To: Robynn Wilson, Chair  
Members of MTC Income & Franchise Tax Uniformity Subcommittee

From: Shirley Sicilian, General Counsel

Date: November 18, 2011

Subject: Model Compact Art. IV.1(a) (Definition of Business Income)

The Executive Committee has asked the Uniformity Committee to consider amendments to the model Compact Art. IV.1(a) (Definition of Business Income). This memo provides:

- Background (section I and CCH materials provided separately)
- Policy issues and draft language options (section II)

I. Background

The Compact currently defines business income (apportionable income), and non-business income as follows:

**Art. IV (1)(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.

**Art. IV (1)(e)** "Nonbusiness income" means all income other than business income.

Today, a majority of states have interpreted the term “business income” to provide two tests for identifying apportionable business income: a transactional test and a functional test.1 But the language of the Act is not very clear on that point and some state courts have held UDITPA provides only a transactional test.2 Under this minority view, the words “and includes” make the second clause (the functional test) a

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qualifying clause that serves to exemplify a certain type of income that is included only if it also fits within the first clause (the transactional test). In states where the courts found only a transactional test, the legislatures generally followed-up with a statutory amendment to clearly add the functional test.\(^3\) There has also been a trend over the last few years to adopt legislation defining business income simply as all income apportionable under the U.S. Constitution.\(^4\) In part, this trend is a reaction to court cases that found income from the sale of a business or its assets are not included under the UDITPA definition, even under the functional test, if the entire business is being liquidated.\(^5\)

II. Policy Issues and Draft Language

**Policy Issues**

The Drafting Group\(^6\) has developed the following policy issues and draft language options for the Committee’s consideration.

1. Should “business income” include both a transactional and a functional test?

2. If “business income” includes a functional test, should that test encompass income from cessation or liquidation of a business or line of business?
   a. Does it matter whether the transaction is a deemed liquidation under 338(h)(10) or an actual liquidation?
   b. Does it matter how the gains are used?

3. Functional income is currently described as “income from tangible and intangible property if acquisition, management and disposition of property constitute integral parts of the taxpayer's regular trade or business operations.”
   a. Would it be clearer to state the test as “acquisition, management and or disposition of property constitutes...?”
   b. Should other terms be included, such as “employment” and “development?”

Iowa: Iowa Code § 422.32 after Phillips Petroleum v. Iowa Dep’t of Rev. and Fin., 511 N.W. 608 (Iowa 1994).


\(^6\) The drafting group includes Ben Miller and Melissa Potter (CA-FTB), Ted Spangler (ID), Gary Humphrey and Janielle Lipscomb (OR), Michael Fatale (MA), Joe Garrett (AL), and Commission Staff Shirley Sicilian and Bruce Fort. The drafting group has been regularly joined by Wood Miller (MO), Donnita Wald and Mary Loftsgard (ND), and Phil Horwitz (CO).
c. Both the transactional and functional tests use the word “regular.” Is it clear that "regular" does not limit the functional test to frequent events, or does this need to be clarified? The California Supreme Court explained in *Hoechst Celanese*: “In the transactional test—which focuses on the income-producing transaction—‘regular’ modifies ‘course of the taxpayer's trade or business’ and makes the nature of the transaction relevant. In the functional test—which focuses on the income-producing property—‘regular’ modifies ‘trade or business operations’ and follows the phrase ‘an integral part of.’ Consequently, ‘regular,’ as used in the functional test, does not refer to the nature of the transaction, and the extraordinary nature or infrequency of the income-producing transaction is irrelevant.” Could the term “regular” be eliminated from the functional test?

d. The term "integral" is the touchstone for determining whether property has a close enough relationship to the taxpayer to satisfy the functional test. But is the term clear or is it needlessly vague? 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). The Court found that “integral” should be construed somewhere between these two – e.g., “*materially* contributing to.”

e. Should “tangible and intangible property” be replaced with “property or assets?”

4. If “business income” includes both functional and transactional tests, and includes gain/loss from cessation of business,
   a. Is the intent to encompass all income apportionable under the U.S. Constitution? If so, should that be stated in the statute? Tying the statutory definition to the scope of the constitution is not very specific guidance, and may introduce some additional uncertainty, on the one hand. On the other hand, the absence of such a statement could result in an interpretation that is something short of the constitutional scope. Is the more important goal increased clarity or full apportionment?
   b. Would it be useful to retitle “business income,” e.g., as “apportionable income” or “unitary income”?

5. Is it necessary for the statutory definition to explicitly anticipate the potential for a single taxpayer to operate more than one “trade or business”? Or, because that concept is a constitutional requirement, is it sufficient that that it be addressed, as it is now, in regulation?

**Draft Language Options**

**OPTION A:** Art. IV (1)(a) “Business income” means income arising from (1) transactions and activity in the regular course of the taxpayer’s trade or business, and includes income from (2) tangible and intangible property if the acquisition, management and/or disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations.

OR
Option B: Art. IV (1)(a) "Business income" means income subject to apportionment to the extent allowed by the Constitution of the United States, and includes income arising from (1) transactions and activity in the regular course of the taxpayer's trade or business, and includes income from (2) tangible and intangible property if the acquisition, management, employment, development, and disposition of the property constitute integral parts of materially contributes to the taxpayer's regular trade or business operations.

OR

OPTION C: Art. IV (1)(a) “Apportionable income” means all income subject to apportionment to the extent allowed by the Constitution of the United States, and includes:

(i) income arising from transactions and activities in the regular course of the taxpayer’s trade or business of the taxpayer, and includes income from

(ii) income arising with respect to tangible and intangible property or assets if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations that are or were acquired, managed employed, developed, or disposed in connection with the operation of a trade or business of the taxpayer.

OR

Option D: Art. IV (1)(a) “Apportionable income” means all income subject to apportionment to the extent allowed by the Constitution of the United States, including but not limited to income of a trade or business of a taxpayer:

(i) arising from transactions and activities in the regular course of the taxpayer’s trade or business, and includes income from

(ii) arising from transactions and activity with respect to tangible and intangible property or assets if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations that are or were acquired, managed, employed, developed, or disposed by, or during, the operation of the same trade or business of the taxpayer.

AND

Art. IV (1)(e) "Non-business Income" means all income other than business income.