



**To: The MTC Uniformity Project Workgroup on
Model Regulations for Section 1(g) “Receipts”**

From: Helen Hecht, MTC General Counsel

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**Subject: DISCUSSION DRAFT
Review of Existing Model Allocation and Apportionment
Rules Relevant to the Project**

Summary

The workgroup is considering what regulations may be necessary to implement the amendment to UDITPA Section 1(g)— “receipts” (for purposes of the receipts factor.) The workgroup has identified issues for discussion and consideration. This memo highlights portions of the MTC’s existing model regulations that speak to those issues. It also provides some analysis as to whether applicable model regulations are effectively superseded by the amendment to Sec. 1(g), or related amendments.

The existing regulations that are relevant to this task are not just those that address the term “sales” (now “receipts”), but also that apply Sec. 18 to the receipts factor generally, and that address the transactional and functional tests (under the definition of “business income”). Therefore, this memo also considers regulations in each of these areas. It further considers the relationship between the transactional and functional tests and how that relationship may bear on the new definition of receipts.

While the amendments do not alter general long-standing policy positions of the Commission as reflected in the regulations, the regulations may nevertheless require some modification or revision. This is not meant to limit additions or other changes to the regulations that the workgroup may deem necessary to implement the change in the definition of

“receipts.”

Change in the Definition of Receipts

UDITPA Sec. 1(g), originally read as follows:

“Sales’ means all gross receipts of the taxpayer not allocated under Sections 4 through 8 [allocated nonbusiness income] of this Act.”

The amendment – changed the operative term from sales to “receipts” and redefining it as follows:

“(g) “Receipts” means all gross receipts of the taxpayer that are not allocated under paragraphs of this article, and that are received from transactions and activity in the regular course of the taxpayer’s trade or business; except that receipts of a taxpayer from hedging transactions and from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities, shall be excluded.

In addition to the existing MTC model Allocation and Apportionment Regulations, information contained in the MTC Report Recommending the Amendments (to UDITPA) is useful in understanding whether and how related amendments may reflect a change in the MTC’s longstanding position on the inclusion or exclusion of receipts from the sales factor. Both the existing regulations and this report are posted on the MTC’s project page at: <http://www.mtc.gov/Uniformity/Project-Teams/Section-1-Model-Definition-of-Receipts%E2%80%9D-Regulation>

MTC’s Report Recommending the Amendments

The amendments to the definition of “receipts” have the effect of : 1) including receipts that meet the transactional, but not the functional, test, and 2) excluding certain treasury function receipts. The MTC’s Report Recommending the Amendments notes that the prior definition (of “sales”) explicitly excludes only allocable (nonbusiness) income. The report, however, goes on to note:

But the Commission’s model regulations, in place since 1973, specify “the term ‘sales’ means all gross receipts derived by the taxpayer from “transactions and activity in the regular course of the

trade or business.” This regulatory language mirrors the Compact’s transactional test. The language of the functional test is not included. And the model regulations explicitly exclude certain types of receipts generally associated with functional test income, such as “substantial amounts of gross receipts from an incidental or occasional sale of a fixed asset used in the regular course of the taxpayer’s trade or business.”

Other, more recent Commission regulations further limit “sales” by excluding treasury function transactions – such as repayment of a loan, short-term investments of working capital, or other financial activity – even though income associated with the activity could be included in business income by virtue of the transactional test. Excluding these amounts from the sales factor is consistent with the current rule in the overwhelming majority of states that have addressed the issue. . . .

[The proposed amendment] would place the transactional test limitation, which has been in the Commission’s model regulations since 1973, into the statute. . . .

It’s generally agreed that the purpose of the sales factor is to reflect the taxpayer’s market activity, not its production activity. If that is the case, then the type of receipts that are included in the sales factor should be those that reflect the contribution of the taxpayer’s market to the earning of income. It is unnecessary, and may be counter-productive, to include receipts from transactions involving the taxpayer’s production property – such as plant, machinery, and equipment – in the sales factor. Including receipts from these types of assets would not reflect the market for the taxpayer’s product and could essentially double count the property factor. . . .

Also, basing the definition of “sales” on the purpose of the sales factor has implications for whether to include receipts from the treasury function and other financial activities where there is no “customer” (e.g., receipt of dividends or interest income). If the purpose of the sales factor is to reflect the taxpayer’s market for its product, then, unless the taxpayer is a securities dealer, receipts from its treasury function and other financial activities should be excluded. These exclusions are consistent with the Commission’s

current model regulations. . . .

The report then gives the following examples of how the amendments were intended to be applied:

- Taxpayer manufactures a tangible product that it sells at wholesale. Taxpayer's income from these sales meets the transactional test and is treated as business income.
 - The gross receipts are "sales" for sales factor purposes.
 - The answer does not change if instead of manufacturing tangible property for sale at wholesale, Taxpayer sells or leases tangible property at retail, sells or licenses intangible property at wholesale or retail, sells or leases real property, or sells a service.
- In the course of its manufacturing process, Taxpayer produces a byproduct that it sells at retail. Taxpayer's income from these sales meets the transactional test and is treated as business income.
 - The gross receipts are "sales" for sales factor purposes.
- Taxpayer makes an incidental or occasional sale of a large piece of equipment that it used to manufacture its product. The income from this sale meets the functional test and is treated as business income.
 - The gross receipts are not "sales" for sales factor purposes.
- Taxpayer routinely sells and replaces a certain type of equipment used in the production of its product (e.g., fleet vehicles). Taxpayer's income from these sales meets the transactional test and is treated as business income.
 - The gross receipts are "sales" for sales factor purposes.
- Taxpayer makes an installment sale and receives interest income on the installment payments.
 - The interest on installment payments is included as gross receipts for sales factor purposes.
- Taxpayer is not a securities dealer, but earns interest income from short-term investment of working capital. This income meets the transactional test and is treated as business income.

- The gross receipts are not “sales” for sales factor purposes.
- Taxpayer is not a securities dealer, but earns income from hedging transactions which were entered into mainly to control for variation in input prices. The income from these transactions meets the transactional test and is treated as business income.
 - The gross receipts are not “sales” for sales factor purposes.
- Taxpayer is a securities dealer, and earns interest income on its securities, and other income from hedging transactions and securities sales. The income from these transactions meets the transactional test and is treated as business income.
 - The gross receipts are “sales” for sales factor purposes.

Analysis of the Existing Sec. 1 (g) Regulations

The following are the existing MTC model regulations addressing Sec. 1(g)—the definition of “sales” (“receipts”) and “gross receipts” (as used in the prior definition of sales) and the “sales factor” (or “receipts factor”). Given the workgroup’s recent discussion of various issues, the most critical provisions are highlighted.

Reg. IV.2.(a). Definitions.

...

(5) “Gross receipts” are the gross amounts realized (the sum of money and the fair market value of other property or services received) on the sale or exchange of property, the performance of services, or the use of property or capital (including rents, royalties, interest and dividends) in a transaction which produces business income, in which the income or loss is recognized (or would be recognized if the transaction were in the United States) under the Internal Revenue Code. Amounts realized on the sale or exchange of property are not reduced for the cost of goods sold or the basis of property sold. Gross receipts, even if business income, do not include such items as, for example:

- 1) repayment, maturity, or redemption of the principal of a loan, bond, or mutual fund or certificate of deposit or similar marketable instrument;
- 2) the principal amount received under a repurchase agreement or other transaction properly characterized as a loan;

- 3) proceeds from issuance of the taxpayer's own stock or from sale of treasury stock;
- 4) damages and other amounts received as the result of litigation;
- 5) property acquired by an agent on behalf of another;
- 6) tax refunds and other tax benefit recoveries;
- 7) pension reversions;
- 8) contributions to capital (except for sales of securities by securities dealers);
- 9) income from forgiveness of indebtedness; or
- 10) amounts realized from exchanges of inventory that are not recognized by the Internal Revenue Code.

Exclusion of an item from the definition of "gross receipts" is not determinative of its character as business or nonbusiness income. Nothing in this definition shall be construed to modify, impair or supersede any provision of Section IV.18.

Reg. IV.15.(a). Sales Factor: In General.

(1) Article IV.1.(g) defines the term "sales" to mean all gross receipts of the taxpayer not allocated under paragraphs (5) through (8) of Article IV. Thus, for the purposes of the sales factor of the apportionment formula for each trade or business of the taxpayer, the term "sales" means all gross receipts derived by the taxpayer from transactions and activity in the regular course of the trade or business. The following are rules for determining "sales" in various situations:

(A) In the case of a taxpayer engaged in manufacturing and selling or purchasing and reselling goods or products, "sales" includes all gross receipts from the sales of such goods or products (or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the tax period) held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. Gross receipts for this purpose means gross sales less returns and allowances, and includes all interest income, service charges, carrying charges, or time-price differential charges incidental to such sales. Federal and state excise taxes (including sales taxes) shall be included as part of such receipts if the taxes are passed on to the buyer or included as

part of the selling price of the product.

(B) In the case of cost plus fixed fee contracts, such as the operation of a government-owned plant for a fee, "sales" includes the entire reimbursed cost plus the fee.

(C) In the case of a taxpayer engaged in providing services, such as the operation of an advertising agency or the performance of equipment service contracts or research and development contracts, "sales" includes the gross receipts from the performance of such services, including fees, commissions, and similar items.

(D) In the case of a taxpayer engaged in renting real or tangible property, "sales" includes the gross receipts from the rental, lease, or licensing the use of the property.

(E) In the case of a taxpayer engaged in the sale, assignment, or licensing of intangible personal property such as patents and copyrights, "sales" includes the gross receipts therefrom.

(F) If a taxpayer derives receipts from the sale of equipment used in its business, those receipts constitute sales. For example, a truck express company owns a fleet of trucks and sells its trucks under a regular replacement program. The gross receipts from the sales of the trucks are included in the sales factor.

(2) Exceptions. In some cases certain gross receipts should be disregarded in determining the sales factor in order that the apportionment formula will operate fairly to apportion to this state the income of the taxpayer's trade or business. See Regulation IV .18.(c).

(3) Year to year consistency. In filing returns with this state, if the taxpayer departs from or modifies the basis for excluding or including gross receipts in the sales factor used in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.

(4) State to state consistency. If the returns or reports filed by the taxpayer with all states to which the taxpayer reports under Article IV of this Compact or the Uniform Division of Income for Tax

Purposes Act are not uniform in the inclusion or exclusion of gross receipts, the taxpayer shall disclose in its return to this state the nature and extent of the variance.

Regulations Applying Sec. 18 to the Sales Factor

The workgroup has discussed whether issues should be dealt with under the definition of “receipts” or under Sec. 18, which is outside the group’s scope. Whether the group addresses these issues or recommends to the Uniformity Committee that particular issues be considered, the group may want to consider existing MTC model regulations applying Sec. 18 to the sales factor. Again, portions of the regulations that appear to address issues identified by the workgroup in its discussions are highlighted.

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

(1) Where substantial amounts of gross receipts arise from an incidental or occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business, those gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory or plant will be excluded.

(2) Insubstantial amounts of gross receipts arising from incidental or occasional transactions or activities may be excluded from the sales factor unless their exclusion would materially affect the amount of income apportioned to this state. For example, the taxpayer ordinarily may include in or exclude from the sales factor gross receipts from transactions such as the sale of office furniture, business automobiles, etc.

(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)).

Where business income from intangible property cannot readily be attributed to any particular income producing activity of the taxpayer, the income cannot be assigned to the numerator of the sales factor for any state and shall be excluded from the denominator of the sales factor. For example, where business income in the form of dividends received on stock, royalties received on patents or copyrights, or interest received on bonds, debentures or government securities results from the mere holding of the intangible personal property by the taxpayer, the dividends and interest shall be excluded from the denominator of the sales factor.

(4) (A) Where gains and losses on the sale of liquid assets are not excluded from the sales factor by other provisions under Reg.IV.18.(c)., such gains or losses shall be treated as provided in this subsection. This subsection does not provide rules relating to the treatment of other receipts produced from holding or managing such assets. If a taxpayer holds liquid assets in connection with one or more treasury functions of the taxpayer, and the liquid assets produce business income when sold, exchanged or otherwise disposed, the overall net gain from those transactions for each treasury function for the tax period is included in the sales factor. For purposes of this subsection, each treasury function will be considered separately.

(B) For purposes of this subsection, a liquid asset is an asset (other than functional currency or funds held in bank accounts) held to provide a relatively immediate source of funds to satisfy the liquidity needs of the trade or business. Liquid assets include foreign currency (and trading positions therein) other than functional currency used in the regular course of the taxpayer's trade or business; marketable instruments (including stocks, bonds, debentures, options, warrants, futures contracts, etc.); and mutual funds which hold such liquid assets. An instrument is considered marketable if it is traded in an established stock or securities market and is regularly quoted by brokers or dealers in making a market. Stock in a corporation which is unitary with the taxpayer, or which has a substantial business relationship with the taxpayer is not considered marketable stock.

(C) For purposes of this subsection, a treasury function is the pooling and management of liquid assets for the purpose of satisfying the cash flow needs of the trade or business, such as providing liquidity for a taxpayer's business cycle, providing a reserve for business contingencies, business acquisitions, etc. A taxpayer principally engaged in the trade or business of purchasing and selling instruments or other items included in the definition of liquid assets set forth herein is not performing a treasury function with respect to income so produced.

(D) Overall net gain refers to the total net gain from all transactions incurred at each treasury function for the entire tax period, not the net gain from a specific transaction.

(E) Examples.

Example (i). A taxpayer manufactures various gift items. Because of seasonal variations, the taxpayer must keep liquid assets available for later inventory acquisitions. Because the manufacturer wants to obtain a return on available funds, the manufacturer acquires liquid assets, which are held and managed in State A. The net gain resulting from all gains and losses on the sale of the liquid assets for the tax year will be reflected in the denominator of the sales factor and in the numerator of State A.

Example (ii). A stockbroker acts as a dealer or trader for its own account in its ordinary course of business. Some of the instruments sold are liquid assets. This subsection does not operate to classify those sales as attributable to a treasury function.

Relationship Between “Receipts and “Apportionable” Income

As noted in the introduction, the group will want to include in its review of existing regulation the provisions that define “business” (now “apportionable”) income. Both the old definition of “sales” and the new definition of “receipts” exclude from the sales factor receipts that are allocated--that is, receipts that are nonbusiness receipts and subject to allocation under other provisions of UDITPA. Nonbusiness income (now “nonapportionable” income) is defined using two tests—the transactional and functional tests.

The new definition of “receipts” explicitly includes in the apportionment factor only receipts that meet the transactional test (“received from transactions and activity in the regular course of the taxpayer’s trade or business”). Therefore, the new definition of “receipts” excludes receipts if they 1) meet neither test, or 2) meet only the functional test.

The task of reviewing the existing regulations explaining the application of the transactional and functional tests is somewhat complicated by the fact that the Commission has also amended the definition of business/ apportionable income. Critically, by making the definition coterminous with the Constitutional limits, that definition now includes items that might meet neither the transactional or functional test. With the exception of this addition, according to the MTC’s Report Recommending the Amendments, the amendments simply clarified the statutory language, cleaning up ambiguous terms.¹ The report makes clear that the statutory language was changed so as to better track the majority position, which is also reflected in existing MTC regulations.

A review of the regulations (see below) does reveal some provisions that appear inconsistent with the new statutory language, although there are only a limited number of such inconsistencies. Otherwise, because the change in the statutory language was not meant to be a substantial change to the existing position of the MTC and the majority of states, this memo presumes that existing regulations that do not clearly conflict with the new language are not superseded. Because the report also makes clear that the transactional test is not affected in any material way, the existing

¹ For reference purposes, the new definition of apportionable income is as follows:

(a) “Apportionable income” means:

(i) all income that is apportionable under the Constitution of the United States and is not allocated under the laws of this state, including:

(A) income arising from transactions and activity in the regular course of the taxpayer’s trade or business, and

(B) income arising from tangible and intangible property if the acquisition, management, employment, development or disposition of the property is or was related to the operation of the taxpayer’s trade or business; and

(ii) any income that would be allocable to this state under the Constitution of the United States, but that is apportioned rather than allocated pursuant to the laws of this state.

regulations that address this test specifically are unlikely to be superseded. Again, this is not meant to limit the workgroup's ability to make changes they deem are needed to the existing regulations—but to indicate that regulations that are not changed (and present no clear conflict) would continue to be in effect.

Are the functional/transactional tests mutually exclusive?

The inclusion of receipts meeting only the transactional test raises the question, recognized in discussions by the workgroup, as to whether the transactional and functional tests should be viewed as potentially overlapping or mutually exclusive. If the tests are mutually exclusive, then when receipts clearly meet the functional test, they would presumably not meet the transactional test—and would be excluded. So, if the tests are mutually exclusive, existing regulations addressing the functional test specifically would be directly relevant to defining the receipts that may be included under the transactional test. But if the two tests overlap to some material degree, the existing regulations that address only the functional test may have a more limited usefulness, since receipts that meet the functional test might also be found to meet the transactional test.

As to the question of whether the transactional and functional tests are mutually exclusive, the MTC's report may shed some light. First, the report notes that the original statute connected the text of the transactional test and the text of the functional test with the words "and includes." So it was not clear whether two separate tests were created (leading some courts to conclude that there was only one test). The amended statutory language removes the word "includes," to clarify that there are two separate tests. This alone, however, does not answer the question of whether the two separate tests are mutually exclusive.

The report goes on to say that in addition to other changes, the word "regular" was removed from the text of the functional test to clarify that receipts need not be from regular transactions or activities in order to meet the functional test (whereas they do need to be regular to meet the transactional test). While this gives more indication that the transactional and functional tests are different, it does not settle the question as to whether they are mutually exclusive.

The Hearing Officer report says this about the transactional and functional test:

“Quite possibly, transactions might simultaneously satisfy both definitions, but there is no reason these two categories have to be mutually exclusive. Situations not falling within either (A) [transactional] or (B) [functional test] will be tested against the constitutional standard, although with the broadening of (A) and (B) these should not be common.”

As the HO report suggests, the answer to whether there is overlap between the tests has little practical affect on the determination of apportionable income under the new definition of that term since that it is now extended to the limits of the Constitution.

Nor does it appear that the tests have been found to be mutually exclusive in the recent past. Hellerstein’s treatise notes:

The line between the transactional and functional tests was initially fairly clear, as reflected in . . . earlier decisions addressing the issue. In recent years, however, the line between the two tests—or at least the precise meaning of the functional test—has become somewhat muddier, as the ensuing discussion reveals. Indeed, some courts, although purporting to adopt the functional test, have in fact construed that test in a manner that renders it essentially indistinguishable from the transactional test.

Therefore, there may be no definitive answer to the question whether the transactional and functional tests are mutually exclusive. It would greatly assist the drafting and evaluation of regulations implementing the definition of “receipts,” however, if they were treated as such. The dividing line between the two tests could be simply whether the transaction is “regular,” or “irregular—or it may involve other factors.

Review of existing model regulations defining “business” income.

Below, the relevant provisions from the existing MTC regulations concerning the transactional and functional tests are set out. **The most critical of the provisions, in terms of the issues identified by the workgroup, are highlighted in yellow.** Again, it is important to note that certain limited provisions of these regulations may be superseded.

••• Reg. IV.1.(a). Business and Nonbusiness Income Defined.

(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 income if it falls within the definition of business income. An item of income is nonbusiness income only if it does not meet the definitional requirements for being classified as 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).(4), the "transactional test", or (5), the "functional test". 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.*, is of no aid in determining whether income is business or non-business income.

(3) Terms Used in Definition of Business Income and in Application of Definition. As used in the definition of business income and/or in the application of the definition,

(A) "Trade or business" means the unitary business of the taxpayer, part of which is conducted within [this State].

(B) "To contribute materially" includes, without limitation, "to be used operationally in the taxpayer's trade or business." Whether property materially contributes is not determined by reference to the property's value or percentage of use. If an item of property materially contributes to the taxpayer's trade or business, the attributes, rights or components of that property are also operationally used in that business. However, property that is held for mere financial betterment is not operationally used in the taxpayer's trade or business.

(4) Transactional Test. Business income includes income arising from transaction 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. Most, but not all, frequently occurring transactions or activities will be in the regular course of that trade or business and will, therefore, satisfy the transactional test. 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. However, even if a taxpayer frequently or customarily engages in investment activities, if those activities are for the taxpayer's mere financial betterment rather than for the operations of the trade or business, such activities do not satisfy the transactional test. The transactional test includes, but is not limited to, income from sales of inventory, property held for sale to customers, and services which are commonly sold by the trade or business. The transactional test also includes, but is not limited to, income from the sale of property used in the production of business income of a kind that is sold and replaced with some regularity, even if replaced less frequently than once a year.

(5) 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. "Property" includes any interest in, control over, or use in property (whether the interest is held directly, beneficially, by contract, or otherwise) that materially contributes to the production of business income. "Acquisition" refers to the act of obtaining an interest in property. "Management" refers to the oversight, direction, or control (directly or by delegation) of the property for the use or benefit of the trade or business. "Disposition" refers to the act, or the power, to relinquish or transfer an interest in or control over property to

another, in whole or in part. "Integral part" 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 business income.

(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, or operative component used in the taxpayer's trade or business operations, or otherwise materially contributed to the production of business income of the trade or business, part of which trade or business is or was conducted within this State. Property that has been converted to nonbusiness use through the passage of a sufficiently lengthy period of time (generally, five years is sufficient) or that has been removed as an operational asset and is instead held by the taxpayer's trade or business exclusively for investment purposes has lost its character as a business asset and is not subject to the rule of the preceding sentence. Property that was an integral part of the trade or business is not considered converted to investment purposes merely because it is placed for sale.

(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. (Property that has been converted to nonbusiness use (see IV.1.a.(4)(A)) has lost its character as a business asset and is not subject to the rule of the preceding 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.

(C) Under the functional test, income from intangible property is business income when the intangible property serves an operational

function 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 an intangible interest, as, for example, corporate stock or other intangible interest in a business or a group of assets, is business income when the intangible itself or the property underlying or associated with the intangible is or was an integral, functional, or operative component to the taxpayer's trade or business operations. (Property that has been converted to nonbusiness use (see IV.1.(a).(4)(A)) has lost its character as a business asset and is not subject to the rule of the preceding sentence.) 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 interest served

an operational rather than an investment function of mere financial betterment.

(6) 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 a unitary business that the taxpayer alone may be conducting and a unitary business the taxpayer may conduct with any other person or persons. Satisfaction of either the transactional test or the functional test 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.

Note on Examples Used in the Regulations.

The existing MTC model regulations also include a number of examples explaining whether certain types of income are business or nonbusiness and, if nonbusiness, how they should be allocated. (See pages 14-18.) These examples, however, do not say whether the income meets the transactional test or the functional test.