

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".

65 (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
70 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.

75 (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
80 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
85 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
90 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,
95 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.

100 (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
105 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.

110 (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].

115 (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
120 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
125 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
130 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

135 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
140 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
145 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
150 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
155 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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160 **••• 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
165 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

170 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.

175 *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.
180 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
185 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
190 business income of the grocery store trade or business. Therefore, the net rental income is nonbusiness income.

195 *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.
200 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.

205 *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
210 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
215 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
220 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
225 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
230 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
235 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.

240 *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.

245 *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.

250 *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
255 loss). The gain (or loss) on the sale is nonbusiness income and the rental income received over the lease period is nonbusiness income.

260 *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.

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270 **(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,~~
275 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
280 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
285 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
290 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
295 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
300 and traveler's checks, the taxpayer earns interest income by
the investment of the funds pending their redemption. The
interest income is business income.

305 *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.

310 ~~— *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.~~

315 *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.

330 **(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.

335 *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.

340 *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
345 exchanges. ~~Both the interest income and any~~ Any dividends
received are business income.

350 *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.

355 *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
360 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.

365 *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.

370 *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.

375 **(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
380 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.
385 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.

390 *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
395 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
400 ~~phonographs or phonograph equipment~~ digital audio recordings. Any royalties received on the patent would be nonbusiness income.

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405 ••• **Reg. IV.2.(a). Definitions.**

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410 (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:

- 415 ➤ IV.1.(b)., *example*;
- IV.2.(b).(1);
- IV.3.(a).;
- IV.3.(a).(1);
- IV.3.(a).(2);
- 420 ➤ IV.3.(b).(1);
- IV.3.(b).(1)(A);
- IV.3.(b).(1)(B);
- IV.3.(b).(1)(B), *example*;
- IV.3.(b).(2);
- 425 ➤ IV.3.(b).(2), *example (i)*;
- IV.3.(b).(2), *example (iv)*;
- IV.3.(c).;
- IV.18.(a).;
- IV.18.(a).(3);
- 430 ➤ 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
- 435 ➤ 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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440 **••• 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
445 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
450 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
455 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
460 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
465 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
470 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

475 extended period of time (normally, five years) during which the
property is held for sale.

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

480 **(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
485 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.)

490 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.

495 *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.

500 *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
505 subrents are business income, they are not deducted from the
rent paid by the taxpayer.

510 *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.

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520 (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
525 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.

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

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535 (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

540 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)).