

July 31, 1996

Mr. Paul Mines
General Counsel
Multistate Tax Commission
444 North Capitol Street, N.W., Suite 425
Washington, DC 20001-1538

Re: MTC Regulation IV.1.(a). Business and Nonbusiness Income Defined

Dear Mr. Mines:

Enclosed are the American Institute of Certified Public Accountant's comments on the Multistate Tax Commission proposed amendment of *MTC Regulation IV.1.(a). Business and Nonbusiness Income Defined*. These comments were developed by members of the State and Local Taxation Committee.

We would be pleased to discuss the comments and proposed amendment with you or a member of your staff. You may contact one of the following: me at (202) 467-3004; Debbie Manos-McHenry, Chair of the State and Local Taxation Committee, at (216) 689-7836; or Eileen Sherr, AICPA Technical Manager, at (202) 434-9256.

Sincerely,



Deborah Walker
Chair
Tax Executive Committee

Enclosure

DW/ers/kbl

cc: Dan Bucks, Executive Director of the MTC
Deborah Manos-McHenry, Chair of the State and Local Taxation Committee

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Comments Regarding Multistate Tax Commission Proposed Amendment to
MTC Regulation IV.1.(a). Business and Nonbusiness Income Defined

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State & Local Taxation Committee - Business and Nonbusiness Income Working Group

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Approved By:

State and Local Taxation Committee

and

Tax Executive Committee

Submitted to the Multistate Tax Commission
July 31, 1996

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
Comments Regarding Multistate Tax Commission Proposed Amendment to
MTC Regulation IV.1.(a). Business and Nonbusiness Income Defined
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GENERAL COMMENTS

In April, 1995, the Executive Committee of the Multistate Tax Commission (MTC) released a proposed amendment to regulations regarding the classification of income as business or nonbusiness. The proposed amendment is designed to clarify confusion over the limits of business (apportionable) income. In particular, the amendment attempts to reconcile the transactional and functional tests for distinguishing business income with the constitutional limitations on the scope of apportionable income. As these comments will point out, it seems that the MTC has not fully accomplished this goal. *As a result, we recommend that the MTC revise its proposed amendment to MTC Reg. IV.1.(a) to abandon the transactional and functional test and instead clarify the unitary business and the operational and investment function tests that are established by the U.S. Supreme Court.*

Traditionally, the U.S. Supreme Court has interpreted the Constitution as prohibiting the apportionment of income derived from a non-unitary business. *See, e.g. ASARCO Inc. v. Idaho Department of Revenue*, 458 U.S. 354 (1982); *F.W. Woolworth Co. v. Taxation & Revenue Department*, 458 U.S. 354 (1982). Ten years after these two cases, the Court held, however, that a unitary business determination is not the exclusive means of finding apportionable business income. In *Allied-Signal, Inc. v. Director, Division of Taxation*, 112 S. Ct. 2251 (1992), the Court held that a transaction or activity may create business income, if it serves an operational rather than an investment function. Hence, the Court has established another test for classifying income: the operational versus investment function test.

SPECIFIC COMMENTS

Before commenting on the proposed amendment, several points should be addressed regarding the need for the transactional and functional tests to distinguish between business and nonbusiness income as set forth in Article IV, Division of Income, Multistate Tax Compact, which adopts the Uniform Division of Income for Tax Purposes Act (UDITPA) and in MTC Reg. IV.1.(a)(3)&(4).

First, the definition of business income under UDITPA §1(a) does not plainly include a separate "functional test." Instead, business income is defined as income meeting the transactional test and is said to include income which meets the functional test. If the MTC plans to include a separate functional test in its regulations, it should recommend a statutory change which clearly sets forth the functional test as a separate and distinct test for determining business income. We note that a regulation, even an interpretive regulation, can only interpret the statutory language. While the U.S. Supreme Court guidelines for determining allocable or apportionable income are intended to accomplish the same function as the statutory definition of business or nonbusiness income, they do not interpret the meaning of the statutory language "transactions and activities in the"

Even more fundamental than the need to clarify whether the functional test is a separate and distinct test from the transactional test is the need to consider whether either of these tests are desirable. It is difficult to clear up the confusion in distinguishing business from nonbusiness income when the

Court sets forth certain tests and the MTC expounds separate and distinct tests. Since the U.S. Supreme Court has made it clear that the unitary business test, as well as the operational versus investment function test are the constitutional limitations on business income, the transactional and functional tests appear at the best unnecessary and at the worst confusing. Although the attempt of the proposed amendment to reconcile the functional and transactional tests with the constitutional limitations on business income is a desirable goal, a better goal would be to conform Article IV of the Multistate Tax Compact and the MTC Regulations with the constitutional limitations by eliminating the unnecessary proliferation of standards and tests. While the intent of the MTC appears to be to define business income as broadly as constitutionally allowable, it is difficult to see why any tests other than the ones set forth by the Court are needed.

Putting aside this initial objection to the need for the functional and transactional tests, it is then necessary to determine whether the proposed amendment successfully reconciles those tests with the constitutional limitations on business income. The proposed regulations do attempt to incorporate the operational and investment function test. For instance, under proposed Reg. IV.1.(a)(4)(C), income from intangible property is deemed business income when the intangible property "serves an operational as opposed to solely an investment function." Similarly, in sections dealing with the classification of interest (Reg. IV.1.(c)(3)), dividends (Reg. IV.1.(c)(4)), and patent and copyright royalties (Reg. IV.1.(c)(5)), the proposed amendment adds the phrase "operative component" of the taxpayer's trade or business as an indicator of business income.

The proposed regulations also attempt to reconcile the unitary business test with the functional and transactional tests. A new section (5) is added to Reg. IV.1.(a) to explain how "satisfaction of either the transactional test or the functional test complies with the unitary business principle." This explanation is questionable. It is doubtful whether the current U.S. Supreme Court would hold that satisfaction of the transactional or functional test meets the constitutional requirement for finding business income. The unitary business test deals with the interdependence and interrelationship of business units as evidenced by functional integration, centralized management and economics of scale. It is possible to have business income without meeting the unitary business test. In fact, the Court in *Allied-Signal* recognized such a possibility and held that a unitary business determination is not the exclusive means of finding apportionable business income. It is because the Court recognized the existence of business income outside the scope of the unitary business principle that it formulated the operational versus investment function test. By way of example, the Court points out that income received from stock of a company held by a corporation to assure a steady supply of raw materials for the corporation's production process would presumably constitute business income even if the supplier were not part of the taxpayer's unitary business. In light of the Court's position, it would seem misleading to assert that satisfaction of either the transactional test or the functional test (which under the regulations are the only ways to create business income) also satisfies the unitary business test (which is clearly not the only means for determining business income).

There are several instances in the proposed regulations where a presumption in favor of finding business income arguably goes beyond the standard of fairness and possibly the constitutional limitations. For instance, the proposed Reg. IV.1(a)(2)(B) states that "[a]ll income of the taxpayer is business income unless clearly classifiable as nonbusiness income." Furthermore, the proposed

regulations set forth a presumption of business income that must be overcome by "clear and cogent evidence." This burden of proof for showing nonbusiness income appears to be unjustifiably high.

Similarly, in the proposed *Example (vi)* to Reg. IV.1.(c).(3), it is asserted, "All income is business income unless clearly classified as nonbusiness income." As a result, it is concluded that a segregated cash fund generates business income even though there has been no decision to utilize the funds in the unitary business. The mere availability of funds for use in the unitary business results in a business income determination. However, under such a standard, it would seem impossible to have any nonbusiness investment income since there is always the possibility of using any investment income in the business.

In proposed Reg. IV.1.(a).(4)(E), the regulations would presume that an item of property is part of the unitary business if the taxpayer "takes a deduction from business income" or "includes the original cost in the property factor." However, the regulations would allow no presumption in favor of nonbusiness income by the absence of any of these actions. Such a presumption in favor of business income without a corresponding presumption in favor of nonbusiness income is unfair.

The regulations also fail to allow for a change from assets producing business income to nonbusiness income. Proposed Reg. IV.1.(a)(4)(B) suggests that if property were ever used in the taxpayer's business, its sale must forever produce business income. Even if the taxpayer does not remain in the same trade or business, the proposed regulation would classify the sale of the asset as business income. It seems unreasonable to foreclose the possibility of a business asset becoming an investment asset after a change in the taxpayer's business. For instance, if property were acquired for business use, but then taken out of business use and held as an investment for twenty years before sold, it seems unreasonable (and more importantly, unconstitutional) to classify the proceeds from the sale as business income.

In conclusion, it is doubtful whether the proposed amendment to the regulations would clarify the confusion concerning the distinction between business and nonbusiness income. Just as the constitutional limitations on business income are amorphous and difficult to interpret, so too are the transactional and functional tests set forth in the regulations. First, it is unclear whether under UDITPA, these tests are meant to be separate and distinct from each other. More importantly, it is difficult to reconcile the transactional and functional tests with the constitutional limitations for determining business income. For these reasons, we recommend that the MTC abandon the transactional and functional tests. Instead, the MTC should concentrate on clarifying the unitary business and the operational and investment function tests established by the U.S. Supreme Court. New regulations should be drafted that would be based on the constitutional limitations on business income rather than merely attempting to reconcile these limitations with tests that are not approved by the U.S. Supreme Court. If the MTC plans to retain the functional and transactional tests, it is imperative that they do not transgress constitutional limitations. In this regard, it would be advisable to delete certain presumptions in the regulations in favor of finding business income.

We welcome the opportunity to discuss these comments with the MTC staff informally, or in the context of a working group.