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## Multistate Tax Commission

### Business/Government Dialogue on State Tax Uniformity **Working Draft Proposal for a Business Income Regulation** (Paper Prepared By The Staff of The Multistate Tax Commission)

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#### Introductory Comments

Proper determination of business income is critical to ensuring that the income of a multistate business is reported in reasonable relationship to where it is actually earned. Another way to state this observation is that the principles governing the determination of apportionable income is a core provision of any formula apportionment determination of the situs of taxable income of a multijurisdictional operation.

In recognition of the importance of the principles that govern the determination of apportionable income, the MTC Uniformity Committee has proposed a working draft of a regulation that deals with the complexities of distinguishing business and non-business income.<sup>1</sup> The draft regulation that is attached has not been approved by the Commission and still is subject to the possibility of substantial revision. The Committee draft interprets the much maligned UDITPA business income concept with specific reference to the teaching of *Allied-Signal*, the fundamental constitutional authority on when income, gain or loss is apportionable. This Dialogue session is not necessarily limited to discussing the principles that directly pertain to recognizing business income; the session may also, if it is so desired, examine the determination of the extent of a unitary business (to the extent that the scope of a unitary business is germane to completing the necessary income classification).

No one would ever take serious issue with the observation that the determination of apportionable income (and losses) is a constant source of tension between taxpayers and the States. What the member States of the Commission seek to accomplish through the Committee draft is the development of a regulation that eliminates much of the ambiguity that is inherent in applying both state law concepts (UDITPA) and federal constitutional law concepts (Due Process and Commerce Clauses) to this issue. The States believe that the elimination of ambiguity will benefit all, because it will provide greater

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<sup>1</sup>A copy of this working draft is attached to this issue paper. The copy is in red-lined form indicating how the regulation would affect the existing MTC Allocation and Apportionment Regulations (*adopted February 21, 1973, as revised through July 30, 1993*).

certainty and lessen the potential for post-transactional disputes. The States undertook the uniformity project of developing a uniform regulation by which to classify apportionable income knowing that inevitably the regulation could apply both for and against a State revenue position depending upon the actual circumstances of each individual case to which it was applied.

Following this dialogue discussion, the MTC anticipates the appointment of a Commission working group to review not only the Committee draft on business income but also the most recently completed working draft of a regulation that states applicable principles for determining the scope of a unitary business. This MTC working group will be comprised of unpaid representatives of the States, multijurisdictional business, academia, and public interest groups. Once formed, the working group will independently review the work of the Uniformity Committee and advise, for further Commission consideration, on the statement of appropriate rules for classifying business income and the determination of the scope of a unitary business.

The following presentation seeks to suggest areas where this session of the 1996 Dialogue Day might want to place its attention in the discussion of the MTC Committee draft on business income. The listing of specific issues for possible discussion is not intended to preclude consideration of other, and perhaps more appropriate, subjects. The Business/Government Dialogue on State Tax Uniformity belongs to the discussants. The moderators/facilitators of this segment on *Working Draft Proposal for a Business Income Regulation* are available to assist the group to overcome some of the awkwardness that is inherent in assembling a group of people who do not necessarily know one another, but who are committed to a successful group discussion.

The discussion outlined below invites identification and analysis of some of the issues inherent in determining what income (or loss) is apportionable in the non-domiciliary State. This discussion will hopefully facilitate cooperation among affected industry and the States. The Multistate Tax Commission, its member States and its Staff hope you will profit from your participation in these discussions and in the process even have some fun. Please participate freely!

### **Possible Issues for Discussion**

- I. Does it make sense for state tax administrators and multistate business to conduct a dialogue on developing uniform principles for the determination of business income?
  - A. Does multistate business benefit from the development of a uniformity rule on the classification of apportionable income?
    1. Uniformity while avoiding duplicative taxation also facilitates fair apportionment, or in the parlance of the States, full apportionment (not be confused with full taxability) Anecdotal evidence suggests that multijurisdictional business is quite successful in avoiding full apportionment, *i.e.*, the attribution of all business income to some jurisdiction, even though not all the jurisdictions to which the income is attributed may have a state tax based upon net income.
    2. As a generalized rule, does multistate business prefer that the type of income that typically gives rise to a dispute over apportionability be situated to the state of commercial domicile?
      - a. A business is likely to have more influence over legislative choices in a State in which its commercial domicile is located.

- b. The ideal result for multistate business is to have an item of income totally situated to the State of commercial domicile when the rules of that jurisdiction cause the income to be apportioned. This result avoids full apportionment.
  - c. Of course, if the State of commercial domicile does not apportion but allocates the item of income, the result of having the income situated to that State may not be beneficial to the multistate business.
  - d. Whether classifying an item of income as business income is beneficial or detrimental to a multistate business can be affected by the tax rates among the States and even whether the disputed item is income/gain or a loss. While it is feasible to know the most beneficial classification of an item of income *after* the transaction, it is sometimes difficult, or even impossible, to make that determination much in advance of the transaction without assuming certain facts that can easily change by the time the transaction occurs.
3. Does multistate business have a stake in preserving the limited line of cases that have to some extent rejected the two independent tests for determining business income?
    - a. What, if any, is the identifiable interest of business in avoiding the functional test for classifying business income?
    - b. What, if any, is the identifiable interest of business in preserving the functional test for classifying business income?
  4. If multistate business wants to avoid the application of the functional test to classifying business income and the States want to preserve this test, how can multistate business and the States conduct a meaningful dialogue on this aspect of the business income regulation?
    - a. State authority is split on whether UDITPA states an independent functional test for classifying business income. How should State members of a multistate compact dedicated to promoting uniformity and preserving the sovereignty of the States within our federal system act in these circumstances?
    - b. Institutionally speaking, if the States view the independent functional test as a reasonable statutory interpretation of UDITPA and a reflection of sound state tax policy, why should the States forego recognition of the functional test that would give too much credence to late emerging authority that is far from overwhelming in its rationale?

## II. Understanding the specifics of the Committee draft.

- A. The drafting perspective was to recognize business income according to principles that were as close to the U.S. constitutional limits of apportionability, to the extent that position was supported by the actual statutory language of UDITPA.
  1. The Committee draft inherently recognizes UDITPA may not compel apportionment in contravention of the U.S. Constitution.
  2. If the state statutory standard of apportionability (UDITPA) exceeds the limits of the U.S. Constitution, a one-way whipsaw can arise: a taxpayer will adhere to the state standard when that standard is beneficial but then rely on the Constitution to prevent the application of the state statutory standard, when that stance is beneficial. Either way, the taxpayer prevails in an uneven application of a principle that should be neutral. Neutral in the sense

- means that the rules of classifying income as apportionable should neither favor nor prejudice the multistate taxpayer or the State.
3. If the state statutory standard of apportionability (UDITPA) is less than the limits of the U.S. Constitution, then absent special circumstances both the State and the taxpayer are denied apportionment in those cases that go beyond the state standard but less than the Constitution, even though apportionment would be beneficial and the Constitution would permit it.
  4. Has the drafting perspective resulted in misstatements of applicable law?
    - a. Please identify the alleged provisions that you believe offend applicable law and cite available authority for your position.
    - b. Please submit, preferably in writing, suggested alternatives to the alleged provisions that you believe offend applicable law.
- B. Are there portions of the Committee draft that are hard to understand? Please identify the provision and explain the difficulty you have in understanding the cited provision.
- C. All state income tax systems that employ formula apportionment must apply the unitary business principle under the constitutional interpretation of the United States Supreme Court. *There are no exceptions.*
1. The unitary business principle provides—

The unitary business principle requires income that is subjected to formula apportionment by a non-domicillary State to be derived from the **same unitary business** that is being conducted at least in part in the taxing State. The unitary business that is conducted in the taxing State includes both the unitary business that the taxpayer alone may be conducting and any unitary business the taxpayer may be conducting with any other person or persons. *See Prop. MTC Reg. IV.1.(a)(5).*
  2. Do you agree with the statement that satisfaction of either the transactional test or the functional test complies with the unitary business principle. The Committee draft justifies this position by noting each test requires that either the transaction or activity (in the case of the transactional test) or the property (in the case of the functional test) to be tied to the same unitary trade or business that is being conducted within the taxing State.
  3. To say that States must apply the unitary business principle in determining what income is apportionable does not state that there must be a unitary business relationship between the payor and its payee in order to support apportionability as to the payment received. A unitary business relationship between a payor and a payee will support apportionability as to a payment received, but the absence of a unitary business relationship does not preclude finding that the payment received was in furtherance of the unitary business of the payee standing alone.
  4. The Committee draft eschews the term *unitary business*. One justification for avoiding the term unitary business is the belief that use of the term would carry connotations that would interfere with proper understanding of the principles being stated. Yet avoidance of the term unitary business is perhaps misleading. For example, it is not

- uncommon among practitioners and state tax administrators to hear the statement that the unitary business principle has no application to a State not employing combined reporting. This statement is clearly erroneous.
- a. Is the drafting approach of avoiding the use of the term unitary business in the proposed regulation justified or even appropriate?
  - b. Would the Committee draft be improved if it stated that UDITPA's term "trade or business" refers to a unitary business, part of which is being conducted in the taxing State.
5. Do you think the draft proposal has appropriately stated and applied the unitary business principle?
- a. Please identify the alleged provisions that offend the unitary business principle and supply authority for your position.
  - b. Please submit, preferably in writing, suggested alternatives to the alleged provisions that offend the unitary business principle.
6. Some note that a useful MTC regulation would be to explain what the U.S. Supreme Court means when it states that the demarcation between apportionable and non-apportionable income is whether the asset giving rise to the income fulfills an operational role for the unitary business or constitutes an investment unrelated to the unitary business. These observers urge less focus be placed upon interpretative rules of the so-called "transactional test" and the "functional test," if this latter test actually exists under UDITPA.
- a. What regulatory authority does a state tax administrator have from state law to adopt rules and regulations interpreting constitutional limits placed on state taxation?
  - b. To better understand the constitutional limits placed upon state taxation, is it an appropriate regulatory approach to find the common ground of the state statute that is being interpreted with the applicable constitutional limits? For example, the Committee draft indicates why it believes the formulations of the transactional test and the functional test of UDITPA that are stated in the regulation satisfy the unitary business principle. Is this a useful perspective to the practitioner who, if he/she agrees with the statement, may then focus on the regulation without having to be bothered with the fine points of the U.S. Constitution, unless the practitioner believes the end result of the application of the regulation suggests there must be some constitutional infirmity with the stated rules?
- D. Most of the draft regulation discusses the circumstances for determining whether the income/gain or loss was incurred in furtherance of the unitary business of the taxpayer (payee), part of which unitary business is being operated in the taxing State.
1. There are several presumptions in the regulations, some of which have drawn criticism. One presumption is  
"All income of the taxpayer is business income unless clearly classifiable as nonbusiness income. A taxpayer seeking to overcome a classification of income as business income must establish by clear and cogent evidence that the income has been incorrectly classified." *See* Prop. Reg. IV.1.(a).(2)(B).

- a. The Committee draft relies upon several sources for making this statement. First there is UDITPA itself that requires the item being classified to be determined not to constitute business income before it can be classified as non-business income. The presumption also depends upon constitutional understandings that impact when a non-domiciliary State may subject an item to apportionment. The States' adoption of UDITPA, and, more specifically, the adoption of the Multistate Tax Compact that incorporates UDITPA, occurred in the context of these jurisprudential understandings. The constitutional jurisprudence the Uniformity Committee additionally drew upon to justify the quoted presumption includes the following—
    - ☞ *Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194 (1897) (all property held within a company is held and used for purposes of its business).
    - ✂ *Butler Bros. v. McColgan*, 315 U.S. 501 (1942) (one who attacks a formula of apportionment carries the distinct burden of showing by clear and cogent evidence that it results in extraterritorial values being taxed).
    - ☒ *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159 (1983) (recognizes the application of the above principle in the context of “a more or less integrated business enterprise operating in more than one State”)
  - b. The quoted presumption is reflected to some degree in *example (vi)* to Reg. IV.1.1.(c).(3)—

*Example (vi)*: In January, the taxpayer concluded a transaction in which it generates a cash fund of \$20,000,000. The funds generated are placed in a segregated, interest-bearing account pending a decision by management as to how the funds are to be utilized. For the next six months management has under consideration the alternative possibilities of investing the proceeds in the existing unitary business or distributing the proceeds to the shareholders as a dividend. Until a final determination is made to distribute the proceeds to the shareholders as a dividend, the interest income is business income. All income is business income unless clearly classified as nonbusiness income and until the final determination was made the fund was available for future operation of the taxpayer's existing unitary business.
  - c. After consideration of the foregoing, do you consider the quoted presumption erroneous and/or unfair?
    - i. Please note why you believe this provision is erroneous and/or unfair and provide authority for your position.
    - ii. Please submit, preferably in writing, a suggested alternative to the quoted presumption that you believe is a better statement of applicable law.
2. The proper classification of property held in an enterprise can possibly change from time to time.
    - a. Some criticize the Committee draft for not containing principles that recognize classification of an item of property can change from being property held in furtherance of the

- unitary business, part of which is being conducted in the taxing State, to property that has no connection with that unitary business.
- b. Similarly property might first be acquired with no intention that it be held to further the unitary business. Thereafter this property might be converted for use in the unitary business.
  - c. How would you deal with the possibility of changes in classification of property that could occur over time?
    - i. Should the possibility of changes in classification be recognized?
    - ii. If you believe the possibility of changes in classification should be recognized, what language can you propose as an appropriate statement of the applicable principles?
3. Little controversy seems to surround the statement of UDITPA's transactional test in the Committee draft.
- a. Have you identified any aspect of the Committee draft that pertains to the transactional test with which you disagree? If so, please identify the statement and cite any authority upon which you rely for your disagreement?
  - b. Prop. Reg. IV.1.a.(3)(B) provides—

For a transaction or activity to be in the regular course of the taxpayer's trade or business, the transaction or activity need not be one that frequently occurs in the trade or business, although most frequently occurring transactions or activities will be in the regular course of that trade or business. It is sufficient to classify a transaction or activity as being in the regular course of a trade or business, if it is reasonable to conclude transactions of that type are customary in the kind of trade or business being conducted or are within the scope of what that kind of trade or business does.
  - c. Do you agree with the quoted provision? If not what is the basis of your disagreement and what authority do you have for your disagreement?
4. There is much potential for disagreement over the statement of UDITPA's functional test in the Committee draft.
- a. Beyond citing some cases that have taken a critical view of the functional test as an independent test for classifying business income, what is the actual rationale you would advance to justify your position that the functional test is not an independent test for the classification of business income?
    - i. If you think the language of UDITPA itself does not support the functional test, please parse the language of UDITPA that you believe reaches that result. For ready reference UDITPA defines business income as,  
  
**Business income means income arising from transactions and activities in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and**

disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

- ii. How do you deal with the circumstance that property used in furtherance of the unitary business can give rise in one year to deductions from income attributable to that unitary business, *e.g.*, depreciation, and the sale of that property that results in gain and a recovery of these tax deductions does not result in income that can be subjected to apportionment in a different year even though the State previously recognized the deductions?
- b. UDITPA's statement of the functional test of UDITPA appears awfully close to the constitutional test the U.S. Supreme Court recognized in *Allied-Signal* for determining apportionable income. The Committee draft states the relevant determination as,  

Under the functional test, income from intangible property is business income when the intangible property serves an operational as opposed to solely an investment function. The relevant inquiry focuses on whether the property is or was held in furtherance of the taxpayer's trade or business, that is, on the objective characteristics of the intangible property's use or acquisition and its relation to the taxpayer and the taxpayer's activities. The functional test is not satisfied where the holding of the property is limited to solely an investment function as is the case where the holding of the property is limited to mere financial betterment of the taxpayer in general.
- i. Do you agree that the functional test of UDITPA appears awfully close to the constitutional test the U.S. Supreme Court recognized in *Allied-Signal* for determining apportionable income? If not, what is your disagreement and what authority would you cite to support your position?
- ii. Do you agree with the quoted provision? If not what is the basis of your disagreement and what authority do you have for your disagreement?
5. The Committee draft contains few new examples of the principles stated. What need is there for newer examples?
  - a. Do you think examples create more confusion than enlightenment?
  - b. Do you have any specific examples you would like to see added to the regulation?
- E. What other provisions of the Committee draft should be discussed. You are invited to bring written suggested revisions with you and to leave them with the staff of the Commission, if that be your desire.

III. Formation of the Working Group. Are there suggestions as to how the Working Group should actually be formed?

**MULTISTATE TAX COMMISSION**  
**ALLOCATION AND APPORTIONMENT REGULATIONS**  
(adopted February 21, 1973, as revised through July 30, 1993)

(INTEGRATING AMENDMENT REGARDING CLASSIFICATION OF INCOME AS BUSINESS OR  
NONBUSINESS—APRIL 1995 PROPOSAL)

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~~•• Reg. IV.1.(a). Business and Nonbusiness Income Defined.~~ Article IV.1.(a) defines "business income" as income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. In essence, all income which arises from the conduct of trade or business operations of a taxpayer is business income. For purposes of administration of Article IV, the income of the taxpayer is business income unless clearly classifiable as nonbusiness income. (1) **Apportionment and Allocation.** Article IV.1(a) and (e) require that every item of income be classified either as business income or nonbusiness income. Income for purposes of classification as business or nonbusiness includes gains and losses. Business income is apportioned among jurisdictions by use of a formula. Nonbusiness income is specifically assigned or allocated to one or more specific jurisdictions pursuant to express rules. An item of income is classified as business or nonbusiness by determining first whether it falls within the definition of business income. An item of income may only be classified as nonbusiness income if it does not meet the definitional requirements for being classified as business income.

~~—Nonbusiness income means all income other than business income.~~

(2) **Business Income.** Business income means income of any type or class, and from any activity, that meets the relationship described either in IV.1.(a).(3), the "transactional test", or (4), the "functional test".

(A) The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, nonoperating income, ~~etc.~~ etc., is of no aid in determining whether income is business or non-business income. ~~Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is "business income" or "nonbusiness income" is the identification of the transactions and activity which are the elements of a particular trade or business. In general all transactions and activities of the taxpayer which are dependent upon or contribute to the operations of the taxpayer's economic enterprise as a whole~~

~~constitute the taxpayer's trade or business and will be transactions and activity arising in the regular course of, and will constitute integral parts of, a trade or business. (See Regulation IV.1.(c) for more specific examples of the classification of income as business or nonbusiness income; see Regulation IV.1.(b) and IV.2.(b)(2) for further explanation of what constitutes a trade or business.)~~

(B) All income of the taxpayer is business income unless clearly classifiable as nonbusiness income. A taxpayer seeking to overcome a classification of income as business income must establish by clear and cogent evidence that the income has been incorrectly classified.

(3) **Transactional Test.** Business income includes income arising from transactions and activity in the regular course of the taxpayer's trade or business.

(A) If the transaction or activity is in the regular course of the taxpayer's trade or business, part of which trade or business is conducted within [this State], the resulting income of the transaction or activity is business income for [this State]. Income may be business income even though the actual transaction or activity that gives rise to the income does not occur in [this State].

(B) For a transaction or activity to be in the regular course of the taxpayer's trade or business, the transaction or activity need not be one that frequently occurs in the trade or business, although most frequently occurring transactions or activities will be in the regular course of that trade or business. It is sufficient to classify a transaction or activity as being in the regular course of a trade or business, if it is reasonable to conclude transactions of that type are customary in the kind of trade or business being conducted or are within the scope of what that kind of trade or business does.

(4) **Functional test.** Business income also includes income from tangible and intangible property, if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

(A) Under the functional test, business income need not be derived from transactions or activities that are in the regular course of the taxpayer's own particular trade or business. It is sufficient, if the property from which the income is derived is or was an integral, functional, necessary, or operative component to the taxpayer's trade or business operations, part of which trade or business is or was conducted within this State.

(B) Income that is derived from isolated sales, leases, assignments, licenses, and other infrequently occurring dispositions, transfers, or transactions

involving property, including transactions made in liquidation or the winding-up of business, is business income, if the property is or was used in the taxpayer's trade or business operations. 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.

(C) Under the functional test, income from intangible property is business income when the intangible property serves an operational as opposed to solely an investment function. The relevant inquiry focuses on whether the property is or was held in furtherance of the taxpayer's trade or business, that is, on the objective characteristics of the intangible property's use or acquisition and its relation to the taxpayer and the taxpayer's activities. The functional test is not satisfied where the holding of the property is limited to solely an investment function as is the case where the holding of the property is limited to mere financial betterment of the taxpayer in general.

(D) If the property is or was held in furtherance of the taxpayer's trade or business beyond mere financial betterment, then income from that property may be business income even though the actual transaction or activity involving the property that gives rise to the income does not occur in [this State].

(E) If with respect to an item of property a taxpayer (i) takes a deduction from business income that is apportioned to [this State] or (ii) includes the original cost in the property factor, it is presumed that the item or property is or was integral to the taxpayer's trade or business operations. No presumption arises from the absence of any of these actions.

(F) Application of the functional test is generally unaffected by the form of the property (e.g., tangible or intangible property, real or personal property). Income arising from intangible property, as for example, corporate stock or other intangible interest in a business, is business income when the intangible itself or the underlying value of the intangible is or was an integral, functional, necessary or operative component to the taxpayer's trade or business operations. Thus, while apportionment of income derived from transactions involving intangible property as business income may be supported by a finding that the issuer of the intangible property and the taxpayer are engaged in the same trade or business, i.e., the same unitary business, establishment of such a relationship is not the exclusive basis for concluding that the income is subject to apportionment. It is

sufficient to support the finding of apportionable income if the holding of the intangible property served an operational rather than an investment function.

(5) **Relationship of transactional and functional tests to U.S. Constitution.** The Due Process Clause and the Commerce Clause of the U.S. Constitution restrict States from apportioning income as business income that has no rational relationship with the taxing State. The protection against extra-territorial state taxation afforded by these Clauses is often described as the “unitary business principle.” The unitary business principle requires apportionable income to be derived from the same unitary business that is being conducted at least in part in [this State]. The unitary business that is conducted in [this State] includes both the unitary business that the taxpayer alone may be conducting and any unitary business the taxpayer may conduct with any other person or persons. Satisfaction of either the transactional test or the functional complies with the unitary business principle, because each test requires that the transaction or activity (in the case of the transactional test) or the property (in the case of the functional test) to be tied to the same trade or business that is being conducted within [this State]. Determination of the scope of the unitary business being conducted in [this State] is without regard to extent to which [this State] requires or permits combined reporting.

(6) **Nonbusiness income.** Nonbusiness income means all income other than business income.

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**•• Reg. IV.1.(c). Business and Nonbusiness Income: Application of Definitions.** The following are rules and examples applies the foregoing principles for purposes of determining whether particular income is business or nonbusiness income. (The examples used throughout these regulations are illustrative only and do not purport to set forth all pertinent facts.)

**(1) Rents from real and tangible personal property.** Rental income from real and tangible property is business income if the property with respect to which the rental income was received is used in the taxpayer's trade or business or incidental thereto and therefore is includable in the property factor under Regulation IV.10.

*Example (i):* The taxpayer operates a multistate car rental business. The income from car rentals is business income.

*Example (ii):* The taxpayer is engaged in the heavy construction business in which it uses equipment such as cranes, tractors, and earth-moving vehicles. The taxpayer makes short-term leases of the equipment when

particular pieces of equipment are not needed on any particular project. The rental income is business income.

*Example (iii):* The taxpayer operates a multistate chain of men's clothing stores. The taxpayer purchases a five-story office building for use in connection with its trade or business. It uses the street floor as one of its retail stores and the second and third floors for its general corporate headquarters. The remaining two floors are leased to others. The rental of the two floors is incidental to the operation of the taxpayer's trade or business. The rental income is business income.

*Example (iv):* The taxpayer operates a multistate chain of grocery stores. It purchases as an investment an office building in another state with surplus funds and leases the entire building to others. The net rental income is not business income of the grocery store trade or business. Therefore, the net rental income is nonbusiness income.

*Example (v):* The taxpayer operates a multistate chain of men's clothing stores. The taxpayer invests in a 20-story office building and uses the street floor as one of its retail stores and the second floor for its general corporate headquarters. The remaining 18 floors are leased to others. The rental of the eighteen floors is not incidental to but rather is separate from the operation of the taxpayer's trade or business. The net rental income is not business income of the clothing store trade or business. Therefore, the net rental income is nonbusiness income.

*Example (vi):* The taxpayer constructed a plant for use in its multistate manufacturing business and 20 years later the plant was closed and put up for sale. The plant was rented for a temporary period from the time it was closed by the taxpayer until it was sold 18 months later. The rental income is business income and the gain on the sale of the plant is business income.

*Example (vii):* The taxpayer operates a multistate chain of grocery stores. It owned an office building which it occupied as its corporate headquarters. Because of inadequate space, taxpayer acquired a new and larger building elsewhere for its corporate headquarters. The old building was rented to an investment company under a five-year lease. Upon expiration of the lease, taxpayer sold the building at a gain (or loss). The net rental income received over the lease period is nonbusiness income and the gain (or loss) on the sale of the building is nonbusiness income.

**(2) Gains or losses from sales of assets.** Gain or loss from the sale, exchange or other disposition of real property or of tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used

in, or was otherwise included in the property factor of, the taxpayer's trade or business. However, if the property was utilized for the production of nonbusiness income or otherwise was removed from the property factor before its sale, exchange or other disposition, the gain or loss will constitute nonbusiness income. See Regulation IV.10.

*Example (i):* In conducting its multistate manufacturing business, the taxpayer systematically replaces automobiles, machines, and other equipment used in the business. The gains or losses resulting from those sales constitute business income.

*Example (ii):* The taxpayer constructed a plant for use in its multistate manufacturing business and 20 years later sold the property at a gain while it was in operation by the taxpayer. The gain is business income.

*Example (iii):* Same as (ii) except that the plant was closed and put up for sale but was not in fact sold until a buyer was found 18 months later. The gain is business income.

*Example (iv):* Same as (ii) except that the plant was rented while being held for sale. The rental income is business income and the gain on the sale of the plant is business income.

*Example (v):* The taxpayer operates a multistate chain of grocery stores. It owned an office building which it occupied as its corporate headquarters. Because of inadequate space, taxpayer acquired a new and larger building elsewhere for its corporate headquarters. The old building was rented to an unrelated investment company under a five-year lease. Upon expiration of the lease, taxpayer sold the building at a gain (or loss). The gain (or loss) on the sale is nonbusiness income and the rental income received over the lease period is nonbusiness income.

*Example (vi):* Taxpayer operated a business as a corporate division for a number of years. No part of the activities of this corporate division was conducted in [this State], although the taxpayer conducted other activities in [this State]. Taxpayer later sells all of the assets of the corporate division, no part of whose activities was ever conducted in [this State]. If the business of the sold division was a part of the same unitary business conducted in [this State] or if taxpayer's ownership of the division furthered the unitary business being conducted in [this State] beyond mere financial betterment, then the income derived from the sale of the division is business income.

**(3) Interest.** Interest income is business income where the intangible with respect to which the interest was received arises out of or was created in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the intangible is ~~related to or incidental to such an~~ integral, functional, necessary, or operative component to the taxpayer's trade or business operations.

*Example (i):* The taxpayer operates a multistate chain of department stores, selling for cash and on credit. Service charges, interest, or time-price differentials and the like are received with respect to installment sales and revolving charge accounts. These amounts are business income.

*Example (ii):* The taxpayer conducts a multistate manufacturing business. During the year the taxpayer receives a federal income tax refund and collects a judgment against a debtor of the business. Both the tax refund and the judgment bear interest. The interest income is business income.

*Example (iii):* The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business, the taxpayer maintains special accounts to cover such items as workmen's compensation claims, rain and storm damage, machinery replacement, etc. The moneys in those accounts are invested at interest. Similarly, the taxpayer temporarily invests funds intended for payment of federal, state and local tax obligations. The interest income is business income.

*Example (iv):* The taxpayer is engaged in a multistate money order and traveler's check business. In addition to the fees received in connection with the sale of the money orders and traveler's checks, the taxpayer earns interest income by the investment of the funds pending their redemption. The interest income is business income.

*Example (v):* The taxpayer is engaged in a multistate manufacturing and selling business. The taxpayer usually has working capital and extra cash totaling \$200,000 which it regularly invests in short-term interest bearing securities. The interest income is business income.

~~—*Example (vi):* In January, the taxpayer sold all of the stock of a subsidiary for \$20,000,000. The funds are placed in an interest-bearing account pending a decision by management as to how the funds are to be utilized. The interest income is nonbusiness income.~~

Example (vi): In January, the taxpayer concluded a transaction in which it generates a cash fund of \$20,000,000. The funds generated are placed in a segregated, interest-bearing account pending a decision by management as to how the funds are to be utilized. For the next six months management has under consideration the alternative possibilities of investing the proceeds in the existing unitary business or distributing the proceeds to the shareholders as a dividend. Until a final determination is made to distribute the proceeds to the shareholders as a dividend, the interest income is business income. All income is business income unless clearly classified as nonbusiness income and until the final determination was made the fund was available for future operation of the taxpayer's existing unitary business.

**(4) Dividends.** Dividends are business income where the stock with respect to which the dividends are received arises out of or was acquired in the regular course of the taxpayer's trade or business operations or where the purpose of acquiring and holding the stock is related to or incidental to such an integral, functional, necessary, or operative component to the taxpayer's trade or business operations.

*Example (i):* The taxpayer operates a multistate chain of stock brokerage houses. During the year, the taxpayer receives dividends on stock that it owns. The dividends are business income.

*Example (ii):* The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business, the taxpayer maintains special accounts to cover such items as workmen's compensation claims, *etc.* ~~A portion of the moneys in those accounts is invested in interest-bearing bonds.~~ The remainder is moneys are invested in various common stocks listed on national stock exchanges. ~~Both the interest income and any~~ Any dividends received are business income.

*Example (iii):* The taxpayer and several unrelated corporations own all of the stock of a corporation whose business operations consist solely of acquiring and processing materials for delivery to the corporate owners. The taxpayer acquired the stock in order to obtain a source of supply of materials used in its manufacturing business. The dividends are business income.

*Example (iv):* The taxpayer is engaged in a multistate heavy construction business. Much of its construction work is performed for agencies of the federal government and various state governments. Under state and federal laws applicable to contracts for these agencies, a contractor must have adequate bonding capacity, as measured by the ratio of its current assets

(cash and marketable securities) to current liabilities. In order to maintain an adequate bonding capacity the taxpayer holds various stocks and interest-bearing securities. Both the interest income and any dividends received are business income.

*Example (v):* The taxpayer receives dividends from the stock of its subsidiary or affiliate which acts as the marketing agency for products manufactured by the taxpayer. The dividends are business income.

*Example (vi):* The taxpayer is engaged in a multistate glass manufacturing business. It also holds a portfolio of stock ~~and interest-bearing securities~~, the acquisition and holding of which ~~are unrelated to~~ fulfill no operational purpose for the manufacturing business. The dividends ~~and interest income~~ received are nonbusiness income.

**(5) Patent and copyright royalties.** Patent and copyright royalties are business income where the patent or copyright with respect to which the royalties were received arises out of or was created in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the patent or copyright is ~~related to or incidental to such~~ an integral, functional, necessary, or operative component to the taxpayer's trade or business operations.

*Example (i):* The taxpayer is engaged in the multistate business of manufacturing and selling industrial chemicals. In connection with that business, the taxpayer obtained patents on certain of its products. The taxpayer licensed the production of the chemicals in foreign countries, in return for which the taxpayer receives royalties. The royalties received by the taxpayer are business income.

*Example (ii):* The taxpayer is engaged in the music publishing business and holds copyrights on numerous songs. The taxpayer acquires the assets of a smaller publishing company, including music copyrights. These acquired copyrights are thereafter used by the taxpayer in its business. Any royalties received on these copyrights are business income.

*Example (iii):* Same as example (ii), except that the acquired company also held the patent on a ~~type of phonograph needle~~ method of producing digital audio recordings. The taxpayer does not manufacture or sell ~~phonographs or phonograph equipment~~ digital audio recordings. Any royalties received on the patent would be nonbusiness income.

\* \* \* \* \*

•• Reg. IV.2.(a). Definitions.

\* \* \* \* \*

(4) “Business activity” refers to the transactions and ~~activity~~ activities occurring in the regular course of a particular trade or business of a taxpayer or to the acquisition, management, and disposition of property that constitute integral parts of the taxpayer’s regular trade or business operations.

[Ed. Note: Note where the term “business activity” is used in the MTC regulations:

- IV.1.(b)., *example*;
- IV.2.(b).(1);
- IV.3.(a).;
- IV.3.(a).(1);
- IV.3.(a).(2);
- IV.3.(b).(1);
- IV.3.(b).(1)(A);
- IV.3.(b).(1)(B);
- IV.3.(b).(1)(B), *example*;
- IV.3.(b).(2);
- IV.3.(b).(2), *example (i)*;
- IV.3.(b).(2), *example (iv)*;
- IV.3.(c).;
- IV.18.(a).;
- IV.18.(a).(3);
- IV.18.h.(4)(iii)A.2.;
- IV.18.(j).(1);
- IV.18.(j).(3)(i)B.2.;
- IV.18.(j).(3)(i)B.3.; and
- The financial institution apportionment principles to the extent that States adopt the uniformity recommendation as a regulation that is folded into the existing MTC regulations and thereby picks up the floating definition of “business activity”.]

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••• **Reg. IV.10.(a). Property Factor: In General.** The property factor of the apportionment formula for each trade or business of the taxpayer shall include all real and tangible personal property owned or rented by the taxpayer and used during the tax period in the regular course of the trade or business. The term “real and tangible personal property” includes land, buildings, machinery, stocks of goods, equipment, and other real and tangible personal property but does not include coin or currency. Property used in connection with the production of nonbusiness income shall be excluded from the property factor. Property used

both in the regular course of the taxpayer's trade or business and in the production of nonbusiness income shall be included in the factor only to the extent that the property is used in the regular course of the taxpayer's trade or business. The method of determining that portion of the value to be included in the factor will depend upon the facts of each case. The property factor shall include the average value of property includable in the factor. See Regulation IV.12.

**••• Reg. IV.10.(b). Property Factor: Property Used for the Production of Business Income.** Property shall be included in the property factor if it is actually used or is available for or capable of being used during the tax period in the regular course of the trade or business of the taxpayer. Property held as reserves or standby facilities or property held as a reserve source of materials shall be included in the factor. For example, a plant temporarily idle or raw material reserves not currently being processed are includable in the factor. Property or equipment under construction during the tax period (except inventoriable goods in process) shall be excluded from the factor until such property is actually used in the regular course of the trade or business of the taxpayer. If the property is partially used in the regular course of the trade or business of the taxpayer while under construction, the value of the property to the extent used shall be included in the property factor. 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 the lapse of an extended period of time (normally, five years) during which the property is held for sale.

\* \* \* \* \*

**••• Reg. IV.11.(b). Property Factor: Valuation of Rented Property.**

**(1) Multiplier and subrentals.** Property rented by the taxpayer is valued at eight times its net annual rental rate. The net annual rental rate for any item of rented property is the annual rental rate paid by the taxpayer for the property less the aggregate annual subrental rates paid by subtenants of the taxpayer. (See Regulation IV.18.(a) for special rules when the use of such net annual rental rate produces a negative or clearly inaccurate value or when property is used by the taxpayer at no charge or is rented at a nominal rental rate.)

Subrents are not deducted when they constitute business income because the property which produces the subrents is used in the regular course of a trade or business of the taxpayer when it is producing such income. Accordingly there is no reduction in its value.

*Example (i):* The taxpayer receives subrents from a bakery concession in a food market operated by the taxpayer. Since the subrents are business income, they are not deducted from rent paid by the taxpayer for the food market.

*Example (ii):* The taxpayer rents a 5-story office building primarily for use in its multistate business, uses three floors for its offices and subleases two floors to various other businesses and persons such as professional people and shops. The rental of the two floors is incidental to the operation of the taxpayer's trade or business. Since the subrents are business income, they are not deducted from the rent paid by the taxpayer.

*Example (iii):* The taxpayer rents a 20-story office building and uses the lower two stories for its general corporation headquarters. The remaining 18 floors are subleased to others. The rental of the eighteen floors is not incidental to but rather is separate from the operation of the taxpayer's trade or business. Since the subrents are nonbusiness income they are to be deducted from the rent paid by the taxpayer.

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•• **Reg. IV.13.(a). Payroll Factor: In General.**

\* \* \* \* \*

(2) The total amount "paid" to employees is determined upon the basis of the taxpayer's accounting method. If the taxpayer has adopted the accrual method of accounting, all compensation properly accrued shall be deemed to have been paid. Notwithstanding the taxpayer's method of accounting, compensation paid to employees may, at the election of the taxpayer, be included in the payroll factor by use of the cash method if the taxpayer is required to report such compensation under that method for unemployment compensation purposes.

The compensation of any employee on account of activities which are connected with the production of nonbusiness income shall be excluded from the factor.

\* \* \* \* \*

•• **Reg. IV.18.(c). Special Rules: Sales Factor.** The following special rules are established in respect to the sales factor of the apportionment formula:

\* \* \* \* \*

(3) Where the income producing activity in respect to business income from intangible personal property can be readily identified, the income is included

in the denominator of the sales factor and, if the income producing activity occurs in this state, in the numerator of the sales factor as well. For example, usually the income producing activity can be readily identified in respect to interest income received on deferred payments on sales of tangible property (Regulation IV.15.(a)(1)(A)) and income from the sale, licensing or other use of intangible personal property (Regulation IV.17.(2)(D)).