

## Gain from Goodwill Sale Subject to Minnesota Apportionment as Business Income

Alert

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The Minnesota Supreme Court recently held that the gain from the sale of goodwill was subject to apportionment as business income derived from a unitary asset rather than allocation of nonbusiness income pursuant to Minnesota Statute §290.17. *Cities Management, Inc. v. Comm’r of Rev.*, No. A23-0222, Nov. 22, 2023; \_\_\_ NW2d \_\_\_ (Minn. 2023); 2023 WL 8102829.

Cities Management, Inc. (CMI), organized as a subchapter S corporation and operating in Minnesota and Wisconsin, was partly-owned by a Minnesota nonresident individual. In 2015, the shareholders sold their CMI stock to an unrelated third party and made an Internal Revenue Code section 338(h)(10) election to treat the transaction as an asset sale. CMI, relying on *Nadler v. Commissioner of Revenue*, No. 7736 R, 2006 WL 1084260 (Minn. T.C. April 21, 2006), treated the income generated by the sale of goodwill as nonbusiness income subject to allocation under Minn. Stat. §290.17, subd. 2(c). The Minnesota Department of Revenue (DOR) determined that CMI’s income generated from the sale of goodwill was business income subject to apportionment pursuant to Minn. Stat. §290.17, subd. 3 and assessed \$433,017 in nonresident withholding tax plus interest and penalties. Unbeknownst to CMI, the DOR had taken the internal position that it would not follow the *Nadler* decision, although this position was not publicized until July 2017.

The Minnesota Tax Court determined that the DOR was not bound by the *Nadler* decision and that CMI’s income from the sale of goodwill was business income of a unitary business subject to apportionment. Despite being “troubled by the Commissioner’s conduct” in issuing an internal decision regarding its non-acquiescence of *Nadler* without public notice, the Minnesota Supreme Court nonetheless affirmed the tax court position.

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The *Nadler* case decided in 2006, involved similar facts: an S corporation with nonresident stockholders in a deemed assets sale. The Minnesota Tax Court in *Nadler*, carved out the gain from the sale of the goodwill portion of an asset sale from the method otherwise applied to the sale of business assets, apportionment, and determined that the gain from the sale of goodwill would be treated in a different manner than the general apportionment and allocation methods. Instead, income from the sale of goodwill would be allocated to Minnesota but in an amount not to exceed the amount of income apportioned to Minnesota in the prior year. Eleven years later, the DOR decided to take the position that the Minnesota Tax Court was wrong in *Nadler*, and that income from the goodwill portion of an asset sale was to be apportioned with no special limitation on the amount of income assigned to Minnesota. See *Minnesota Revenue Notice No. 17-02* (July 3, 2017).

Unfortunately, CMI's deemed asset sale occurred in 2015 and tax returns were filed for the sale, both occurring well before *Notice No. 17-02* discussed immediately above. Once again, in the CMI matter, the DOR made the same argument rejected in *Nadler*, the gain from the sale of the goodwill portion of the asset sale was business income. This time however, more recent authorities from the Minnesota Tax Court and the Minnesota Supreme Court supported their position.

As a result, Minnesota joins the states that treat income of this nature as income that must be treated as business income and apportioned. To reach that result, the DOR had to fail to follow a Minnesota Tax Court decision that would have decided the case in a more taxpayer favorable manner and contend the Minnesota Tax Court decision was not binding on the DOR, even though their refusal to follow the decision was not made public until after the periods at issue. The dissenting opinion in the *CMI* case deemed the DOR's actions in the case as "outrageous conduct" and would have decided the case against the DOR on that basis. The Chief Justice of the Minnesota Supreme Court joined the dissent.

For more information on the implications of the *Cities Management, Inc. v. Comm'r of Rev* decision, please contact [Charley Jensen](#), [David Jenson](#), [Molly Maurin](#), [Jay Simpson](#) or the Stinson LLP contact with whom you regularly work.

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