

## NJ Tax Court: Gains from complete liquidation not apportionable

### Overview

On April 10, 2017, the New Jersey Tax Court ("Tax Court") in a published opinion in *Xylem Dewatering Solutions, Inc. v. Director, Division of Taxation* ("Xylem") held that the gain from a deemed asset sale under IRC §338(h)(10) recognized by a New Jersey domiciled S corporation was considered non-operational income and therefore non-apportionable and allocable to New Jersey pursuant to New Jersey Corporate Business Tax ("CBT") rules.<sup>1</sup> The Tax Court determined that its 2007 holding in *McKesson Water Prods. Co. v Director, Div. of Taxation*<sup>2</sup> was controlling and allocation of the income at issue to New Jersey as the S corporation's domiciliary state was proper.

This Tax Alert summarizes the relevant arguments and holdings in the *Xylem* decision<sup>3</sup> and provides some taxpayer considerations.

### Background

In *Xylem*, the shareholders of the company sold all of the shares on or about August 3, 2010. The parties elected to apply IRC §338(h)(10) to the transaction. Because of the election, for federal income tax purposes the sale of stock was deemed to be a sale of the assets of the corporation followed immediately by the liquidation of the corporation.<sup>4</sup> The corporation filed a short period return for the period ending August 3, 2010, including the gain from the deemed sale of assets. The gain was approximately \$357 million, of which \$49 million was associated gain on tangible assets, the remaining gain was attributed to goodwill. Xylem also filed a New Jersey S corporation return for the same short period that reported income of approximately \$370 million. On its original return the corporation allocated \$113 million to New Jersey sources using the CBT sourcing rules. In April of 2015 the corporation filed an amended return sourcing the gain on fixed assets based on the location of the assets and sourcing the gain on the goodwill based on the three year average of its allocation for the immediately preceding three tax years 2007, 2008 and 2009, applying New Jersey gross income tax ("GIT", i.e., personal income tax) rules.<sup>5</sup>

### Sourcing of income

In New Jersey, the entire net income of an electing S corporation is subject to CBT; however, there is no tax that is imposed on the S corporation itself.<sup>6</sup> Accordingly, while the S corporation does not pay the CBT, the S corporation's income is subject to the CBT's sourcing rules and principles. Also, while the S corporation is not subject to the GIT, its shareholders must pay the GIT on their pro rata shares of S corporation income that was sourced to New Jersey under CBT principles.<sup>7</sup> The taxpayers in the *Xylem* matter argued that the gain, while recognized by the S corporation, should be sourced using the GIT rules instead, thereby avoiding the application of the CBT business/non-business test, as interpreted by the Tax Court in the *McKesson* decision. The Tax Court, however, concluded that the application of the "CBT sourcing rules to the deemed gain... is wholly consistent with the taxation of such income as net gains from the disposition of property under the GIT".<sup>8</sup>

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<sup>1</sup> Docket Nos. 011704-2015, 00056-2016, 00057-2017 (N.J. Tax 2017), available [here](#).

<sup>2</sup> *McKesson Water Prods. Co. v Director, Div. of Taxation*, 408 N.J. Super. 213 (App. Div.) cert. denied, 200 N.J. 506 (2009).

<sup>3</sup> There are other issues present in the *Xylem* case related to a retroactive S corporation election and consent that are not pertinent to this Alert.

<sup>4</sup> IRC §338.

<sup>5</sup> Note that the New Jersey Division of Taxation has proposed deletion of the 3 year averaging rule under N.J.A.C. 18:7-8.12(g) for apportioning gains in the context of IRC 338(h)(10). 49 N.J.R. 52(b), VOLUME 49, ISSUE 1, ISSUE DATE: JANUARY 3, 2017, RULE PROPOSALS, TREASURY--TAXATION DIVISION OF TAXATION.

<sup>6</sup> N.J.S.A. 54:10A-5(c)(2), 54:10A(c)(2)ii.

<sup>7</sup> N.J.S.A. 54A:5-9.

<sup>8</sup> *Xylem*, supra, at 23.

### Operational vs. Non-operational income

The Tax Court in *Xylem* followed the logic established in its earlier decision in *McKesson*. In *McKesson*, a gain on the deemed sale of property was subject to allocation as it was considered non-operational income. The Tax Court in *Xylem* similarly concluded that the income from the deemed sale of assets by the corporation constitutes non-operational income. The period to appeal this case is still pending.

### Considerations

Non-New Jersey based companies that dispose of assets whether deemed or actual, in conjunction with a complete liquidation should review the facts of the *Xylem* decision in order to determine if a similar basis may exist to exclude gain from their New Jersey apportionable base. One note of caution, however. In 2014 (subsequent to the tax years at issue in *Xylem*), New Jersey amended its CBT statute to require apportionment in situations where the "acquisition, management, or disposition" of the property constitutes an integral part of the taxpayer's regular business,<sup>9</sup> potentially limiting the precedential value of *Xylem*. Consultation with a New Jersey tax specialist is advisable to properly analyze affected transactions.

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<sup>9</sup> *Id.* As amended by P.L. 2014, c. 13, §1 (effective June 30, 2014)  
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