

MTC Public Participation Working Group on Definition of Business and
Nonbusiness Income and of a Unitary Business
Minutes of Task Force C Teleconference
Thursday, July 17, 1997, 11:00am-12:30pm (Eastern)

I. Welcome and roll-call.

Identified Teleconference Participants

John Warren—Task Force Co-Leader	Paull Mines
Brian Toman—Task Force Co-Leader	Valerie Montague
René Y. Blocker (Reporter)	Richard Pomp
Merle Buff	Phil Plant
Paul Castleton	Chuck Redfern
Roxanne Davis	Art Rosen
Bob Feinschreiber	John Sagaser
Alan Friedman (Facilitator)	Joe Thomas
Jennifer Hays	Barry Weissman
Douglas Herbert	

II. Public comment period.

There was no public comment.

[The group agreed that efforts to reach a consensus on any issue should await the next teleconference of the Task Force. This first teleconference was an opportunity for exchange of views.]

III. Discussion of Issue 1: the definition/test(s) of a unitary business.

A participant who submitted a re-draft of the unitary business definition proposal summarized his perspective. The participant noted his emphasis of a single workable test based upon the three elements of centralized management, functional integration and economies of scale. The participant would de-emphasize the “unworkable” three unities and contribution/dependency tests. The participant also noted his clarification of the evidence and presumptions section of the proposal.

The re-draft eliminates the three unities test since it really provides no guidance and the contribution or dependency test because the disjunctive raises constitutional concerns. The re-draft notes that States may define a unitary business reciting one or both of these two tests and that the cases establishing or relying on these tests are still good authority. The name of the third test is changed from the *Mobil* Factors Test to the “Basic Test.”

Several participants were in agreement with the removal of the first two tests. Others in the group noted in response that the first two tests are not troubling, particularly since they have been used over several years and are

familiar to taxpayers. The question was raised about the intention of eliminating the two tests: is it to eliminate the use of the tests or is it a matter of how the tests are labeled? Although there was agreement that the two identified tests include some ambiguity, there also was concern about the effect of removing them – whether matters would be analyzed differently. Regardless of the test, ultimately there must be a factual determination.

An example was posed to illustrate the ineffectiveness of the contribution or dependency test. An out-of-state business is wholly dependent on an in-state business but contributes nothing to the in-state business. The question is whether the out-of-state business should be considered unitary with the in-state business since there is no mutual interdependence, the dependence only flows one way. (There was some disagreement with the conclusion that there is no mutual interdependence in the example). Several California cases (*Superior Oil; Honolulu Oil*) were mentioned as presenting similar facts. A common scenario raising this concern is an in-state corporation in one line of business goes into another line of business located out-of-state to generate losses and offset income of the older business. The in-state business contributes to the out-of-state business, but the out-of-state business only contributes its losses to the in-state business. The question may be whether the losses are business losses and there may be support for determining that they are business losses if in-state personnel helped monitor the activities of the out-of-state business.

The group also discussed submission of another participant. However, several of the participants had not received a copy of the submission, so additional discussion of the submission is expected during the next Task Force teleconference after the other participants have had a chance to review it.

Describing the test.

A suggestion was made to introduce the “basic test” with a more general statement like “flow of value” that will effectively convey the synergy that the indicia set forth are intended to describe. A participant noted III.C., lines 83-97 of the unitary business proposal as a statement that attempted to state this introductory understanding. There seemed to be general agreement there is need to provide some detail to guide taxpayers but that there also is a need to reduce the description to a few words so that there is a greater likelihood of establishing a uniform understanding among the states. Some believed III.C. would require a little tweaking but not much more to achieve that result. The group also acknowledged the quandary of attempting to stick with the undefined terms of the United States Supreme Court while also attempting to use other terms that are more readily definable but which have not been endorsed by the Court.

Task Force participants agreed to continue to consider drafting terms and decided to cancel the next scheduled teleconference for Thursday, July 24th to allow all participants who wanted the opportunity to attempt to restate the test for unitary business that would be consistent with the approach of emphasizing the basic test without totaling negating the three unities test and the contribution/dependency test. It was anticipated that those interested participants would submit written proposals prior to the August 6, 1997 Public Participation Working Group meeting in Whitefish, Montana.

IV. Discussion of Issue 2: treatment of expenses

The Task Force is expected to address this issue during future teleconferences.

V. Discussion of Issue 3: correlation of business income with the property factor

The discussion of this issue commenced with a review of the memorandum submitted by a participant. There seemed to be agreement among the Task Force members that the same principles should govern both whether property is included in the apportionment formula's property factor and whether property is determined to produce business income.

The first of the two sub-issues to this issue concerned the proper apportioning of property that is used to produce both business income and nonbusiness income and reconciling what appears to be two different approaches to this situation under the MTC Regulations. The current MTC property factor regulations (MTC Reg.IV.10), adopt a pro rata rule for determining how much of the value of the property will be included in the property factor. The business income provisions (Reg.IV.1) present examples of partial rental of real property using a predominant activity rule, that is, 100% income from property used to produce both business income and nonbusiness income will be considered business income if the predominant activity of the property is used to produce business income.

This different treatment raises the question of whether the pro rata rule or the predominant activity rule should prevail so that the two regulation provisions correlate. The suggestion was made that the predominant activity rule–pro rata contrast may not be significant since the property factor regulations have adopted the concept of property being “available for use”, thus, the full value of partially rented property could be included in the property factor under that concept, just as the all of the income from such property could be considered business income.

With respect to the pro rata rule, questions were raised regarding the availability of records to demonstrate what proportion of property was used to produce business income. There were strong indications that providing such proof would be very difficult and it was suggested that the predominant activity rule may be simpler. The importance of the predominant activity rule and of the “available for use” concept was highlighted in a discussion of how timber reserves (as an example) would be treated. Some believed that reserves that are “available for use” can be significant to the ability to maintain a viable natural resource business and thus, the very existence of reserves often may be integral to the natural resource trade or business regardless of when these reserves would actually be depleted..

One suggestion was made that the business income regulation could be drafted to incorporate the principle that whether rental income is business or nonbusiness may depend on whether the property being rented is available for use—and one caveat was added that although rental income from a partially rented building could be determined to be nonbusiness income, it is possible that a company could decide to spin off an entirely new independent business of real estate leasing and thereby produce business income through that rental income.

A brief discussion regarding the usefulness of examples to illustrate business/nonbusiness income principles confirmed that there continue to be a split of opinion on how helpful examples can be.

The second sub-issue involves whether the removal of property from the property factor should be correlated to the designation of property as no longer producing business income. The suggestion was made to strike language regarding income from intangibles where the taxpayer has changed trade or business as contained on lines 96-98 of the April 1995 draft business income proposal.¹ It was noted in response that although the rule established by that language should not be absolute since at some point the income is no longer business income, the deletion of the language should not preclude a determination that an intangible will still produce business income for some time after the trade or business has changed. It was also noted that States cannot recapture depreciation deductions taken in the years prior to conversion of the property, thus, if the income becomes nonbusiness income immediately after conversion, the taxpayer has an effective tax avoidance

¹ The suggestion is to strike the **bold** language of the following sentence:

Income from the licensing of an intangible asset, such as a patent, copyright, trademark, service mark, know-how, trade secrets, or the like, that was developed or acquired for use by the taxpayer in its trade or business operations, constitutes business income whether or not the licensing itself constituted the operation of a trade or business, **and whether or not the taxpayer remains in the same trade or business from or for which the intangible asset was developed or acquired.**

tool. It was suggested that the five-year rule (Reg.IV.10.(b)) is a means of minimizing tax avoidance and establishes a useful bright line.² There was a tentative consensus to delete the language on lines 96-98 and stick with the five-year rule as means of eliminating the absolute rule created by that language and also of deterring tax avoidance. The group decided to withhold its final consensus on this issue until the outcome on how to treat expenses becomes clearer.

VI. Discussion of Issue 4: the definition/test(s) of non-business income

The Task Force is expected to address this issue during future teleconferences.

VII. Plans for future meetings

As noted above, the July 24, 1997 teleconference was cancelled. The Task Force anticipates future teleconferences after the Whitefish meeting.

VIII. Adjournment

The meeting was adjourned at approximately 12:30pm (Eastern).

² The relevant portion of Reg.IV.10.(b) states: "Property used in the regular course of the trade or business of the taxpayer shall remain in the property factor until its permanent withdrawal is established by an identifiable event such as its conversion to the production of nonbusiness income, its sale, or lapse of an extended period of time (normally, five years) during which the property is held for sale."