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North Carolina DOR: Gain on sale of partnership interest allocable income under unitary business principle

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Background

Taxpayer is a Texas limited partnership taxed as a corporation for federal and state tax purposes. The taxpayer and an affiliated corporation jointly operated an automobile consumer finance business, which engaged in operations in many states, including North Carolina. In August of 2000, the taxpayer and the affiliated corporation contributed all of their interests in the automobile consumer finance business to a limited partnership. Subsequent to the contribution, the taxpayer owned approximately 36 percent of the new limited partnership, which was the taxpayer's only asset.

For the tax years 2000 through 2004, the taxpayer filed North Carolina corporate income and franchise tax returns and treated its pro rata share of income from the limited partnership interest as apportionable income. In late 2004, the taxpayer sold its partnership interest, and treated the gain from the sale as nonapportionable income not subject to North Carolina corporate income tax.

Upon audit, the North Carolina Department of Revenue reclassified the gain as apportionable income and assessed tax. The taxpayer requested a review of the proposed assessment, and the Department issued its final determination confirming



the assessment, including penalties and interest. The Administrative Law Judge (ALJ) granted summary judgment in favor of the taxpayer, and the Department subsequently appealed to the Office of Administrative Hearings (OAH).

Statutes and regulations at issue

Under North Carolina law, apportionable income means "all income that is apportionable under the United States Constitution." G.S. 105-130.4(a)(1). Such income is apportioned to North Carolina based on the appropriate apportionment formula set forth in G.S. 105-130.4. All other income is nonapportionable income and is allocated to North Carolina based on the provisions of G.S. 105-130.4(c)-(h).

Nonapportionable partnership income is allocated to North Carolina "if the business situs of the activities or investments" is located in North Carolina. G.S. 105-130.4(h). Additionally, nonapportionable gain or loss from the sale of an intangible asset is allocated to North Carolina "if the corporation's commercial domicile" is in North Carolina. G.S. 105-130.4(e)(3).

Hearing officer rules in favor of taxpayer

Before the OAH, the Department contended that the gain from the sale of the interest in the limited partnership was apportionable because the taxpayer participated in a unitary business with the limited partnership. Furthermore, the Department argued that--unlike shareholders of a corporation--partners are deemed to be operating the partnership by virtue of their status as partners, and therefore a partnership interest is *automatically* unitary with the partner, thus resulting in apportionable income.

The OAH disagreed, however, and upheld the ALJ's determination that the taxpayer's gain on the limited partnership interest was allocable to the taxpayer's commercial domicile. The OAH's decision turned on whether the gain from the sale of the interest in the limited partnership was apportionable or nonapportionable income.

The OAH analyzed whether the gain from the sale of the interest in the limited partnership was apportionable income. The OAH applied the reasoning set forth in *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 781 (1992), where the Supreme Court ruled that the income of a nonresident corporation (or a partnership taxed as a corporation) is apportionable under the Commerce Clause of the constitution only if the income is earned as part of a unitary business.

To determine whether the taxpayer's income was derived from a unitary business, the OAH looked to the three-part unitary relationship test vis-à-vis the taxpayer's relationship to the limited partnership:

1. **Functional integration:** The business assets, agreements, facilities, service providers, and resources of the taxpayer and limited partnership were not integrated. There was no functional integration.
2. **Centralization of management:** The management teams of the taxpayer and limited partnership were distinct and separate. There was no centralization of management.

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3. Economies of scale: There were no shared employees, assets, or common business ventures between the taxpayer and limited partnership. There were no economies of scale.

Finding that none of the three hallmarks of a unitary relationship existed between the taxpayer and the limited partnership, the OAH reasoned that there was no unitary relationship between the taxpayer and the limited partnership. As a result, the OAH ruled that the taxpayer's gain from the sale of the limited partnership interest was nonapportionable income and, therefore, not taxable in North Carolina.

In delivering its decision, the OAH stated:

"The facts before this Court pertinent to the three-part unitary business test are similar in their material respects to the facts in *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992), which the Supreme Court held failed to satisfy the constitutional unitary business test. *Allied-Signal* also involved the gain from the sale of the taxpayer's passively held interest in an unrelated business. The Supreme Court held that, because the taxpayer passively held this interest, the taxpayer was not unitary with the unrelated business, so the gain from the sale of the interest was nonapportionable income. The undisputed material facts lead to the same conclusion in the case before this Court."

In addition to ruling that none of the three characteristics of a unitary relationship existed between the taxpayer and the limited partnership, the OAH also disagreed with the Department's contention that an interest in a partnership is *automatically* unitary with the partner, thus resulting in apportionable income. The Department's view, the OAH stated, runs contrary to a regulation, which specifies that

"[W]hether a corporate partner's share of the partnership's net income is classified as apportionable income or nonapportionable income depends upon the facts in each case. Such income is classified as nonapportionable income where the corporate partner limits its connection to the partnership to the mere investment of funds or property and does not regularly or materially participate in the day-to-day operation of the partnership. Where the business of the partnership is directly or integrally related to the business of the corporate partner, the corporate partner's share of the partnership net income is classified as apportionable income." 17 N.C.A.C. § 5C.1702.

Accordingly, because the taxpayer's relationship with the partnership was passive and not one of regular and material day-to-day involvement, the gain was nonapportionable income allocable to the taxpayer's state of commercial domicile.

PwC observes

"The significance of this decision cannot be overstated," says Stu Lockerbie, SALT Director with PwC in Charlotte. "The Department was clearly under the impression that *all* income is apportionable following an earlier statutory change that replaced the UDIPTA 'business/nonbusiness income' standard with a 'to the extent allowed under the Constitution' standard," Lockerbie explains. "However, this ruling shows there are definite boundaries that apply in determining when a specific item of income is subject to apportionment versus allocation."

Furthermore, the decision provides a definition of unitary business that may provide guidance for taxpayers concerned about June 2011 legislation that authorizes the North Carolina Secretary of Revenue to require combined reporting by an affiliated group conducting a unitary business when intercompany transactions lack economic substance or are not at fair market value. The new legislation, which applies to assessments proposed for taxable years beginning on or after January 1, 2012, uses the term "unitary business," but does not provide guidance regarding the factors to consider in making a unitary business determination, Lockerbie explains.

"Given that the Department has acquiesced to the administrative officer's decision, it appears that the decision will cover two major areas of concern, i.e., apportionable and allocable income, and unitary business operations," says Lockerbie.

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