s nonbusiness income analysis.

Fair Apportionment

One suspects, however, that the dissenters may have taken issue with the majority’s fair apportionment analysis under the Commerce Clause and Due Process requirements – the company’s second argument. The most problematic fact in this case is that, taken together, Delaware and Pennsylvania taxed 142% of Glatfelter’s income. Without the gain from sale of the Delaware timberland, the company realized a loss. Delaware taxed 100% of the gain on the land – which one could argue was fair because that state provided various legal, environmental and other protections to the land holding. Pennsylvania, however, attempted to impose a tax of more than \$2 million based on a gain from sale of property to which it arguably provided few or no benefits and protections.

The majority cited to the four-prong test set out in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), the second prong of which requires that a state tax be “fairly apportioned” and the fourth prong of which requires that the tax be “fairly related to the services provided by the state.” Applying what is generally known as the “Internal Consistency” test of fair apportionment, the majority noted that the test was satisfied because if every state applied Pennsylvania’s version of the three-factor apportionment formula, no more than 100% of Glatfelter’s income would be taxed.

The majority, however, did not specifically discuss the “External Consistency” test of fair apportionment. This is curious since actual double taxation would seem to be a factor requiring consideration of that test.

The majority held that the tax passed muster under the fourth prong of the Complete Auto test because Pennsylvania hosted the infrastructure used by Glatfelter to deliver all its pulpwood - thereby providing services for which it could fairly ask compensation by taxation. We suspect, however, that the company may argue on appeal that Pennsylvania provided no services to the Delaware land, itself, and by taxing 42% of the gain on sale of that land, imposed a tax out of all reasonable proportion to the benefits provided by the Commonwealth.

Unrelated Assets

Glatfelter also argued for relief under what we call Pennsylvania's "Multiformity and Unrelated Assets Doctrine." This doctrine has some similarities to the Unitary Business doctrine. But, since Pennsylvania is a separate-company state, the PA doctrine looks only at the activities and assets of the company being taxed by the Commonwealth. The doctrine excludes lines of business which are not operationally integrated with the business activities conducted by the company within the state, and excludes investments and other assets which are not used in the integrated business conducted in whole or in part in the state. With facial logic, the court majority rejected this argument because Glatfelter had used its timberland holdings as part of its integrated pulpwood production and acquisition business.

We expect that Glatfelter will file exceptions to the Commonwealth Court's decision and that, ultimately, the case will be appealed to the Pennsylvania Supreme Court.

If you have any questions concerning Pennsylvania corporate taxes, please contact Jim Fritz (jfritz@mwn.com) or another member of the **McNees SALT group**.

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