MULTISTATE TAX COMMISSION

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

From: Shirley Sicilian, General Counsel

Date: February 24, 2012

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:

- Legal and policy background (section I)
- Policy checklist –with Subcommittee's November 2011 answers and 2 new questions (section II)
- Draft model language – based on answers given in November 2011 and new questions (section III)

I. Background

The Compact currently defines business income (income to be apportioned among states in which the taxpayer is doing business), and non-business income (income to be allocated to a single state) 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

[1] CCH Commentary, Multi-Corp-Income, *Distinction Between Business and Non-Business Income* (2007). See also, e.g., *Hoechst Celanese Corp. v. Franchise Tax Board,* 25 Cal.4th 508 (2001); *Gannett Satellite Information Network Inc. v. Montana Dep't of Rev*., 348 Mont. 333, 201 P.3d 132 (2009); *Texaco-Cities Service Pipeline Co. v. McGaw*, 695 N.E. 2d 481 (Ill. 1998); *Polaroid Corp. v. Offerman*, 349 NC 290 (1998); *Willamette Industries, Inc. v. Oregon Department of Revenue*, 331 Or 311 (2000); *Kemppel v. Zaino*, 746 N.E. 2d 1073 (Ohio, 2001).

[2] *See*, *e.g.*, *Uniroyal Tire Co. v. State Department of Finance*, 779 So.2d. 227 (Ala. 2000); *Appeal of Chief Industries, Inc.*, 255 Kan. 640, 875 P.2d 278 (1994); *Phillips Petroleum Co. v. Iowa Dep't. of Rev. and Fin,* 511 N.W.2d 608 (Iowa 1993). *Associated Partnership I, Inc. v. Huddleston*, 889 S.W.2d 190 (Tenn. 1994).

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

Policy Checklist with Subcommittee Answers Given November, 2011

At its November 2011 meeting, the Uniformity Subcommittee answered a Policy Checklist developed by the Drafting Group[6] as follows:

1. Should "business income" include both a transactional and a functional test?
   - **YES**
2. If "business income" includes a functional test, should that test encompass income from cessation or liquidation of a business or line of business?
   - **YES**
     a. Does it matter whether the transaction is a deemed liquidation under 338(h)(10) or an actual liquidation?
        - **NO**
     b. Does it matter how the gains are used?
        - **NO**
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 or disposition of property constitutes …?"

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[3] *See, e.g.*:
Alabama: Ala. H.B. 7 (Dec. 28, 2001) *amending* Ala. Code Sec. 40-27-1.1 after *Uniroyal Tire Co. v. State Department of Finance*, 779 So.2d. 227 (Ala. 2000).
Iowa: Iowa Code § 422.32 after *Phillips Petroleum v. Iowa Dep't of Rev. and Fin.*, 511 N.W. 608 (Iowa 1994).
Kansas: K.S.A. 79- 3271(a) after *Appeal of Chief Industries, Inc.*, 255 Kan. 640, 875 P.2d 278 (1994).
Tennessee: T.C.A. § 67-4-2004 after *Associated Partnership I, Inc. v. Huddleston*, 889 S.W.2d 190 (Tenn. 1994).

[4] *See, e.g.*:
Illinois: 35 ILCS 5/1501(a)(1); *Kansas*: K.S.A. 79-3271(a); *Minnesota*: Minn. Stat. §290.17 Subd.4.(a); *North Carolina*: N.C. Gen. Stat. §105-130.4(a)(1); *Pennsylvania*: 72 P.S. §7401(3)2.(a)(1)(A).

[5] *Lennox v. Tolson*, 353 N.C. 659 (2001); *Laurel Pipe Line Co. v. Commonwealth of Pennsylvania Board of Finance and Revenue*, 537 Pa. 205(1994); *Kemppel v. Zaino*, 746 N.E. 2d 1073 (Ohio, 2001); *Blessing/White, Inc. v. Zehnder,* 329 Ill.App.3d 741 (2002).

[6] The drafting group includes Ben Miller and Melissa Potter (CA- FTB), Ted Spangler (ID), Gary Humphrey, Janielle Lipscomb, and Jeff Henderson (OR), Michael Fatale (MA), Joe Garrett and Holly Coon (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).

- **YES**

b. Should other terms be included, such as "employment" and "development?"
   - **Employment – Yes; Development – Yes**

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?
   - **YES, Eliminate "regular" from 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." Another option would be to use the language of the U.S. Supreme Court in Allied Signal and require that the property from which the income arises is "operationally related to" or "related to the operation of" the taxpayer's business.
   - **NO, but the vote was so close that the drafting group included language, for consideration.**

e. Should "tangible and intangible property" be replaced with "property or assets?"
   - **NO**

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?
      - **YES**

   b. 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?
      - **YES, but instead of "to the extent," use a phrase that sounds less like a limitation, such as "all income apportionable under."**

   c. Would it be useful to retitle "business income," e.g., as "apportionable income" or "unitary income"?
      - **MAYBE; Review UDITPA**

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?
   - **NO**

New Policy Questions

6. Income arising from a taxpayer's assets or investments that are not a part of the taxpayer's unitary business may constitutionally be allocated directly to the state where the asset is located or the taxpayer is domiciled.[7] But that state is certainly not required by the constitution to tax all of this non-unitary income, and may constitutionally apportion it, instead. Should a qualification be added to clarify that "all income that is apportionable under the Constitution…" does not include non-unitary income which would otherwise be allocable to this state?

7. Some states have chosen to apportion certain types of non-unitary income that would otherwise be allocable to the state. Should a provision be added to clarify that these types of income are to be included in "business income" and thus apportioned accordingly?

II. Draft Language

The Drafting Group developed these amendments to reflect the Subcommittee's policy direction given in November, 2011. The draft also reflects the clarifications discussed in questions 6 and 7.

Art. IV (1)(a) "Business 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 ~~includes~~

(B) income arising from tangible and intangible property if the acquisition, management, employment, development, or disposition of the property ~~constitute integral parts of~~ is or was related to the operation of the taxpayer's ~~regular~~ trade or business ~~operations~~; 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.

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

[7] *See* Compact Art.IV.4 – 8. *See Whitney v. Graves*, 299 U.S. 366 (1937) (New York could impose income tax on out-of-state resident's capital gain from sale of New York stock exchange membership). See also, *Allied-Signal v. Director, Div. of Tax.,* 504 U.S. 768, 778 (1992); *Exxon Corp. v. Wisconsin*, 447 U.S. 207, 229 (1980).