

Follow up information to UDITPA Section 1 Work Group Meeting held on Thursday, May 21, 2015.

Item #1:

Pages 3 and 4, Subsection (5)¹

“Relates to the operation of the business” refers to property that ~~constituted a part of the composite whole of the trade or business, each part of which gave value to every other part, in a manner which~~ materially contributed to the production of apportionable income.

Comment: It may be helpful for staff to analyze the court cases cited by Shirley against the definition of “related to the operation” to see if the phrase “constituted a part of the composite whole of the trade or business, each part of which gave value to every other part, in a manner which” is language that could or should be removed from the definition.

In Shirley’s memo date May 3, 2012, she provides the following analysis starting on Page 9:

The fourth functional test clarification is to require that the property be “related to the operation,” rather than constitute an “integral part,” of the taxpayer’s trade or business. In the current rule, the term “integral” is the touchstone for determining whether property has a close enough relationship to the taxpayer to satisfy the functional test. But the term is subject to multiple interpretations. In *Hoechst Celanese*, the California Supreme Court explained that interpreting “integral” as “contributing to” could be unconstitutionally broad, while interpreting “integral” as “necessary to” or “essential to” would be too restrictive (since no asset would be sold if it were necessary or essential). [footnote omitted] The Court found that “integral” should be construed somewhere between these two – e.g., “materially contributing to.” [footnote omitted] The language of the U.S. Supreme Court in *Container* and *Allied Signal* requires that the property from which the income arises performed an “operational” function, that it be “operationally related to” or “related to the operation of” the taxpayer’s business, in order for the income to be apportionable. [footnote omitted] This phrase – “related to the operation” – was chosen because it is more concrete than “integral part” and it satisfies the concern expressed in *Hoechst* by specifying how the property must contribute to the business – i.e., operationally. (Emphasis underlying added)

See at [http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Events/2013-14_Committee_Meetings/Exhibit%202%20Memo%20from%20Shirley%20Sicilian%20to%20Cory%20Fong%20Art%20IV%20%20\(05-03-2012\).pdf](http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Events/2013-14_Committee_Meetings/Exhibit%202%20Memo%20from%20Shirley%20Sicilian%20to%20Cory%20Fong%20Art%20IV%20%20(05-03-2012).pdf)

¹ The pages references are to the clean draft current as of May 20, 2015.

Item #2:

Page 4, Subsection (5)(A)

Property, not subject to the rule of the preceding sentence, is property that is no longer related to the operation of the taxpayer's trade or business due to the passage of a sufficiently lengthy period of time (generally, five years is sufficient) or that has been removed as an operational asset from the taxpayer's trade or business and is instead held by the taxpayer's trade or business exclusively for investment purposes ~~has lost its character as a functional asset and is not subject to the rule of the preceding sentence.~~

Item #3:

Page 4, Subsection (5)(B)

(Property that is no longer related to the operation of the taxpayer's trade or business, (see pursuant to subsection (A) of this section, IV.1.a.(5) (A)) ~~has lost its character as a business asset and~~ is not subject to the rule of the preceding sentence.)

Item #4:

Page 5, Subsection (5)(F)

(Property that is no longer related to the operation of the taxpayer's trade or business, (see pursuant to Reg. IV.1.(a).(5)(A)), ~~has lost its character as a functional asset and~~ is not subject to the rule of the preceding sentence.)

Item #5:

Page 14, Reg. IV.1.(c).(1)

(Property that is no longer related to the operation of the taxpayer's trade or business, (see pursuant to Reg. IV.1.(a).(5)(A)), ~~has lost its character as a business asset and~~ is not subject to the rule of the preceding sentence.)

Comment: Items 2 through 5 are an attempt to avoid having to define "operational asset", "functional asset", or "business asset".

Item #6:
Page 16, Reg. IV.1.(c).(3)

(3) Interest. Interest income is apportionable income where the intangible with respect to which the interest was received arose out of or was created in the regular course of the taxpayer's trade or business or where the acquiring and holding the intangible is related to the operation of the taxpayer's trade or business, ~~or otherwise~~ and materially contributes to the production of apportionable income of the trade or business.

Comment: The portion of the sentence “arose out of or was created in the regular course of the taxpayer's trade or business” appears to be referring to the transactional test. The next language following the “or” “where the acquiring and holding the intangible is related to the operation of the taxpayer's trade or business”, appears to be referring to the “functional test.” Doesn't the remaining “materially contributes” language refer to just the functional test? If so, would changing “or otherwise” to “and” clarify the role “materially contributes” plays in this example, create more confusion, or result in unintended consequences?

If we make the change to “and”, a similar change would need to be made on Page 17 (Dividends), Page 18 (Patent and copyright royalties)