Why Define Business Income?

A DILEMMA CREATED BY THE U.S. SUPREME COURT

- Under the Negative Commerce Clause, a state cannot tax income unless the income has substantial nexus with the state.
- Income earned by a foreign corporation operating only outside the state has nexus with the state if some or all of its income is earned by a unitary business that has nexus with the state.
- A state does not have nexus to tax the non-unitary income (e.g., non-business income) of a foreign corporation not engaged in business in the state.
Options for Defining Business Income

- All income is business income (rule in some states, but presents constitutional issues).
- All income that can be taxed constitutionally is business income (i.e., any income with nexus).
- Non-business income defined, and all other income is business income (my preferred).
- MTC and UDITPA: “Business income” defined, and all other income is “non-business income”.

Definitional Guidelines

Suggestions for drafting, whatever the option

1. The residual category should be the category unfavorable to the tp (e.g., business income).
2. The rebuttable presumption should be business income.
3. There is no external standard (in economics or elsewhere) for distinguishing between business and non-business income.
4. Any definition depending on an external rule (e.g., whatever is constitutional) should be ambulatory; no history tests.<grin>
5. As a safeguard, the tax department should have some discretion to treat income as non-business income.
**Business Deductions**

The deduction Q may be as important as the income Q

- Recapture of prior deductions against business income is always business income.
- Expenses should be allocated to non-business income unless the tp can show otherwise.
- If the tp shows that deductions relate to both business and non-business income, the allocation should be based on net income, excluding the deduction at issue.

**MTC and UDITPA Definition**

Definition in the MTC compact

IV,l,(a) “Business income” means 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.

(e) “Nonbusiness income” means all income other than business income.
R. Pomp and P. Willson Note

Outline of needed UDITPA changes

*Section 1(a) and 1(e) (definition of business income). No one has disputed the need to clean up the existing definition. All seem to agree that it should be broadened to, at a minimum, pick up what the framers of UDITPA intended, namely, that property used in the trade or business should give rise to apportionable income when sold, even in a complete liquidation or other extraordinary transaction. It will be appropriate to consider broader options as well. (* means important)

MTC Regs. Test

Two tests, Functional OR Transactional

(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.
Definitions of the Two Tests

(4) **Transactional Test.** Business income includes income arising from transaction and activity in the regular course of the taxpayer’s trade or business.

(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. . . . 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.

Critique of MTC Definitions

**Problems, in theory and practice**

- The transactional test and functional test make sense at an interpretation of UDITPA but make little sense if we were starting afresh.

- The “regular course” standard is not required by the Supreme Court and has no normative support. It sounds like *Corn Products*, which is a response to the nonsensical rules for capital gains.

- The “integral parts” test also has a capital gains flavor and no policy support; it leaves out stuff that should be taxed.
McIntyre Test

My suggested approach, undeveloped

1. Business income is all income other than income that the tp has established constitutes non-business income.

2. “Non-business income” is passive investment income of the tp that is not related to a unitary business conducted by the taxpayer.

3. Passive investment income is related to a unitary business, inter alia, if the investment income is derived from property that is used in the business as working capital or otherwise, is held in reserve for the future benefit of that business, or is used to provide security, directly or indirectly, for loans, leases, or other advances made to the unitary business.

Critique of McIntyre Test

Some problems with my approach

- At some point, my “related to” test, as applied, might raise constitutional questions.
- “Passive investment income” is a vague term, meant to exclude financial services income.
- My definition of “related to” is very broad, yet in some cases may not be broad enough.
- The proper treatment of income from intangible property is not addressed.