

Multistate Tax Commission  
Task Force A, Corporate Tax Working Group  
Reporter's Notes on Teleconference Meeting  
July 9, 1997 (10:00 a.m. EST)

The following individuals assigned to Task Force A as their "Home Room" participated in the teleconference:

\*Scott Heyman (Sidley & Austin)  
\*Marshall Stranburg (FL)  
Merle Buff (Am. Ex.)  
Jeffrey Friedman (COST)  
Karen Boucher (A. Anderson)  
Barry Weissman (ARCO)  
Jennifer Hays (KY)  
Gerry Andert (MO)  
Frank Shaffer (NM)  
Mark Wainright (UT)  
\*\*Michael McIntyre (WSU)

In addition, the following individuals joined the teleconference:

Harold Aldinger (ND)  
Steve Auster (Int'l Paper)  
Rene Blocker (MTC)  
Paul Castlelon (IL)  
\*\*\*Alan Friedman  
Al Heller (NH)  
Wood Miller (MO)  
Paull Mines (MTC)  
Chuck Redfern (NH)  
Frank Shaffer (NM)  
Art Rosen (McD, Will & Emery).

\*Co-leaders  
\*\*Reporter  
\*\*\*Facilitator

### Summary of Consensus Reached

After extended discussion, the group reached consensus that for purposes of developing regulations and considering changes in the UDITPA statute, income should be treated as business income if it satisfies some type of transactional test (however elaborated) or some type of functional test (however elaborated). That is, two tests should be used, and the focus of future discussions should be on how those tests should be formulated to promote clarity and uniformity.

### Issues for Future Discussion

The next step for the group is to try to conceptualize the two tests and relate those tests to Supreme Court precedents, particularly Allied Signal. After that, the task is to decide whether the language of the proposed regulations is acceptable or whether changes in that language or in the UDITPA statute are needed.

### Summary of Points of Discussion

Leading up to the consensus summarized above, the various points were introduced by various members of the group. The following is a summary of what appeared to the reporter to be the main points of discussion.

1. The jumping off point for the group, as summarized in the Reporter's notes from the Dallas meeting, is the current draft of the regulations. The question then is whether the group should suggest a change in the UDITPA statute if it concludes that the statute does not permit the approach taken in the regulations.
2. The transactional and functional tests seem to go to the limits allowed by the Constitution. The group should decide (1) whether the results reached under those tests are good policy and (2) whether the UDITPA statute allows those results.
3. Whatever we call it, we almost certainly want some type of functional test. The early cases treated income as apportionable under what might now be called a functional test. We may not want to call it a "functional" test, but we generally do want income from operations to be apportioned. If the UDITPA statute is changed, then it is completely unimportant what we call the tests. The name is an issue only because of the current wording of the statute.
4. Major emphasis on language of Allied Signal may be a mistake. That case has some problems and may be revisited at some point by the Court. It would be best to have rules that make good sense from a policy perspective.
5. What the states do can affect what the Court does. As a practical matter, if most states adopt an approach, then the Court is more likely to go along than if a state is acting out of the norm. Thus this project, to the extent that it promotes uniformity among the states, can affect the Court's decisions. At a minimum, the Court is unlikely to hold that a rule is unworkable if many states are using it.
6. Commentators have focused intently on whether the UDITPA statute permits only one test only in the 1990's, perhaps as an offshoot of Allied Signal. There are precedents, however, for the argument from early times.

7. The courts in Tennessee, Iowa, perhaps Illinois (case on appeal), and Kansas have read UDITPA as allowing only one test, but there have been statutory fixes in those states. Kansas allows businesses an election to apply a functional test, and Tennessee and Iowa provide a functional test by statute. The issue is also pending in the California courts.

8. The focus on the particulars of the tests may be a mistake. Allied Signal may have constitutionalized UDITPA but it did not really change the test in a practical way. State courts tend to note Allied Signal but then apply their old tests.

9. What the focus should be on is whether the income is properly apportionable. It shouldn't matter if a transaction is "extraordinary" if the assets disposed of in the transaction were used in a unitary business.

10. One might distinguish between transactions based on the expected use of the proceeds, although Allied Signal may suggest the contrary in some circumstances. For example, if a corporation has several lines of business, A-E, and it decides to dispose of E and use the proceeds to strengthen A-D, then the gain from the sale of E should be business income. If the purpose of the sale of E is to increase dividends, however, then the gain on the sale might be classified as nonbusiness.

11. The suggestion was made that there might be a consensus that the test of whether income is business would be made by reference to the taxpayer's practices and not the practices of the industry. Objection was made that perhaps it would be inappropriate to look into the facts of the taxpayer's business if the activity generating the income would be business income in the industry. There ensued discussion about the problems of proving industry practice, and several speakers indicated that they felt it would not be useful to invite expert testimony over what was normal business practice. There seemed to be support for the view that a rule that invited extended debate over industry norms would be undesirable. There was also support for the view that the taxpayer should be able to rebut any presumption that income was business by reference to its special circumstances. The suggestion was made, nevertheless, that a general presumption that income is business if it arose from an activity classified as business under Section 162 of the Internal Revenue Code might promote uniformity and eliminate disputes in a high percentage of cases.

12. The point was made that the need for a presumption that income is business arises only under the transactional test. Under the functional test, income from normal business activities would be treated as business without the need for any presumption.

13. The suggestion was made that a consensus seemed to be emerging in favor of two tests. One participant indicated both a lack of disagreement but also a lack of agreement with that suggestion. He suggested that if land used for a factory was sold for use as an amusement park, the gain from the sale might not be business income. In reply, one participant suggested that the example presented a problem of allocating part of the gain to business and part to investment and that such allocation was impractical. The suggestion also was made that the example went more to how the two tests should be interpreted than to whether there should be two tests.

14. One concern expressed was that any tests should not radically upset existing expectations. We should not want to send shock waves through the business community. In general, what everyone thinks is business income now should be business income after the revision of the regulations.

15. The suggestion was made that the transactional test is closer to the old unitary business test and the functional test is closer to the Allied Signal test.

16. One suggestion was that even if income was classified as business, there still was a question of how it fit into the apportionment formula.

17. Some discussion ensued about the history of UDITPA, as recounted by John Warren at Dallas. On that issue, an article that Jim Peters is reportedly working on might be useful. Jim also has a relevant piece from 1973.

18. There was the suggestion that the next teleconference might address the group's second issue. In reply, it was suggested that a consensus had already been reached on that issue.

#### Next Meeting

The next teleconference is scheduled for Tuesday, July 22, at 10:00 a.m. EDT. Participants should call (703) 736-7307 and log on by identifying the conference as the MTC Task Force and mentioning that Paull Mines is the moderator.