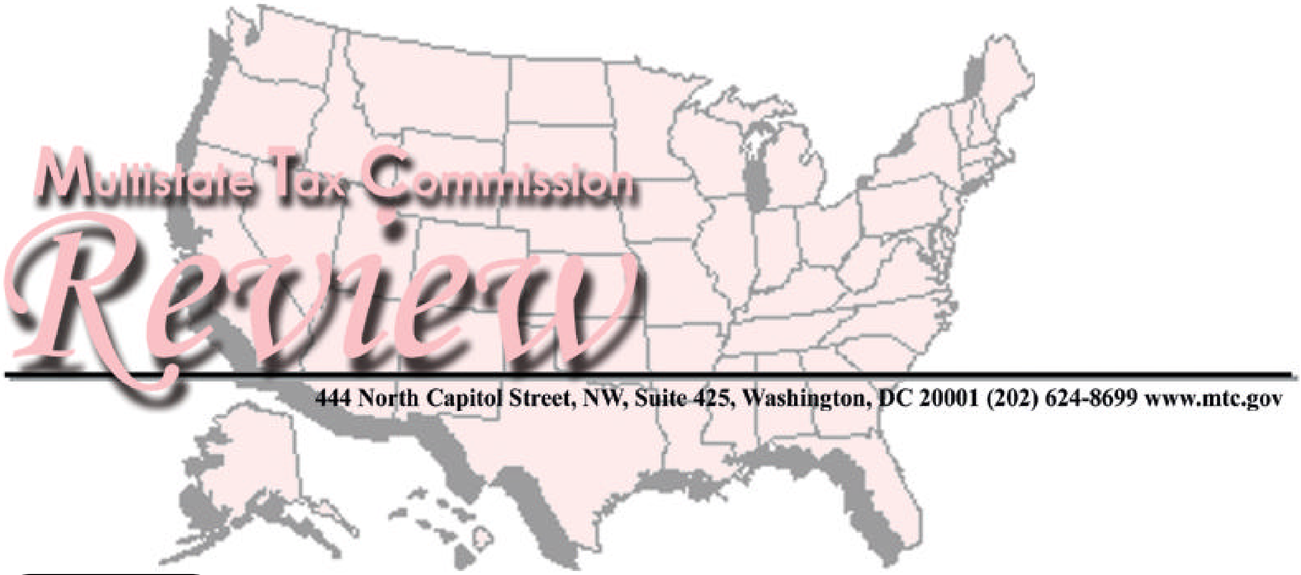

Testimony of
June Summers Haas
Commissioner of Revenue
Michigan Department of Revenue
On the Issue of H.B. 2526 Internet Tax Fairness Act of 2001

Before the United States House of Representatives
Committee on the Judiciary Subcommittee on Commercial and Administrative Law
The Honorable Robert Barr, Chairman
September 11, 2001

Chairman Barr and Members of the Committee, I am June Summers Haas, Commissioner of Revenue, Michigan Department of Treasury. Thank you for the opportunity to address issues of great importance to Michigan and all other states.

I have dedicated my entire professional career to the area of state and local taxation, over half of it working as an attorney advising businesses in the private sector as a tax planner and a litigator. I have also served as an advisor to the states as the Director of the National Nexus Program for the Multistate Tax Commission, as a law professor and now as a civil servant in the State of Michigan. I have been asked to speak to you today because I am an expert on state jurisdiction to tax who has dealt with this issue from all sides, as an advocate for business, an advisor to states, as a civil servant seeking to administer the laws and as a law professor who has taught a course on state jurisdiction to over 1200 attorneys, accountants and state tax administrators.

I will be giving brief oral comments of my testimony today but a more extensive version of my comments will be submitted for the record.

Let's put this issue in context. When we talk of jurisdiction to tax, also known as nexus, we are only asking the question of when a corporation is present enough in the state that the state may tax it. Business entities are legal fictions created on paper that have no physical being. These businesses are present in a state through representatives such as buildings, property, or

Testimony continued on page 3

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Table of Contents

Testimony continued from page 1
inventory they own or persons they hire, such as employees and independent contractors, to do the corporation's work. They are present in the state through the activities they undertake such as leasing, contracting, licensing, selling, and the like. So for a business entity the nexus question is: When is an entity that has no single physical embodiment, present enough in the state to bring it within the state's taxing jurisdiction?

House Resolution 2526 would impose new untested limitations on states' taxing jurisdiction over business entities ostensibly to promote e-commerce. This proposal is fundamentally flawed for four reasons.

First, it violates basic principles of equity and uniform application of tax law by favoring businesses with limited in-state presence over businesses that are based in the state that create jobs to employ state citizens.

Second, it overturns U.S. Supreme Court rulings on nexus and replaces it with a new, poorly defined standard that will plunge businesses and tax administrators into years of litigation over its vagaries.

Third, it is fiscally imprudent, as this proposal will reduce state revenues needed to provide vital state services by an estimated $9 billion per year.

Fourth, it contravenes the basic principles of federalism and state sovereignty upon which this country was founded. Let me elaborate briefly on each of these points.

Flaw One — Unfair Treatment of Businesses Based in Your States. The first flaw in this proposal is that it discriminates against businesses that set up plants and create jobs in your states. It favors businesses with limited physical presence but often with major business activity in the state. In other words, H.R. 2526 shifts state corporate income tax burdens to small businesses, manufacturing, and natural resource and service industries; businesses that create jobs, pay local property taxes, sponsor our little league teams. Their competitors receive a tax shelter for their income from these same business activities because H.R. 2526 elevates form — limitation of physical presence — over substance — doing business in the state.

H.R. 2526 creates tax shelters for businesses but is not limited to e-commerce. For example businesses such as trademark licensing companies, leasing companies, repair service companies, financial service companies, sales solicitation companies, and seminar companies could receive favored treatment. Companies currently doing business in the states and paying business taxes there would be exempted under this proposal if they restructure their businesses to limit the physical presence of property or representatives to meet the artificial limitations of this proposal. There is no rational basis for favoring any business, e-commerce or not, with tax-sheltered income as a reward for limiting the presence of its in-state representatives to 30 days or less.

You have heard that only businesses physically present receive state services and thus businesses that limit their physical presence in the state should not have to pay tax to support these services. This is false. States will provide a court system for tax sheltered industries to enforce contracts, to protect trademarks and trade names. States will provide the police, fire and emergency services to tax-sheltered independent contractors and employees and will provide protections for tax sheltered offices or leased property. States provide roads and bridges for deliveries into and out of the state, a public utility infrastructure for all forms of commerce, and an education system that has produced the most sophisticated Internet consumers in the world. Yet, for those favored businesses, this bill would shelter them from paying their fair share of the cost. This is fundamentally unfair.

Flaw Two — Overturn Supreme Court Decisions. The proposed "substantial physical presence" standard is a new, untested standard that will erase years of Supreme Court precedent on nexus. The U.S. Supreme Court has unequivocally stated that nexus is not based on physical presence. For example, the Court has stated: "The fact that the stockholder-taxpayers never enter Wisconsin and are not represented in the Wisconsin legislature cannot deprive it of its jurisdiction to tax. It has never been thought that residence within a State or country is a sine qua non of the power to tax." *International Harvester v. Wisconsin Dept. of Taxation*, 322 U.S. 435 (1944). Only in the narrow case of use taxes has the Supreme Court upheld a bright-line physical presence nexus standard. Even for use taxes, the Supreme Court specifically rejected the standard that H.R. 2526 seeks to impose.

Testimony continued on page 5

Federal Legislative Update

Congress Pursues Sales and Use and Business Activity Tax Measures

by Ellen Marshall, MTC Legislative Consultant

While the U.S. Congress begins consideration of an economic stimulus package aimed at bolstering the economy, it is also actively pursuing a number of measures that impact state taxing authority. Following is a brief summary of the most active measures currently under consideration.

Internet taxation. The current moratorium against multiple and discriminatory taxes on the Internet and electronic commerce is slated to expire on October 21, 2001. Several pieces of legislation have been introduced to extend the moratorium for a limited period or permanently. Additionally, guidelines to states on ways to simplify sales and use tax laws has now become an integral component of this issue. The most active legislation currently under consideration includes:

- S. 512, the Internet Tax Moratorium and Equity Act, introduced in the Senate by Sen. Byron Dorgan (D-ND) and cosponsored by a bi-partisan group of 14 senators. This legislation seeks to extend the current moratorium until 2005 coupled with providing the states guidelines for simplifying their sales and use tax laws. States that simplify according to the guidelines and enter into a compact with other states will be granted authority to require sellers to collect sales taxes on remote commerce. (The simplification guidelines in S. 512 mirror those proposed by the Streamlined Sales Tax Project.) A hearing on this legislation occurred in mid-March. This legislation is expected to be the focal point of debate on Internet taxation. (Sen. Dorgan introduced legislation nearly identical to S. 512 in the 106th Congress. The principles of that legislation are supported by the MTC in Resolution 00-1.)

- HR 1410, the Internet Tax Moratorium and Equity Act, introduced in the House by Rep. Ernest Istook (R-OK) and a bi-partisan group of 11 representatives. HR 1410 is the companion bill to S. 512, and its language is identical to its Senate counterpart. A House Judiciary Subcommittee held a hearing on H.R. 1410 in late July.

- S. 288, the Internet Nondiscrimination Act, introduced in the Senate by Sen. Ron Wyden (D-OR). S. 288 appears to be very similar to S. 512 with several notable exceptions: 1) it contains language that suggests that Congress direct the states to amend their current laws on business activity tax nexus in the context of sales and use tax simplification; and 2) it does not provide clear authority to the states to require collection of sales taxes on remote commerce even if the states simplify their laws according to the guidelines in the legislation. S. 288 is expected to be the counterpoint to S. 512 for discussions and negotiations on extending the current moratorium and simplification of sales and use tax laws.

Business Activity Tax Nexus. Legislation has been reintroduced in the Senate that seeks to modify P.L. 86-272 by establishing safe harbors for Internet activity, setting a federal standard for sales and use tax nexus, and describing activities that on their own do not constitute substantial physical presence for sales and use tax and business activity tax nexus. S. 664, the New Economy Tax Simplification Act, was re-introduced by Sens. Judd Gregg (R-NH) and Herb Kohl (D-WI) and is identical to S. 2401 from the last Congress. (S. 2401 was opposed by the MTC in Resolution 00-6.)

Specifically, S. 664 states that the following activities do not constitute substantial physical presence and would not trigger nexus for sales and use tax or business activity tax purposes:

- the solicitation of orders or contracts for tangible or intangible property or services that are approved outside a state and are fulfilled from a point outside a state;
- the presence or use of intangible property in a state;
- the use of the Internet to create or maintain a website accessible by persons in the state;
- the use of any service provider for transmission of communications, whether by cable, satellite, radio, telecommunications, or other similar system;
- the affiliation with a person located in the state, unless the person is an "agent" and the activities of the agent constitute a substantial physical presence; and
- the use of an unaffiliated representative or independent contractor in the state for the purpose of performing warranty or repair service.

No legislative action has occurred on S.664. However, its introduction clearly indicates that some in Congress are listening and responding to the arguments and suggestions of industry on the business activity tax issue.

The MTC is actively monitoring the legislative progress on these measures and providing technical assistance to congressional staff on their potential impact on state taxing authority and state revenues.

If you would like to review copies of legislation mentioned in this article, please contact Ellen Marshall, MTC's Legislative Consultant, at ellen_marshall@hotmail.com or Roxanne Bland at rbland@mtc.gov.

Testimony continued from page 3

H.R. 2526 imposes an amorphous nexus standard that does not define what it is – only what it is not. A substantial physical presence will not create a uniform national standard. What is substantial is subjective geographically – 10 sales solicitors may be considered substantial presence in a smaller state such as Massachusetts or Wisconsin but not in larger states such as Texas or California. What is substantial changes depending upon the industry you are measuring – 10 sales solicitors is very substantial presence to cover the auto industry in Michigan but not for the fishing industry in Michigan. The uncertainty inherent in the proposed nexus standard will impede business planning, state fiscal forecasting and create chaos in the nexus field that will only be sorted out through years of time-consuming, costly litigation.

Third Flaw — Fiscal Imprudence. Based on a survey of state revenue estimators conducted by the Multistate Tax Commission, H.R. 2526 will reduce state revenues by $9 billion per year. These are revenues that are already counted in state budgets. The genius of our federalist system of government is that our nation relies on state and local governments to provide vital services tailored to fit local needs. This resolution puts the provision of some of these services in jeopardy.

Fourth Flaw — Contravenes Federalism. Finally, this resolution is flawed because it is contrary to the basic principles of federalism. One of the most important features of state sovereignty is the power to tax. Under this resolution, that fundamental sovereign power would be limited.

I urge this subcommittee to reject the H.R. 2526's vision of federally mandated state tax shelters. Do not discard years of Supreme Court decisions on nexus principles in favor of a legislated nexus standard that will discriminate against our local merchants and businesses in our states and trigger an explosion of nexus litigation.

Mr. Chairman and members of the committee, thank you for the opportunity to speak to you today. I welcome the opportunity to answer any questions you or the Committee members might have.

Business Activity Taxes: Explanation and Potential Implications of Current Legislation

The Issue

Proposals are being floated in Congress to limit state authority to impose income taxes (called Business Activity Taxes or BAT) on only those businesses that have a "substantial physical presence" in a state. If enacted, the proposed legislation would overturn current constitutional standards governing when states can impose income taxes on businesses. It would allow companies that operate electronically, especially via the Internet, to escape taxes they are already paying by sheltering much of their income in tax havens. This new tax sheltering would create substantial revenue shortfalls at the state and local level—robbing states of revenue used to fund essential services like education, transportation and infrastructure.

Current Constitutional Standards

Under current law, both in-state and out-of-state businesses that are doing business in a State pay BAT on the income earned in that state. "Doing business within the state" provides the necessary connection—the "nexus" in legal jargon—to justify the state taxing authority. The United States Supreme Court authorized states to impose income tax on nonresidents doing business in the state as long ago as 1920 in **Shaffer v. Carter**, and further, the Court authorized states to tax even where the taxpayer had no physical presence, but did business, in a state in the 1937 decision **New York ex rel. Whitney v. Graves**. In **Quill Corp. v. North Dakota**, the Court set out a bright-line test of "physical presence" to satisfy the necessary connection with a state—there called "substantial nexus"—but explicitly limited that test to the duty of mail order houses to collect use tax from customers. The Court acknowledged that as to other taxes—such as the two income tax cases mentioned—it had not applied the "physical presence" test.

The Proposed Change

Proponents want to bar states from imposing income tax on businesses that do not have a "substantial physical presence" in a state. They purport simply to be enacting current constitutional standards. **Nothing could be farther from the truth**. No case has ever imposed a nexus standard of "*substantial* physical presence" for taxing jurisdiction of the states. Proponents are "slicing and dicing" words, taking them out of context and mixing them up to produce a defective and deceptive product. They combine the terminology the courts use to describe the degree of connection to a state necessary for that state to have authority to impose tax—"substantial nexus"—with the requirement for use tax collection obligation on mail order houses of "physical presence." They then apply this fictitious standard of "substantial physical presence" to income taxes where the Court has explicitly *not* required physical presence for states to tax. All this wordplay would be entertaining, except that it is dangerous. The proponent's product will grant unjustified tax breaks to a few businesses and favor economic development in a few select states to the disadvantage of investment and job development in most other states. Further the proposals would endanger the financing of schools, transportation and other essential services in communities in the vast majority of the nation and would shift the tax burden to local taxpayers.

What is Really Going On and Who Will Benefit and Who Will Lose With the Proposed Changes?

The Losers

Many businesses are inevitably local taxpayers by nature of their activity—manufacturing firms, main-street retailers, commercial real estate, and natural resource companies. They do not have the ability to do business in a state without being physically present there.

The Winners

Certain other types of businesses are structurally mobile and flexible and can relocate easily while retaining their ability to do business in all states. These mobile businesses—banks, financial services companies, insurance companies, and Internet and media companies—project themselves into a state electronically by conducting much of their business via the Internet and other telecommunications media. This business structure allows them to do business nationwide and internationally while maintaining an actual physical presence in a few select areas. They can then choose their physical location in low-tax or no-tax states, and avoid paying income tax on all the income they earn from doing business in all the other states where they have no "substantial physical presence." Company X, for instance, with $100 Million in annual taxable income could locate its headquarters, and its computers, in a single state. $99 Million of the company's income is derived from business conducted in other states. If the BAT proposals were enacted, the company might only be required to pay taxes on the $1 Million of income earned in the state where the headquarters is located—if it has any income tax at all—while the $99 Million of income earned in other states would now escape taxation.

The Real Losers

Business activity taxes are used by states to fund essential services such as education, transportation, and infrastructure that help support the state and national economies. If the BAT proposals are enacted, the revenue stream to support these essential services will be depleted by the sheltering of large amounts of income from tax—leaving state legislators little choice but to cut essential services or, in order to fund their operations, to increase the tax burden on individual taxpayers and in-state businesses. Thus the real losers are the citizens/customers in the states who are generating this income for Company X. As Company X stops paying tax on income earned off in-state citizens/customers, these citizens/customers will suffer the double indignity of a decline in government services and a shift in tax burden to them.

The Extent of the Loss

State revenue agencies recently estimated the impact of the BAT proposals. If enacted, these proposals could cause states to lose approximately $9 billion in revenue per year. This is a conservative estimate. Because of the lucrative nature of these proposals, it is anticipated that the tax-sheltering opportunities they afford would entice numerous companies to embark on extensive tax planning schemes to further shield currently taxable income. Thus, the actual revenue loss to states could increase dynamically and dramatically. In real-life terms that $9 billion could buy per year: K-12 education for 1.1 million school children; or state university for 584,000 college kids; or 196,000 police officers on the street; or 193,000 firefighters on duty.

Market Distortion Inhibits Balanced Economic Growth and Development

Not only will the states lose money, but the proposed nexus standards will distort investment decisions and create a barrier to the free flow of investment across state boundaries. If Congress allows states to tax businesses only where they are physically located even though they earn income in other states, the result will be a disincentive to businesses to create jobs and investments in those other states. Economic development will be frozen in places of initial investment. The benefits of new technology, industry and jobs will not spread in a balanced way to all geographic regions of the nation. In addition, the proposals will prevent optimal economic efficiency and reduce the economy's long-term growth rate.

International Flexibility Constrained

The U.S. and its foreign trading partners have not yet established any consensus regarding the taxability of income from multinational transactions conducted via the Internet. Recent statements by the OECD indicate that our trading partners are seeking to reach agreement with the U.S. to enact standards that would fairly distribute the taxation of income from these transactions among countries involved in the transaction. The U.S. should not create a domestic policy that it may not want to be tied to internationally or that could create awkward relationships with its trading partners.

Summary

Enactment of the business activity tax proposals could impart serious consequences on the marketplace and on the ability of state and local governments to provide services to taxpayers. However, the most serious impact could be on individual taxpayers and businesses deeply rooted in their communities. They may be forced to bear a greater share of the tax burden if mobile and flexible companies are allowed to shelter much of their income in tax havens. In order to make an informed decision on this issue, Members of Congress and state legislators are strongly encouraged to educate themselves on how these proposals could impact their constituents by discussing the issue directly with your state's revenue officers and in-state businesses.

The Conflict Between the Cessation-of-Business Concept and the Functional Test in California and in Other UDITPA States

*by Andrea H. Chang**

Introduction

The Uniform Division of Income for Tax Purposes Act (UDITPA) provides a definition of business income that has been interpreted in many states as containing two alternate tests: the transactional test and the functional test. The transactional test has not been subject to much controversy. Under that test, income from frequent and regular transactions, such as income from the sale of inventory, constitutes apportionable business income of the taxpayer's trade or business. The existence and scope of the functional test, on the other hand, have been the subject of much debate. Under the functional test, income that would fail the transactional test because it does not arise from regular or recurring transactions can still constitute business income if the income arises from an asset that serves an integral function in the operation of the trade or business. California is one of the many states that recognize the existence of the functional test.

In recent years, some taxpayers and their representatives have argued that any sale of assets that represents a cessation of the taxpayer's trade or business, in whole or in part, should not be subject to the functional test. Proponents of this "cessation-of-business" concept advocate that, instead, a "totality of the circumstances" test be applied to characterize the gains from any such sales. This article explains (1) how the cessation of business segments is treated in California, (2) how the "cessation-of-business" concept has been applied in other states, and (3) how the "cessation-of-business" concept, and its "totality of the circumstances" test, are really no more than an ill-disguised version of the transactional test and are, as a result, an improper replacement for the functional test in states that recognize the existence of the functional test.

I. Cessation of a Business Segment in California

California Revenue and Taxation Code section 25120 specifies that business income "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." (Rev. & Tax. Code § 25120, subd. (a).) This provision, known as the functional test, focuses on the relationship between the asset generating the income or expense and the trade or business of the taxpayer. Accordingly, "gain or loss from the sale, exchange or other disposition of real or tangible or intangible personal property constitutes business income ***if the property while owned by the taxpayer was used in the taxpayer's trade or business."*** (Cal. Code of Regs., tit. 18, § 25120, subd. (c)(2), emphasis added; MTC Apportionment Regulations, reg. IV.1 (c)(2).)

Consistent with this principle, the California State Board of Equalization (SBE) has unequivocally held that gain from the sale of a unitary subsidiary is business income. In ***Appeal of Borden, Inc.,*** Cal. St. Bd. of Equal., February 3, 1977, for example, the SBE held that any income from the sale of assets that are integral parts of a unitary business (including income from the sale of a business division) constitutes business income.[1] The taxpayer in that case, Borden Inc., had sold the Western District of its Dairy/Services Division, its California-based operations,

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*Andrea H. Chang is a Tax Counsel with the California Franchise Tax Board. The opinions expressed in this article are her own and do not necessarily reflect the opinions or positions of the members of the California Franchise Tax Board, its staff, or management.

[1]The language of California Code of Regulations, section 25120, subdivision (c)(2) as it read in the years at issue was: "As a general rule, gain or loss from the sale, exchange or other disposition of real or tangible or intangible personal property constitutes business income *if the property while owned by the taxpayer was used to produce business income*." (Emphasis added.)

while retaining Dairy/Services Division operations elsewhere. Borden argued that the income from the sale of the goodwill involved in the Western District sale constituted nonbusiness income. The SBE explained the following:

> It is helpful to recall the concept of "unitary income" under prior California law. Under prior law income from tangible or intangible property was considered unitary income, subject to apportionment by formula, if the acquisition, management, and disposition of the property constituted integral parts of the taxpayer's unitary business operations. . . . Where that requirement was satisfied, income from such assets was considered unitary income even if it arose from an occasional sale or other extraordinary disposition of the property. . . . . As we explained in the Appeal of W.J. Voit Rubber Corp., decided May 12, 1964:
>
> > *The underlying principle in these cases is that any income from assets which are integral parts of the unitary business is unitary income. It is appropriate that all returns from property which is developed or acquired and maintained through the resources of and in furtherance of the business should be attributed to the business as a whole.* And, with particular reference to assets which have been depreciated or amortized in reduction of unitary income, it is appropriate that gains upon the sale of those assets should be added to the unitary income.
>
> The language of section 25120's definition of "business income" was patterned after the definition of "unitary income" as formulated in the above cited opinions of this board. . . . Specifically, the continuity between the old and new law suggests that when the Legislature adopted the Uniform Act, it did not anticipate a change in the prior rule that income from assets which are an integral part of the taxpayer's business is subject to apportionment by formula, regardless of whether the income may arise from an occasional or extraordinary transaction. (See Keesling and Warren, California's Uniform Division of Income for Tax Purposes Act, 15 U.C.L.A. L. Rev. 156, 164 (1967).)
>
> *Respondent's construction is also supported by the regulation interpreting section 25120, which is based on the original regulation adopted by the Multistate Tax Commission.*

(***Appeal of Borden, Inc., supra,*** emphasis added.)

The SBE reaffirmed the basic principles enunciated in ***Borden*** with ***Appeal of Triangle Publications, Inc.***, Cal. St. Bd. of Equal., August 1, 1984. In that case, Triangle Publications operated a radio and television division, a trade publications division, a magazine division, and a television publications division. During the years in issue, it sold two of these divisions. Triangle Publications contended that the gain from the sale of these two divisions had to be characterized as nonbusiness income. The SBE concluded otherwise, again holding that any income from the sale of assets that are integral parts of a unitary business is business income, even if these assets consist of business divisions:

> *As explained previously, section 25120 contains two alternative tests for determining the character of income, the transactional test and the functional test. Under the functional test, income from the disposition of an asset is generally business income if the asset produced business income while owned by the taxpayer; there is no requirement that the transaction giving rise to the income occur in the regular course of the taxpayer's trade or business.*
>
> *The income from the sales of the divisions and the building falls squarely within the ambit of the functional test. They were all reported by appellant as parts of its unitary business, and any income or loss from them while owned by appellant was apparently reported by appellant as business in character. Appellant's contention on appeal that the divisions were separate businesses directly contradicts, without basis, its own earlier characterization*

(**Appeal of Triangle Publications, Inc., supra**, emphasis added.)

In addition, the California Court of Appeal has held that the income from the sale of a unitary subsidiary constituted business income of the taxpayer's trade or business. In **The Times Mirror Co. v. Franchise Tax Board** (1980) 102 Cal.App.3d 872, the taxpayer sold the stock of one of its unitary subsidiaries, The Sun Company. The parties stipulated that The Sun

Company included the intangible rights represented by its stock, and that the company was managed as an integral part of the regular business operations of Times Mirror. As a result, the California Court of Appeal found that the taxpayer had not held the stock of The Sun Company as an investment and that, instead, the gain on the sale constituted business income.

In **The Times Mirror Co., supra,** 102 Cal.App.3d 872, the mere fact that the subsidiary, prior to its sale, had been an integral part of the taxpayer's trade or business, constituted sufficient grounds for the court's holding. However, the court also placed great emphasis on the fact that the taxpayer had commingled the proceeds from the sale of subsidiary with its other business assets and had used those proceeds to pay expenses of the trade or business. This emphasis is troubling if viewed as the sole or primary reason for the court's holding. That is because such reasoning would be in conflict with the U.S. Supreme Court's admonition that the mere flow of funds does not constitute the requisite operational relationship between an asset and a taxpayer's trade or business to make the income from that asset business income. (**Container Corp. v. Franchise Tax Board** (1983) 463 U.S. 159, 166, explaining that for formula apportionment to be appropriate, "there must be some sharing or exchange of value 'beyond the mere flow of funds arising out of a passive investment or a distinct business operation'"; *cf.* **Lenox, Inc. v. Tolson**, 2001 N.C. LEXIS 671 and **Lenox, Inc. v. Offerman** (N.C. Ct. App. 2000) 538 S.E.2d 203, criticized *infra*, at pp. 8-9.) For that reason, **The Times Mirror Co. v. Franchise Tax Board, supra**, should not be relied upon for the proposition that the use of proceeds determines the business characterization of those proceeds.

As the SBE has correctly pointed out in the past, the use of the proceeds for a business purpose does not govern the characterization of those proceeds. Otherwise, "the income from virtually any investment or activity, no matter how unconnected they are to the operation of the unitary business, would be apportionable business income so long as the income itself was later used in the business. Such a rule could not pass constitutional muster." (**Appeal of Fairmont Hotel Company**, 95-SBE-004, June 29, 1995, citing **Container Corp. v. Franchise Tax Board, supra.**) Similarly, if The Sun Company in **Times Mirror** had been a distinct business operation instead of an integral part of the taxpayer's unitary trade or business, the mere fact that the taxpayer later used the sales proceeds for business expenses would not convert those proceeds into business income. Instead, the court of appeal reached the correct result precisely because The Sun Company had been managed as and constituted an integral part of Times Mirror's unitary business.

More recently, the California Supreme Court has upheld the existence and validity of the functional test, as applied in California by the SBE. (See **Hoechst Celanese Corp. v. Franchise Tax Board** (2001) 25 Cal.4th 508.) Moreover, the California Supreme Court cited its own, pre-UDITPA case, to explain that any gain on the sale of a business asset constitutes business income. (See **Holly Sugar Corp. v. Johnson** (1941) 18 Cal.2d 218.) This pre-UDITPA case, followed by the supreme court in construing the business income definition in UDITPA, involved the characterization of losses from the cessation or liquidation of a unitary subsidiary:

> *In* Holly Sugar*, we held that losses suffered by a taxpayer from the forced liquidation of stock were apportionable because "the stockholding was an integral part of [the taxpayer's] unitary sugar business." (Citation omitted.) The stockholding was "integral" because . . . "the activities of the two companies" constituted "one indivisible, composite whole, each portion giving value to every other portion." (Citation omitted.) Because of "this organic unity of operation,"* we regarded the liquidation of the stockholding as an "integral" part of the unitary business of the taxpayer.

(**Hoechst Celanese Corp. v. Franchise Tax Board, supra**, 25 Cal.4th at pp. 531-532, emphasis added, citing **Holly Sugar Corp. v. Johnson, supra,** 18 Cal.2d 218.)

Thus, the courts and SBE in California have consistently applied the functional test to the cessation or liquidation of a subsidiary or business segment, in the same way they have applied the test to any other asset of the unitary trade or business.

II. The Cessation-of-Business Concept In Other States

Several other states have addressed the characterization of the gain from the cessation or liquidation of a business segment, and have taken an approach that differs from that of California. These states include North Carolina, New Mexico, Pennsylvania, and Illinois.
One of the most recent out-of-state cases on this

subject is **Lenox, Inc. v. Tolson,**[2] 2001 N.C. LEXIS 671. In **Lenox, supra**, the issue was whether the gain on the liquidation of a corporate division constituted business income. Lenox, a manufacturer of a variety of consumer products, including fine china, crystal, dinnerware, fine jewelry, and other items, liquidated its jewelry division (named ArtCarved) and its candle division. Lenox characterized the gain from the liquidation of the jewelry division as nonbusiness gain, but characterized the loss from the liquidation of the candle division as business loss. (See **Lenox, Inc. v. Offerman** (N.C.Ct.App. 2000) 538 S.E.2d 203, 209 (dis. Opn. of Hunter, J.) for a discussion of the facts.) Two years earlier, Lenox had also liquidated a dinnerware subsidiary, and had characterized the loss from that liquidation as a business loss. Prior to the liquidation, Lenox had treated and reported all three segments as being part of its unitary group. (*Ibid.*) The North Carolina Supreme Court held that the gain from the liquidation of the jewelry division was nonbusiness income.

The North Carolina Supreme Court arrived at its holding primarily by interpreting the functional test as requiring an element of frequency or regularity. In doing so, the court applied an interpretation of the functional test that is, for all purposes, indistinguishable from the transactional test. According to the court, the liquidation of the jewelry division was an extraordinary event and, as such, it generated nonbusiness income under both the transactional test and the functional test. Thus, the court relied on an extremely narrow interpretation of the functional test.

The court also emphasized that "when an asset is sold pursuant to a complete or partial liquidation, the court must focus on more than the question of whether the asset was integral to the corporation's business." (**Lenox, Inc. v. Tolson**, 2001 N.C. LEXIS 671 at p. 11, citing **Laurel Pipe Line Co. v. Commonwealth** (1994) 537 Pa. 205 [642 A.2d 472].) "Furthermore," the court added, "this Court has specifically noted that liquidation cases are in a separate category because the transaction at issue is a means of ceasing business operations rather than in furtherance thereof." (**Lenox, Inc. v. Tolson, supra**, at p. 11.) As a result, it appears that the court also relied, to some extent, on the belief that liquidation or cessation-of-business cases represent a special subcategory of business/nonbusiness cases.

The North Carolina Court of Appeals, whose decision the North Carolina Supreme Court upheld, certainly believed that cessation-of-business cases represent a special type of case that warrants the use of a special, "totality of the circumstances test." Using such a test, the North Carolina Court of Appeals held that the gain from the liquidation of Lenox's jewelry division was nonbusiness income. The court of appeal relied on a footnote in **Polaroid Corp. v. Offerman** (1998) 349 N.C. 290 [507 S.E.2d 284], in which the North Carolina Supreme Court had stated that, in true liquidation cases, the asset and transactions are not in furtherance of the unitary business, but are a means of cessation. (*Id.*, at p. 306, fn. 6.) The court of appeals construed this statement as establishing a third test (distinct from the transactional test and the functional test, and derived from out-of-state cases) for liquidation cases. Such a test does not look to whether the asset was integral to the trade or business, but to the "totality of the circumstances," including the nature of the transaction, and how the proceeds are used.

Using this "totality of the circumstances" test, the court of appeals placed great significance on the fact that the liquidation proceeds were not used in Lenox's ongoing business operations, but were distributed as dividends. The court also relied on the fact that the liquidation of ArtCarved represented a cessation of that operation, and that Lenox was not engaged in the business of buying and selling assets or operating divisions. In addition, the court found credible and significant Lenox's claim that the ArtCarved Division was functionally and financially distinct from Lenox and its other businesses, even though Lenox had up until that point treated ArtCarved as part of Lenox's unitary group, and had deducted the division's expenses accordingly.

Among the out-of-state liquidation cases that the **Lenox** court of appeal (and subsequently the supreme court) relied on were **McVean & Barlow, Inc. v. New Mexico Bureau of Revenue** (1975) 88 N.M. 521 [543 P.2d 489], **Welded Tube Co. v. Commonwealth** (Pa. Commw. Ct. 1986) 101 Pa.Commw. 32 [515 A.2d 988], **Laurel Pipe Line Co. v. Commonwealth** (1994) 537 Pa. 205 [642 A.2d 472], and **Texaco-Cities Service Pipeline Co. v. McGaw** (1998) 182 Ill.2d 262 [695 N.E.2d 481].

McVean & Barlow, Inc. v. New Mexico Bureau of Revenue, supra, involved a taxpayer who was in the business of laying pipelines of two types: small-diameter pipelines and large-diameter pipelines. The

[2] In **Lenox, Inc. v. Tolson**, 2001 N.C. LEXIS 671, the North Carolina Supreme Court affirmed the North Carolina Court of Appeals decision in **Lenox, Inc. v. Offerman** (N.C.Ct.App. 2000) 538 S.E.2d 203. E. Norris Tolson replaced Muriel Offerman in the interim as the Secretary of the North Carolina Department of Revenue.

taxpayer sold off its large-diameter pipeline business, and retained only its small-diameter pipeline business. The court held that the income from this partial liquidation was nonbusiness income. The court relied on the fact that the taxpayer was not in the business of buying and selling pipeline equipment (i.e. the court used the transactional test). More importantly, however, the court found that the sale of equipment did not constitute an integral part of the regular trade or business operations of the taxpayer, because the sale represented a cessation of the taxpayer's large-diameter pipeline business.

In **Welded Tube Co. v. Commonwealth, supra**, a case from Pennsylvania, the taxpayer had two manufacturing facilities, one in Pennsylvania and one in Illinois. The Pennsylvania facility became unprofitable, and the taxpayer sold that facility and related equipment while retaining the operations in Illinois. The Pennsylvania court held that the sale of the manufacturing facility resulted in business income because it was a regular practice of the taxpayer to acquire property in the expansion of its business (and therefore, presumably, the disposition of that property was also in the regular course of its business). The court also cited as relevant factors the fact that the sale of the facility did not involve the liquidation or cessation of a business (the taxpayer had retained the other manufacturing facility), and the fact that the sales proceeds were used to satisfy business debt and support the other manufacturing facility.

In **Laurel Pipe Line Co. v. Commonwealth, supra**, also a Pennsylvania case, the company engaged in a partial liquidation, completely selling off one of its pipeline operations. The court looked at the "totality of the circumstances" and held that the sales proceeds constituted nonbusiness income. Among the factors that the court found significant were the fact that the sales proceeds were not reinvested back into the operations of the business (but were instead distributed to the stockholders), and that the pipeline had constituted a separate and distinct aspect of the taxpayer's business.

In **Texaco-Cities Service Pipeline Co. v. McGaw, supra**, an Illinois case, the taxpayer partially liquidated its assets, selling off a non-operational pipeline and the associated real estate. The Illinois Supreme Court held that the sale generated business income because the assets at issue had been used in the taxpayer's trade or business, and therefore the income they generated was business income under the functional test. However, the taxpayer argued that its case was analogous to **Laurel Pipe Line Co. v. Commonwealth, supra**. Instead of simply rejecting the "totality of the circumstances" analysis used by the **Laurel Pipe** court, the court responded by remarking that Texaco's sale did not mark the cessation of the company's activity in its line of business, and that the sales proceeds were reinvested in the company. As a consequence, this case was subsequently cited by the North Carolina Court of Appeals as supporting the latter's use of the "totality of the circumstances" test in a liquidation case.

III. Inapplicability in States Recognizing the Existence of the Functional Test

McVean & Barlow, Inc. v. New Mexico Bureau of Revenue, supra, decided in 1975, was the first case in which income from a sale of assets was held to constitute nonbusiness income because the sale represented a cessation of a line of business. The court in this case provided no legal authority to explain why the cessation of a portion of the taxpayer's business should be treated any differently from the sale of a fixed asset of the trade or business. The court seems to have relied primarily on certain language from ***Western Natural Gas Company v. McDonald*** (1968) 202 Kan. 98 [446 P.2d 781], that stated:

> *It is not the use of the property in the business which is the determining factor under the statute.* The controlling factor by which the statute identifies business income is the nature of the particular transaction giving rise to the income. *To be business income the transaction and activity must have been in the* regular course *of taxpayer's business operations.*

(**McVean & Barlow, Inc. v. New Mexico Bureau of Revenue, supra**, 88 N.M. at p. 523 (emphasis added by the **McVean** court).)

The **McVean** court merely stated that it agreed with the court's decision in **Western Natural Gas Company v. McDonald, supra**, and concluded:

> *In the present case, taxpayer was not in the business of buying and selling pipeline equipment and, in fact, the transaction in question was a partial liquidation of taxpayer's business and a total liquidation of taxpayer's big inch business. The sale of equipment did not constitute an integral part of the regular trade or business operations of taxpayer. This sale contemplated a cessation of taxpayer's big inch business. Accordingly, we reverse the decision and order of the Commissioner.*

(**McVean & Barlow, Inc. v. New Mexico Bureau of Revenue, supra**, 88 N.M. at p. 524.)

The opinion provides no further analysis or explanation for the court's holding. A closer reading of the case reveals, however, that although the New Mexico court paid lip service to the existence of two alternate tests, it actually rested its holding on an interpretation of the statutory definition of business income as containing only the transactional test. The court quoted with approval the language in **Western Natural Gas Company v. McDonald, supra**, that rejected the functional test, and said that the controlling factor was not the use of the property in the business, but the nature of the transaction and whether it arose in the regular course of the business. (**McVean & Barlow, Inc., supra**, 88 N.M. at p. 523.) As a result, it is fair to say that **McVean** is a case rooted in the transactional test, and that it focused on the cessation of a business segment in the context of that test.[3]

The California State Board of Equalization appears to have recognized that **McVean** and **Western Natural Gas** were cases rooted in the transactional test, and explicitly rejected their line of reasoning in **Appeal of Borden, Inc., supra**, and **Appeal of Triangle Publications, Inc., supra:**

> As support for its position, appellant cites decisions from Kansas and New Mexico which held that gain from an extraordinary or occasional sale of an asset is not business income. (McVean & Barlow, Inc. v. New Mexico Bureau of Rev., 88 N.M. 521 [543 P.2d 489] (1975); Western Natural Gas Company v. McDonald, 202 Kan. 98 [446 P.2d 781] (1968).) In the Appeal of Borden, Inc., supra, we specifically rejected the reasoning of the Kansas and New Mexico decisions, and we recently reaffirmed our Borden decision in the Appeal of Calavo Growers of California, decided by this board on February 28, 1984.

(**Appeal of Triangle Publications, Inc., supra**, fn. omitted.)

The next case to cite liquidation as a relevant factor in determining whether the proceeds from the liquidation constituted business income was **Welded Tube Co. v. Commonwealth, supra**, a Pennsylvania case. Unlike other cases, the court in this case was clear in specifying that liquidation and the use of the proceeds were relevant factors when applying the transactional test. As the court explained, "[u]nder the transactional test, earnings held for use in the regular course of on-going business operations or expended in the acquisition of assets to be used in future business operations have been held to be business income . . . [and] liquidation has been held under this same test to be nonbusiness income arising from a transaction of an extraordinary nature outside the regular course of the taxpayer's trade or business. **McVean; Western Natural Gas**." (**Welded Tube Co. v. Commonwealth, supra**, 515 A.2d at p. 993.)

Although the focus on the cessation or liquidation of a business segment originated in the context of applying the transactional test instead of the functional test, the **McVean** line of reasoning soon spawned a host of cases that appear to treat liquidation cases as being outside the reach of the functional test. In **Laurel Pipe Line Co. v. Commonwealth, supra**, the company engaged in a partial liquidation, completely selling off one of its pipeline operations. The Pennsylvania Supreme Court initially stated that, under the functional test, gain on the sale of an asset constitutes business income if the asset produced business income while owned by the taxpayer. (**Laurel Pipe Line Co. v. Commonwealth, supra**, 642 A.2d at p. 475.) However, the court inexplicably went on to apply a different test to the property at issue. Citing **McVean & Barlow, Inc. v. New Mexico Bureau of Revenue, supra**, the court looked at the "totality of the circumstances" and held that the sales proceeds constituted nonbusiness income. Among the factors that the court found significant were that the sales

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[3] *Cf.* the dissenting opinion's scathing criticism of the majority opinion's reliance on the extraordinary nature of the liquidation at issue:

> The taxpayer's second theory, which met with approval by the court, was that this particular sale produced business income because it was extraordinary, both in its size and in that it ended the taxpayer's involvement in big inch work.
>
> The "unusual" criterion established by the majority lacks support in case law and the statute. I submit that the issue is whether the property was used to produce business income – that is, whether it formed, in its "acquisition, management, and disposition" part of the taxpayer's business.
>
> (**McVean & Barlow, Inc. v. New Mexico Bureau of Revenue, supra**, 88 N.M., at p. 524.)

proceeds were not reinvested back into the operations of the business (but were instead distributed to the stockholders), and that the pipeline had constituted a separate and distinct aspect of the taxpayer's business.

Even though the parties had stipulated that the transaction at issue did not meet the transactional test, the court took a roundabout way to essentially apply the transactional test. What is ironic is that the court also found that the pipeline at issue had been idle for over three years prior to the time that it was sold, and that the pipeline was therefore not an integral part of the taxpayer's business at the time of the sale. This alone could have sufficed under the functional test as grounds for the court's holding. However, the court, relying heavily on **McVean & Barlow, supra**, chose to focus instead on factors that are more properly considered in the context of the transactional test.

In **Texaco-Cities Service Pipeline Co. v. McGaw, supra**, as discussed earlier, the Illinois Supreme Court explained why the taxpayer did not meet the "totality of the circumstances" analysis used by the **Laurel Pipe** court. However, the Illinois Supreme Court actually held that the sale generated business income under the functional test. As a result, one cannot convincingly argue that the court was actually endorsing the "totality of the circumstances" analysis.

More troubling is the North Carolina Court of Appeals' conclusion in **Lenox, Inc. v. Offerman, supra**, that "when the asset is sold pursuant to a complete or partial liquidation, courts focus on more than whether or not the asset is integral to the corporation's business. Instead, they concentrate on the "totality of the circumstances," including the nature of the transaction and how the proceeds are used." (**Lenox, Inc. v. Offerman, supra**, 538 S.E.2d at p. 207.) According to the court of appeals, "[c]essation ultimately justified treating the gains as nonbusiness income in **McVean & Barlow** and **Laurel Pipe Line**, whereas non-cessation justified classification as business income in **Welded Tube** and **Texaco-Cities**." (*Ibid.*) The North Carolina Supreme Court made the same conclusion, albeit by incorporating parts of the "totality of circumstances" test (and therefore the transactional test) into the functional test. (**Lenox, Inc. v. Tolson, supra**, 2001 N.C. LEXIS 671 at pp. 18-19.)

However, the North Carolina courts' characterization of those cases is inaccurate. Cessation justified treating the gains as nonbusiness income in **McVean & Barlow** and non-cessation justified classification as business income in **Welded Tube** only because the courts in these two cases were applying the transactional test, and cessation and use of proceeds can be relevant factors when applying that test. Likewise, the court in **Laurel Pipe Line** essentially applied the transactional test, by calling it "the totality of the circumstances," without explaining why it did not apply the functional test as well. As for **Texaco-Cities**, the court in that case was clear in holding that the gain on the sale constituted business income under the functional test, before the court even looked at any other factors under the "totality of the circumstances." Accordingly, non-cessation did not play as crucial a role in **Texaco-Cities** as the court of appeals in **Lenox** would have the reader believe.

Instead, it appears that the court of appeals in **Lenox**, and subsequently the North Carolina Supreme Court, found support primarily in dicta from a footnote by the North Carolina Supreme Court in **Polaroid Corp. v. Offerman** (1998) 349 N.C. 290. In that footnote, the court stated, "[w]e do note, however, that cases involving liquidation are in a category by themselves. Indeed, true liquidation cases are inapplicable to these situations because the asset and transactions at issue are not in furtherance of the unitary business, but rather a means of cessation." (*Id.*, at p. 306, fn. 6.) This footnote, in turn, was based on a point made in the *amicus* brief filed in that case by the Multistate Tax Commission (MTC). The MTC, in explaining why its calculation of the number of UDITPA states which recognize the functional test differed from that of the taxpayer, stated:

> [T]rue liquidation cases are in a category by themselves. Reliance on liquidation cases to establish the absence of a functional test is misplaced. Notwithstanding the sometimes broad language used in liquidation cases, in reality, these cases are saying that the liquidation was not integral to the regular trade or business operations but in termination of it.

(New Brief of *Amicus Curiae* Multistate Tax Commission in Support of Defendant-Appellant, Muriel K. Offerman, Secretary of Revenue, p. 26.)

Regardless of what the MTC intended by its statement, the North Carolina courts' indirect reliance on it and on the **Polaroid** footnote to establish a third, "totality of the circumstances" test for liquidations cases is unwarranted. There is simply no support in the statute or in the regulations for the proposition that liquidation cases are exempt from the functional test and that a third, "totality of the circumstances" test should apply to them instead.

Nor is there any support in the statute or in the regulations, when interpreted in light of their legislative history, for incorporating elements from the "totality of the circumstances" test into the functional test. In fact, an analysis of the so-called "totality of the circumstances" test reveals that it is no more than a type of transactional test that takes into account the fact that a cessation or liquidation is an extraordinary and unusual event.

Contrary to the North Carolina Supreme Court's holding in **Lenox**, the frequency and nature of a transaction are simply not relevant to the functional test, as this test focuses on the asset that produced the income and the asset's operational relationship to the trade or business. Instead, it is the transactional test that focuses on the frequency or regularity of a transaction. The North Carolina Supreme Court's interpretation of the functional test as requiring an element of frequency or regularity renders that test indistinguishable from the transactional test. In essence, the North Carolina Supreme Court in *Lenox* purported to be applying the functional test, while in actuality it was applying only the transactional test.

In **Lenox**, the North Carolina Supreme Court ignored and disavowed its earlier analysis in **Polaroid**, [4] and refused to look to the legislative history of the statutory definition of business income. The latter has its roots in California case law, and the legislative history clearly establishes that the functional test looks to whether the asset at issue served an operational function in the trade or business, not to how frequently the transaction at issue occurred. (See **Polaroid Corp. v. Offerman, supra**, 349 N.C. 290 at pp. 304-305, for an examination of the roots of the business income definition.)

Proponents of the "totality of the circumstances" test argue that, if read literally, the language in the functional test requiring that the "acquisition, management, and disposition" be integral to the trade or business requires that the disposition itself of an asset be integral to the trade or business. These proponents then argue that this is not possible, when the disposition is done pursuant to a cessation or liquidation of the trade or business. Consistent with this principle, the North Carolina Supreme Court argued in **Lenox** that a disposition pursuant to a cessation or liquidation of a business segment is not done in furtherance of the trade or business, but in cessation of it. However, as the dissent in **Lenox, Inc. v. Offerman, supra**, pointed out, even if one agrees that a full liquidation (in which the entire trade or business ceases and is liquidated) is not done in furtherance of the trade or business, this premise would not be true in partial liquidation cases such as **Lenox**. That is because a partial cessation or liquidation would allow the taxpayer to focus its efforts and resources on the remaining segment of the trade or business, thus benefiting the remaining trade or business, even if the proceeds are not reinvested into the latter.

The argument of the dissenting judge in **Lenox, Inc. v. Offerman, supra**, while it reveals the gross error of the holding in that case, is still not analytically complete. The life of any asset of the trade or business starts with its acquisition or development, and ends with its disposition. To hold that the asset generated business expenses during its acquisition and management, but that it did not generate business income during its disposition would be illogical and would turn the business income statute on its head.

If one were to adopt the **Lenox** courts' rationale and carry it to its logical conclusion, no sale of a business asset would ever produce business income~~,~~ because all sales can be characterized as partial liquidations of one sort or another. This is because at the point each asset is disposed of, it is arguably no longer integral to the trade or business—otherwise the taxpayer would not be disposing of it. (See **Hoechst Celanese Corp. v. Franchise Tax Board, supra**, 25 Cal.4th at p. 531, explaining that if "integral" were to mean "necessary or essential," many sales of business assets would not satisfy the functional test because the assets would no longer be necessary or essential at the time of the sale.) However, such an outcome would clearly conflict with the explanatory comments to UDITPA. (*Id.*) According to those comments, "[i]ncome from the disposition of property used in a trade or business of the taxpayer is includible within the meaning of business income." (Uniform Division of Income for Tax Purposes Act, 7A U.L.A. § 1, Comment (1966), *reprinted in* 2 Multistate Corporate Income

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[4] The court repudiated the explanation it had made two years earlier in **Polaroid Corp. v. Offerman** (1998) 349 N.C. 290 that the frequency or regularity of a transaction was irrelevant to the functional test, and stated instead that the frequency or regularity of a transaction is relevant to the functional test. (**Lenox, Inc. v. Tolson**, 2001 N.C. LEXIS 671 at pp. 8-9.) According to the court, "the source of corporate income cannot be disregarded, as extraordinary or infrequent transactions may well fall outside a corporation's regular trade or business." (*Id.* at p. 9.) In other words, the court inserted into the functional test a requirement that the transaction giving rise to the income be regular or frequent.

Tax Guide (CCH) ¶ 8005.) As a result, the *Lenox* holding is inconsistent with the intent behind UDITPA. (*Cf*. Peters, *The "Cessation-of-Business Concept"* (May 21, 2001) 20 State Tax Notes 1771, for a critique of the concept that gains from liquidations of unitary business segments should not be subject to the same rules as gains from sales of other unitary assets.)

In addition, as the California Supreme Court recently explained, "the phrase 'acquisition, management, and disposition of property' [merely] establishes that the taxpayer must: (1) obtain some interest in and control over the property; (2) control or direct the use of the property; and (3) transfer, or have the power to transfer, control of that property in some manner." (**Hoechst Celanese Corp. v. Franchise Tax Board**, *supra*, 25 Cal.4th at pp. 528-529.) The phrase does not require that the disposition of an asset be indispensable to the trade or business. As a result, the reasoning in **Lenox** cannot be followed in California. Furthermore, because the cessation-of-business concept is rooted in the transactional test and represents but a variant of that test, it cannot be used to the exclusion of the functional test in any state that truly recognizes the existence of the functional test and does not merely pay lip service to its existence.

Conclusion

In California, the liquidation or sale of a subsidiary is treated like the disposition of any other asset of the trade or business. That is, if the asset or subsidiary was an integral part of the trade or business (that is, if it served an operational function in the trade or business), any gain or loss upon its sale or disposition constitutes business income. Other states, such as Pennsylvania in **Laurel Pipe Line, supra**, and North Carolina in **Lenox, Inc. v. Tolson, supra**, have either concluded that a "totality of the circumstances" test, and not the functional test, should apply to liquidation cases, or that such a "totality of the circumstances" test is in fact part of the functional test.

However, there is simply no support in the statute or in the regulations for the proposition that liquidation cases are exempt from the functional test, or that a "totality of the circumstances" requirement, which includes the frequency or regularity of the transaction, is part of the functional test. In fact, such treatment would contradict the clear intent of the drafters of UDITPA, as the legislative history and the official comments to the uniform act reveal. As a result, the line of reasoning that started with **McVean & Barlow, supra**, and which has culminated in **Lenox, Inc. v. Tolson, supra**, must be rejected.

States' Adoption of Transactional and Functional Tests

Compiled by Deborah Mayer, Special Assistant Attorney General Illinois Department of Revenue

State	Functional & Transactional	Transactional Only
Alabama		Yes
Alaska	Yes	
Arizona	Yes	
Arkansas	Yes	
California	Yes	
Colorado	Yes	
Connecticut	N/A	N/A
Delaware	N/A	N/A
District of Columbia	Yes	
Florida	N/A	N/A
Georgia	N/A	N/A
Hawaii	Yes	
Idaho	Yes	
Illinois	Yes	
Indiana	Yes	N/A
Iowa	Yes	
Kansas	Yes	
Maine	Yes	
Maryland	N/A	N/A
Massachusetts	N/A	N/A
Michigan	N/A	N/A
Minnesota	N/A Statutory Change after *Firstar* and *Hercules*	
Mississippi	Yes	
Missouri	Yes	
Nebraska	Yes	
New Hampshire	N/A	N/A
New Jersey	Yes	
New Mexico	Yes	
New York	N/A	N/A
North Carolina	Yes	
North Dakota	Yes	
Ohio	No/Corp. Franchise Tax Yes (for individuals and Sub S corps.)	
Oklahoma	Yes	
Oregon	Yes	
Pennsylvania	Yes	
Rhode Island	N/A	N/A
South Carolina	N/A	N/A
Tennessee	Yes	
Utah	Yes	
Vermont	N/A	N/A
Virginia	N/A	N/A
West Virginia	N/A	N/A

Conducting Corporate Income Tax Audits

by Les Koenig, Director, MTC Joint Audit Program

Over the last 25 years I have witnessed numerous misunderstandings between state income tax auditors and representatives of corporate multistate taxpayers over what records are needed to conduct a corporate income tax audit. Often these misunderstandings lead to unnecessary confrontations that delay completion of the audit. It is hoped that this article may help clarify the need for certain records to complete an audit in a timely fashion.

The primary responsibility of any state auditor is to verify that any taxpayer has filed its state return in compliance with the state's law. Certain minimal records are needed to verify the return as filed. The following is a list of the basic records an auditor should obtain when conducting an audit of a multistate income tax taxpayer:

Federal Consolidated 1120 Return

It is imperative that the state auditor obtain access to the taxpayer's Federal Consolidated 1120 Return. This return forms the basis for most if not all state income tax returns. Net income, reported apportionment factors and state tax adjustments reported on the state tax return need to be verified by review of the Consolidated Federal 1120. The auditor should obtain all of the detail supporting the Consolidated 1120. (Sometimes this supporting data is included in internal "pro forma" 1120 returns.) The details regarding state tax adjustments are often found in the details for line items such as other deductions, other income or depreciation expenses. The auditor should not accept the pro forma 1120 returns in lieu of the Consolidated 1120. The Consolidated 1120 is the official document filed with the IRS while the pro forma returns are not an official return for state purposes. There well may be consolidating adjustments that would impact the separate pro forma returns.

Annual Reports/10-Ks

Publicly held companies are required to file Annual Reports/Form 10-Ks with the SEC. These documents are helpful to an auditor to obtain general information about the company being audited. They also may be useful in obtaining information about the corporate group to determine whether or not there is a unitary business for states that require a unitary return.

Apportionment Information

A multistate taxpayer by necessity must have detailed information regarding how the apportionment factors for the state have been calculated. Usually a taxpayer will obtain this information from various source documents and compile this information in a spreadsheet format. This spreadsheet is generally referred to as a 51-state detail for property, payroll and sales. The auditor at a minimum should obtain access to this document, although the auditor also may find it necessary to obtain access to the source documents if the information reported on the 51-state details appears to be inaccurate. Below is a description of some of the specific apportionment information that an auditor should look for.

- ☛ The denominator of the property factor should include fixed assets, inventory, real property and capitalized rent expense. The amounts reported in the denominator should be verified to the separate 1120 balance sheet items for the assets and rent expense items on the income statement of the Federal 1120. The reported numerator amounts should at a minimum be verified to the 51-state detail.
- ☛ The reported denominator should be verified either to Federal 940's or the payroll accounts on the Federal 1120 return. The reported numerator should be verified either to the state payroll filing requirements or the 51-state detail.
- ☛ The denominator of the reported sales factor should be verified by review of the source documents of each company's total sales. States that require a combined return need to obtain verification of the total of inter-company sales. Inter-company sales are eliminated for the sales factor. Line 1 sales on the Consolidated Federal 1120 often include inter-company sales. The taxpayer's consoli-

dating work papers used to prepare the financial information for the Annual Report will include detail for inter-company sales. The auditor should request the consolidating work-papers to ascertain all inter-company transactions. The reported numerator sales should be verified to the 51-state detail.

Unitary Information

Many states require combined reporting if a unitary business exists among members of the corporate group. The following information is needed to determine whether a unitary business exists:

- A list of officers and directors of all companies in corporate group.
- Policy and Procedure Manuals to determine if there are common policies among corporate group.
- Consolidating Work-papers to identify all inter-company transactions such as inter-company sales, purchases, loans, royalties, etc.
- List of any common trade names or trademarks used by any member of the corporate group.
- List of common functions (accounting, legal, auditing, tax, etc.) performed on behalf of members of the corporate group.
- Board of Director's Minutes and Committee Minutes to verify the control exercised by the Board of Directors.
- Copies of financing or loan agreements among members of the corporate group.
- Documents reflecting central purchasing and benefits therefrom among corporate group.
- Documents that reflect inter-company personnel transfers among corporate group.

The above list of documents should not be construed as an exhaustive list. Each audit is unique and additional records may be needed to conduct an income tax audit. However, if a taxpayer provides prompt access to these records, the audit should be completed in a timely manner. It should always be the goal of a state auditor to conduct the audit in a timely and professional manner. Taxpayer cooperation in supplying the necessary documents will help insure that the auditor will meet that goal.

Commission Adopts New Uniformity Recommendations

During a very active annual meeting session on July 27th, the Multistate Tax Commission voted to adopt three new uniformity provisions. An amendment to the MTC's statement concerning P.L. 86-272 deletes from the list of unprotected activities the shipment by an out-of-state seller of goods into a state by private truck, rail, *etc.* The adoption of a definition of "gross receipts" amends the income apportionment regulations to define a key term important to the determination of the sales (receipts) factor. Finally, a provision for defining for state tax purposes the residence of trusts containing funds for pre-arranged funeral services addresses uniformity concerns of the death-care industry. All three uniformity proposals, published below, were unanimously adopted by the Commission.

Adopted July 27, 2001

Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States Under Public Law 86-272 {amended by deleting IV.A.20}

IV. Specific Listing of Unprotected and Protected Activities

A. Unprotected Activities:

The following in-state activities (assuming they are not of a de minimis level) are not considered as either solicitation of orders or ancillary thereto or otherwise protected under P.L. 86-272 and will cause otherwise protected sales to lose their protection under the Public Law:

1. Making repairs or providing maintenance or service to the property sold or to be sold.

2. Collecting current or delinquent accounts, whether directly or by third parties, through assignment or otherwise.

* * *

19. Entering into franchising or licensing agreements; selling or otherwise disposing of franchises and licenses; or selling or otherwise transferring tangible personal property pursuant to such franchise or license by the franchisor or licensor to its franchisee or licensee within the state.

20. ~~Shipping or delivering goods into this state by means of private vehicle, rail, water, air or other carrier, irrespective of whether a shipment or delivery fee or other charge is imposed, directly or indirectly, upon the purchaser.~~ [RESERVED]

21. Conducting any activity not listed in paragraph IV.B. below which is not entirely ancillary to requests for orders, even if such activity helps to increase purchases.

Adopted July 27, 2001

Definition of "Gross Receipts" {amends MTC Reg. IV.2.(a) to add new paragraph 5}

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

(1) "Taxpayer" means [each state should insert the definition in Article II.3. or the definition in its own tax laws].

(2) "Apportionment" refers to the division of business income between states by the use of a formula containing apportionment factors.

(3) "Allocation" refers to the assignment of non-business income to a particular state.

(4) "Business activity" refers to the transactions and activity occurring in the regular course of a particular trade or business of a taxpayer.

(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.

Adopted July 27, 2001

MTC Uniformity Recommendation Defining the Residence of a Funeral Trust Statutory or Regulatory Provision

A resident of this state includes

* * *

a trust whose trustee has elected treatment as a Qualified Funeral Trust pursuant to alternative 1: [§685 of the Internal Revenue Code of 1986] alternative 2: [citation to specific state code provision establishing "qualified funeral trust"] where, at the time of the initial funding of the trust, the trust is required to be established under the laws of this state, or, in the absence of such a requirement, where a funeral home or cemetery located in this state is identified to provide the services or merchandise or both under the terms of preneed contract requiring the establishment of the trust.

Two More States Become MTC Sovereignty Members

The number of Sovereignty Members States of the Multistate Tax Commission has grown to five, with New Jersey and, most recently, Louisiana joining Florida, Wyoming and Kentucky in this membership catergory. Sovereignty Membership became available in 1994 as an opportunity for a State to fully support the Commission's activities even though a State has not enacted the Multistate Tax Compact. The Commission extends its appreciation and a warm welcome to Robert Thompson, Director, New Jersey Division of Taxation , and to Cynthia Bridges, Secretary, Louisiana Department of Revenue. New Jersey became a Sovereignty Member State on May 3 , 2001 and Louisiana was accepted as a Sovereignty Member State on July 25, 2001.

Both New Jersey and Louisiana were Associate Members and participated in one or more MTC projects prior to becoming Sovereignty Members.

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Calendar of Events

October 28 - November 2, 2001	Fall Program and Executive Committee Meetings **Featuring**: Federalism at Risk - (POSTPONED) The Wyndham Washington DC Hotel
January 17-18, 2002	Winter Executive Committee U.S. Grant Hotel, San Diego, California
March 18 - 21, 2002	Winter Program Committee Meetings Doubletree Hotel at Reid Park, Tucson, Arizona
July 28-August 2, 2002	35th Annual Meeting & Committee Meetings Monona Terrace Convention Center & Hilton Madison Monana Terrace, Madison, Wisconsin

Please contact Teresa Nelson, Production Editor, at 202-624-8699 to request a more detailed Calendar of Events that includes hotel and meeting registration information and tentative committee meeting schedules.

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