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REPORT OF THE HEARING OFFICER RE PROPOSED REGULATIONS UNDER ARTICLE IV OF THE COMPACT AND SUSPENSION OF THE ARBITRATION BY-LAWS
(Uniform Division of Income for Tax Purposes Act)

By-Law No. 7 of the Multistate Tax Commission requires the hearing officer to submit to the Commission a report which shall contain a synopsis of the hearing proceedings and a detailed recommendation for Commission action. In the case of a hearing held pursuant to Article VII(2), the recommendation shall include a proposed draft of those regulations which constitute the subject matter of the hearing.

Pursuant to the referred-to By-Law requirements, this report is necessarily divided into two parts. The first part is a synopsis of the written and oral reports pertaining to the proposed regulations; the second part is a detailed recommendation for Commission action by the hearing officer, including a proposed draft of the regulations.

I. A synopsis of the hearing proceedings:

A. Material Submitted

The hearing proceedings consisted of (a) the oral testimony presented at the formal hearing held by the Commission in accordance with the procedural requirements of the Commission; (b) submission of several written statements; and (c) a discussion of the suspension of the By-Laws concerning arbitration.

(a) The following persons testified at the hearing on April 26, 1971:

1) James H. Peters, Chief Tax Attorney, American Telephone and Telegraph Company, New York, New York, and Thomas S. Miller, Tax Department, Gulf Oil Corporation, Pittsburgh, Pennsylvania.

on behalf of the Committee on State Taxation of the Council of State Chambers of Commerce (generally referred to as the C.O.S.T. Committee). [The testimony of Mr. Peters and Mr. Miller was offered in conjunction with a written report, dated April 13, 1971, submitted by R. C. Cahoon, Chairman of the Committee on State Taxation of the Council of State Chambers of Commerce.]

2) Thane W. Swenson, Tax Department, American Oil Company, Chicago, Illinois. [Mr. Swenson's testimony was given from a prepared statement which was submitted in conjunction with his oral presentation.]

3) Mr. Claus Motulsky of the New York law firm of Casey, Lane and Mittendorf, 26 Broadway, New York, New York.

4) Carroll Newton, Chief Deputy, and acting Commissioner of the Revenue Division of the Michigan Department of Treasury, and Lawrence R. Abramczyk, Assistant Attorney General for the State of Michigan.

5) David B. Sarver, Manager, Regulations and Hearings Division, Income Tax Group, Department of Revenue, State of Illinois. [Mr. Sarver, in conjunction with his testimony, submitted "Proposal for a Uniform Regulation on Business Income under UDITPA" and a proposed set of rules and regulations for the State of Illinois.]

6) Mr. James Hamilton, Chief Counsel, Franchise Tax Board, Sacramento, California.

7) Mr. Theodore deLooze, Chief Tax Counsel for the State of Oregon.

(b) In addition to the oral testimony and the statements referred to above as having been submitted in conjunction with the oral testimony, the following written statements were submitted:

1) A letter dated April 14, 1971, signed by Frank H. Roberts and Toni Rembe on behalf of the law firm of Pillsbury, Madison & Sutro, Standard Oil Building, 225 Bush Street, San Francisco, California.

2) "Comments of the State and Local Tax Committee of the Tax Executives Institute, Inc. with Respect to the Proposed Uniform Regulations Under Article IV of the Multistate Tax Compact," under a transmittal letter dated April 26, 1971, signed by Alexander B. McKie, President.

3) Letter of April 8, 1971, from Stephen C. Nemeth, Jr., Assistant Secretary, Republic Steel Corporation, Cleveland, Ohio.

4) Substituted regulations for Reg. IV. 1. (a)(1) and Reg. IV. 1. (a)(2) submitted by Allison Green, Treasurer of the State of Michigan.

5) Comments submitted by Franklin C. Latcham, Chairman, Committee on State and Local Taxes of the Section of Taxation, American Bar Association, Crocker Plaza, San Francisco, California, prepared by Donald H. Burnett, 527 Pacific Bldg., Portland, Oregon, Thomas S. Miller, Gulf Oil Corp., Gulf Bldg., Pittsburgh, Pa., Donald K. Barnes, 14-206 General Motors Bldg., Detroit, Mich., and James H. Peters, Chief Tax Attorney, American Telephone & Telegraph Company, New York, New York.

6) A transmittal statement and memorandum on proposed Multistate Tax Commission regulations governing the treatment of interest income, submitted by Sperry & Hutchinson Company, 330 Madison Avenue, New York, New York.

7) A letter of April 15, 1971 submitted by D. C. Tischler, Tax Department, White Consolidated Industries, Inc., Cleveland, Ohio.

8) A letter of April 23, 1971, and enclosed comments by Martin Huff, Executive Officer, Franchise Tax Board, Sacramento, California, in response to those submitted by Franklin C. Latcham, Chairman, Committee on State and Local Taxes, Section of Taxation, American Bar Association.

9) A short statement read into the record by the hearing officer, submitted by Arthur England, Special Counsel for the State of Florida.

(c) The only material submitted in regard to the suspension of the By-Laws pertaining to arbitration was the testimony of Helmut O. Wolff, Regional Director, American Arbitration Association, Dallas, Texas.

B. Summary of Record of Proceedings

The material submitted at the hearing will be summarized in reference to subject matter and specific proposed regulations, rather than as a summary of the comment and recommendations of particular testimony or written statements.

Reg. IV. 1. (a)(1): Business and Nonbusiness Income

The only specific comments in regard to this provision were: (1) the testimony of Lawrence Abramczyk, Assistant Attorney General of the State of Michigan; (2) a proposed regulation submitted by Allison Green, Treasurer of the State of Michigan, as a substitute for this regulation and Reg. IV. 1. (a)(2); and (3) the testimony of David Sarver and the written material submitted in conjunction with his oral testimony.

Spokesmen for the States of Michigan and Illinois were critical of the approach taken in the proposed rules and regulations concerning the distinctions between business and nonbusiness income. While they agreed with the business community that Reg. IV. 1. (a)(2) inconsistently classified certain income in light of the basic statutory standard set forth in Reg. IV. 1. (a)(1), spokesmen for these states took the position that as a general proposition all income, from whatever source derived and however classified, was business income of a corporate taxpayer unless it constituted income derived from unusual, sporadic or isolated sources, transactions or events. Not only were those spokesmen critical of the distinction drawn by the regulations, for example, between the classification of interest income and dividend income; they were also critical of the failure of the regulations to follow the statutory language.

Other spokesmen who addressed themselves to this problem were equally critical of the difference in the treatment of dividend income and income from other investments and sources such as rents and royalties, gains or losses from sales of assets, interest, patents and copyrights.

The proposed regulation of the State of Michigan which would be substituted for Reg. IV. 1. (a)(1) and Reg. IV. 1. (a)(2) is as follows:

> "Article IV(1)(a) defines 'business income'. The term 'business income' means income from any source arising from transactions and activities in the regular course of a trade or business. The critical element in the proper characterization of income as 'business income' or 'nonbusiness income' is identification of those activities and or transactions which constitute the taxpayer's trade or business. In general, the activities and or transactions of a taxpayer will be considered a 'trade or business' if there is evidence to indicate that such activities and/or transactions were dependent upon or contributed to each other and to the operations of

the taxpayer as a whole. The term 'trade or business' is used in several sections of the Internal Revenue Code for federal income tax purposes, and this term, as used in Article IV(1)(a), in general, has the same meaning as when used in the Internal Revenue Code. For example, a particular activity will presumptively constitute part of a taxpayer's trade or business if the taxpayer, for federal income tax purposes, is able to deduct expenses incurred therein under § 162 of the Internal Revenue Code which provides for a deduction of certain 'trade or business' expenses. Similarly, income derived from the utilization, sale or other disposition of tangible property for which depreciation deductions have been taken under § 167 of the Internal Revenue Code, providing for deduction of depreciation on tangible 'trade or business' property, will be regarded as presumptively business income.

"If the above standard is inconclusive, a determination of whether the activities and/or transactions of a taxpayer constitute a 'trade or business' will turn on the facts of each case.

"In order for income from an activity and/or transaction to be classified as 'nonbusiness income', it must be income arising out of or directly attributable to occasional, isolated, unusual and/or sporadic activity of the taxpayer and not income on which the taxpayer relies, or could reasonably rely, in the conduct of any part of his trade or business.

"The classification of income by the labels occasionally given to such income, such as manufacturing income, income derived from sales activities, interest income, dividend income, income from the sale of property, income from copyrights, income from patents, income from royalties, operating income, nonoperating income, income from short term investments, foreign source income, etc. is of no aid in determining whether that income is business or nonbusiness income. In every instance the relationship of the income producing activity or transaction to the total business activities and/or transactions of the taxpayer is controlling.

"Because a taxpayer's trade or business is usually the sum of all related activities and/or transactions that it regularly engages in for profit, it is improper to single out any particular activity as constituting a taxpayer's 'principal' trade or business and thereby limit the scope of the taxpayer's trade or business. All activities generating income on other than a sporadic basis, which income is used in the operations of the taxpayer, will constitute elements of the taxpayer's trade(s) or business(es) and concomitantly give rise to business income.

"Because of the regularity with which most corporate taxpayers engage in investment activities, because the source of capital for such investments arises in the ordinary couse of a taxpayer's business, because the income from such investments is utilized in the ordinary course of the taxpayer's business and because such investment assets are used for general credit purposes, income arising from the ownership and/or sale or other disposition of such investments shall be regarded as presumptively business income. Such presumption may be rebutted if the corporate taxpayer can prove that such investment is an insignificant, irregular and unusual source of income.

"The term 'trade or business' is not limited to the carrying on of ordinary industrial or commercial activities. The term includes, for example, the professions, the arts, athletic activities, wagering, etc. There can be no ultimate definition of business income because the applicability of the term turns upon all the facts and circumstances pertaining to what constitutes the taxpayer's 'trade or business'."

Illinois would substitute the following in lieu of the general definition of business and nonbusiness income set forth in Reg. IV. 1. (a)(1):

"§ 300-2. Business and nonbusiness income
(a) General definitions. Business income is defined in section 1501(a)(1) to mean income arising from transactions and activity in the regular course of a trade or business, net of the deductions allocable thereto, and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of a person's regular trade or business operations. In essence, a person's business income is that income which arises from the conduct of such person's trade or business operations. The term does not include compensation or the deductions allocable thereto (see § 300-3).

Nonbusiness income means all income other than business income or compensation. The holding for investment purposes of stock, securities, land or other property, or the making of casual sales thereof, does not normally constitute a trade or business, and therefore investment income will, in general, be presumed to be nonbusiness income. However, if a person is engaged in a trade or business and if such person's regular trade or business operations include the acquisition, management and disposition of tangible or intangible property, then income from such property will be business income, even though such income is a type of investment income."

<u>Reg. IV. 1. (a)(2)</u>: <u>Business and Nonbusiness Income; Application of Definitions</u>

The only specific comment in reference to the first paragraph of this regulation is the suggestion of the addition of the term "dividends" after the word "interest" on line 2. This suggestion was made by the law firm of Pillsbury, Madison and Sutro.

<u>Reg. IV. 1. (a)(2)(A)</u>: <u>Rents and royalties from real and tangible personal property</u>

The use of the word "principal" in the general statement pertaining to rents and royalties and the phrase "related to or incidental to" were subject to criticism. The criticism was directed to the proposition that this statutory language which defines business income does not support the use of the word "principal" or the phrase "related to or incidental to" in defining "business income."

Comments submitted by members of the State and Local Taxes Committee of the Taxation Section of the ABA (hereinafter referred to as the "ABA Committee"), the Committee on State Taxation of the Council of State Chambers of Commerce (hereinafter referred to as the "C.O.S.T. Committee"), and the Tax Executive Institute, Inc. (hereinafter referred to as "T.E.I.") suggest, with minor variations, the following language:

"Rental income from real and tangible property constitutes business income when the rental of such property is a principal business activity of the taxpayer or the rental of the property is an integral part of the taxpayer's principal business activity."

The ABA and C.O.S.T. Committees argue further that "integral" means essential or necessary. They thus assert that all income is nonbusiness income unless the income is essential to the conduct of the taxpayer's principal business activity. The ABA and C.O.S.T. Committees disagree with Example (iii). They argue that the profitability of the retail business was in no way affected by the purchase and rental of excess building space. They also disagree with results in Examples (vi) and (vii) under the reasoning that these examples constitute an improper interpretation of the word "integral" as used in the statutory definition of business income.

<u>Reg. IV. 1. (a)(2)(B): Gains or losses from sales of assets</u>

The Tax Executive Institute asserts that this regulation also tries to differentiate between certain types of transactions to determine the nature of the income, rather than looking at its relationship to the taxpayer's business as a whole. T.E.I. then asserts that gains or losses from the sale or other disposition of real or tangible personal property should be considered business income only when the taxpayer is engaged in the sale or disposition of this property as a principal business activity.

The ABA comment suggests that the general introductory statement departs from the statutory definition of business income and would have it rewritten to read

"As a general rule, gain or loss from the sale, exchange or other disposition of real or tangible personal property constitutes business income if the acquisition, management and disposition of the property constituted integral parts of the taxpayer's regular trade or business operation."

Reg. IV. 1. (a)(2)(C): Interest

The proposed regulation on interest income provoked substantial comment. While the states of Michigan and Illinois agreed with the business community that the statutory language does not permit one standard to be applied to determine whether interest income is business income and another standard to be applied to determine whether dividend income is business income, they disagree with the "principal business activity" and the "necessary and essential" arguments submitted by most of the spokesmen for various business interests.

In statements submitted on behalf of Sperry & Hutchinson Company and by a member of the ABA Committee, it was argued that the proposed interest regulation is improper because (1) it conflicts with the statutory language; (2) it is inconsistent with the proposed regulations dealing with rents and royalties [Reg. IV. 1. (a)(2)(A)] and dealing with dividends [Reg. IV. 1. (a)(2)(D)]; and (3) it ignores sound previous learning in the field.

The statutory conflict argument revolves around the meaning of the term "integral." Sperry & Hutchinson Company and the ABA Committee member assert (1) that "integral" means "essential" and (2) that "essential" means the inability of the taxpayer to carry on its principal business activities if it does not have interest income. These opponents prefer the following statutory language, in the alternative:

1. "Interest income constitutes business income when dealing in securities is a principal business activity of the taxpayer or when the receipt of interest income is an integral part of the taxpayer's principal business activity."

2. "Interest income is business income when dealing in securities is a principal business activity of the taxpayer. Most interest income is nonbusiness income."

The first suggested language is adopted from Reg. IV. 1. (a)(2)(A) and the second from Reg. IV. 1. (a)(2)(D). In accordance with this revised language, it is suggested by Sperry & Hutchinson and the ABA Committee member that Examples (iii), (iv) and (v) be deleted.

Further comment on this proposed regulation characterizes it as a blatantly "market state" rewriting of the Uniform Act which is detrimental to state cooperative efforts.

In referring to previous learning in the field, the ABA comment uses the test of whether or not "the income arises in the main course of the taxpayer's trade or business."

Additional statements submitted on behalf of the business community are analogous to the statements submitted by a member of the ABA and Sperry & Hutchinson. The statement of the T.E.I. is critical of the introductory paragraph in the interest regulation and sets forth objections to Examples (ii), (iii) and (iv) because interest income in these examples does not result from the principal business activity of the taxpayer.

California submitted a statement in response to the ABA statement and supports the interest regulation. California asserts that the use of the term "integral" as suggested in the ABA and Sperry & Hutchinson statements is not helpful "since every act of a corporation can be characterized as having a necessary business purpose." California further finds no inconsistency between Examples (iv), (v) and (vii) under Reg. IV. 1. (a)(2)(A) (rents and royalties) and the interest regulation and examples. California's position is thus contrary to the statement of the ABA member and the Sperry & Hutchinson statement.

Other objections to the interest regulation pertain to what its opponents refer to as a "tracing problem." They argue that the regulations as written pose a compliance problem in determining the income, which interest "arises out of or what is created by a business activity of the taxpayer."

California denies the existence of this compliance problem as follows:

> "When the income is business income or nonbusiness income depends upon the relation of the intangible property from which the income is derived to the taxpayer's trade or business. This is made clear in Reg. IV. 1. (a)(2)."

Reg. IV. 1. (a)(2)(B): Dividends

Spokesmen on behalf of the business community and the state of California, except the law firm of Pillsbury, Madison & Sutro of San Francisco, favor the dividend treatment in the proposed rules with minor exceptions. The states of Illinois and Michigan oppose putting dividend income in any different category than other forms of intangible income subject to the specific allocation rules of UDITPA.

In support of the dividend income regulation C.O.S.T. supports their position by reference to the history preceding the adoption of the UDITPA language by the Conference of Commissioners of Uniform State Laws and the principal integrated activity argument submitted in connection with the interest income regulation. The result contemplated by business spokesmen is stated as follows in the statement of White Consolidated Industries, Inc.:

> "From a practical standpoint, however, it is desirable to have a rule making as much dividend income as possible non-

business income. This would enable an allocation of this income to the taxpayer's commercial domicile and leave the taxpayer to deal with the legislature in its home state over the question of the taxability of this income. Furthermore, it would not hinder the growing movement to exempt dividend income which I believe to be appropriate."

The C.O.S.T. Committee commended the Commission on its regulation with respect to dividends. It felt, however, that the interest and dividend described in Example (ii) of the dividend regulation be classified as nonbusiness income. The C.O.S.T. Committee further commented that this treatment of dividend income was the intent of the drafters of the Uniform Act.

The Tax Executive Institute generally agreed with the dividend regulation, but disagreed with the result reached in Example (ii) since the dividend income in Example (ii) did not result from the principal activity of the taxpayer.

The law firm of Pillsbury, Madison & Sutro of San Francisco states that the dividend regulation as drafted departs from the language of Article IV of the Multistate Tax Compact. This law firm contends that Article IV requires the classification of income as business or nonbusiness income by relationship of the intangible income to the taxpayer's trade or business operations and not by the classification of intangible income as interest, dividends, royalties, etc. This is also the position of the states of Illinois and Michigan. Pillsbury, Madison & Sutro suggest the following amendments:

"1. Regulation IV.1.(a)(1) - In the first sentence, insert the word 'dividends' after the word 'interest.'

"2. Regulation IV.1.(a)(2)(D) - Insert the following sentence between the first and third sentences:

"'Similarly, in those situations where the acquisition and ownership of stock is directly related to and constitutes an integral part of the conduct of the taxpayer's trade or business operations, dividends on such stock are business income.'

"3. Regulation IV.1.(a)(2)(D), Example (iii) - Insert a comma at the end and add the following phrase: 'unless the acquisition and continued holding of the stock of the subsidiary corporation is directly related to and constitutes an integral part of the conduct of the taxpayer's trade or business operations.'

"4. Regulation IV.1.(a)(2)(D), Example (iv) - Delete the word 'supplies' in the first sentence and insert in lieu thereof the phrase 'is engaged exclusively in supplying' and change the second sentence to read as follows: 'Dividends received from the owned corporation generally will constitute business income.' In the alternative, delete Example (iv) in its entirety."

Specifically in regard to dividends Mr. Abramczyk, speaking on behalf of the State of Michigan, stated as follows:

"The thrust of the objection of the State of Michigan to these initial regulations deals with proposed Reg. IV.1(a)(2)(D), namely the regulation dealing with treatment of dividend income. We think that the limitation of this kind of business income to securities dealers is impossible. From statutory language indicating that business income is generated by investment activities which are integral parts of a taxpayer's business, the draftsmen imply that such investments must be the principal business activity of the taxpayer. There is no justification for moving from this requirement that investment be a complementary part of a taxpayer's business before dividend income therefrom can be regarded as business income."

And, further commenting on the dividend question by reference to the substitute draft submitted by Michigan, he stated:

"The fifth element of our draft pertains to the area of proposed regulations that dividend income is, in the large majority of cases, presumptively nonbusiness income. An examination of the UDITPA standard reveals that the income from intangibles is regarded as business income where the ownership of such intangibles is an integral part of the taxpayer's business. Note that the statute does not say that such income is business income where the ownership of intangibles is the principal business activity of the taxpayer. Rather, all that is required is that it be an integral part of the taxpayer's overall business. The draftsmen of the regulations, when they analyzed dividend income, erroneously substituted the unwarranted principal activity test for the statutorily mandated integral part test. In this portion of our draft, we merely returned to the statute.

"In answer to the critical question of when investment activities are sufficiently related to other elements of taxpayer's overall business so as to justify inclusion of the income of such investments in the state's apportionable tax base, we rely heavily on the Michigan case of <u>Cleveland Cliffs Iron Company</u>, cited at 351 Mich 652. The standards laid down by the Michigan Supreme Court in that case represent intelligent and viable standards for determing when investment is an integral part of a taxpayer's business.

"I would like to discuss that case very, very briefly. The facts were that a corporation doing business in Michigan, but not domiciled therein, was subject to the Michigan franchise fee. The corporation argued that in the computation of the fee there should be excluded therefrom the value of its investment portfolio. Its argument was that the portfolio had a situs outside of the State of Michigan, and furthermore that the investments were not related to its activities in Michigan which consisted of the mining and transportation of iron ore. The Michigan Supreme Court took cognizance of the fact that the investments were purchased from income which was generated in the regular course of the taxpayer's business; that the investments were used as assets for general credit purposes; and furthermore, that the income from the investments was funneled directly into the corporation's ordinary business activities. And from these factual determinations, the Michigan Supreme Court concluded that these investments were indeed related to the taxpayer's ordinary business operation in the State of Michigan. Therefore, the Court included these investments in the measure of franchise tax.

"We feel that there is a parallel between the question in that case and the question that is before the states presently in the area of proper characterization of dividend income; and we feel that the standards of that case should be followed because they present the best approach toward classification of dividend income as business or nonbusiness income."

Michigan also criticized the examples used in the regulation as being too broad.

Mr. Sarver, speaking on behalf of Illinois, stated that he subscribed to most of what has been said already by the State of Michigan, and introduced into the record a journal article called "Proposal For a Uniform Regulation On Business Income Under UDITPA," Vol. 22, No. 1, Hastings Law Journal, and provisions of the Illinois income tax regulations. As did Michigan, Mr. Sarver suggested that income be treated in a single definition and that he did not think it appropriate to deal with interest income, dividend income, etc., as single items of income in the regulations. He further stated that

> "* * * The treatment of dividends is erratically different from the treatment of interest, and I can see no distinction that can be drawn between interest and dividends as to when one is business income and the other is business income. I think that this is so self-evident that I don't need to elaborate further.
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> "Example 4 under the dividend section is in direct opposition to common sense. Let me read it to you. 'Taxpayer and three other corporations each own 25% of the stock of a corporation which supplies materials to all four corporate owners. Dividends received from the owned corporation constitute nonbusiness income.' What could be more a part of a business operation of a taxpayer than maintaining partial control over, and a financial interest in, the supplies."

Illinois asserts that the proposed regulations dealing with dividend income and other intangible income ignores the fact that the statutory language employs two categories, namely,

1. Income arising from transactions and activities in the regular course of a taxpayer's trade or business; and

2. 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.

Illinois would emphasize the difference between the taxpayer's trade or business and the taxpayer's trade or business operations.

As above suggested, while other testimony and statements agreed that, for example, interest and dividends should not be treated differently, proponents of the business community argued that the interest regulations should be changed to conform to the dividend regulations standard. The State of California took no issue with the dividend regulation.

Reg. IV. 1. (a)(2)(E): Patent and copyright royalties

The C.O.S.T. Committee criticized Example (i) as being too broadly stated. It contended:

> "* * * If patents are incidental to a taxpayer's regular trade or business operations and licensing does not represent a principal business activity, royalties therefrom constitute nonbusiness income. * * * Any license activity is incidental and not a necessary part of the taxpayer's business.* * *"

California approved of the regulation as written. In the language of the California spokesman:

> "It is our view that patent royalties are in the purview of business income if the patents are acquired through the taxpayer's research activities in the regular course of business. Such research activities are an integral part of the regular business of the taxpayer and the expenses of such research are business expenses. Consequently, the income from such activities constitute business income."

It would appear that Michigan and Illinois would agree with California's statement in regard to patent and copyright royalties, since the phrase "regular course of business" is very analogous to the phrase "regular trade or business operations."

Reg. IV. 1 (a)(3): Proration of Deductions

Comment was offered on the last sentence of this paragraph, namely, that the 'taxpayer shall be consistent in the proration of deductions in filing returns or reports to all income tax states to which the taxpayer reports under Article IV of this Compact or the UDITPA." In referring generally to this regulation, the T.E.I. suggested that the Uniform Act does not require the proration of deductions to both business income and nonbusiness income or to more than one business of the taxpayer. Another spokesman suggested the deletion of this whole regulation. Another felt that it was a matter beyond the scope of the regulations and the enforcement capability of any one state.

Reg. IV. 2. (a): Apportionment and Allocation of Income Generally

Mr. Nemeth of Republic Steel criticized the second paragraph of this regulation which requires consistency in reporting business and nonbusiness income and the disclosure of inconsistencies on returns. Another suggestion was to have this regulation revised to read as follows:

> "'In the event the taxpayer in reporting to this state under identical regulations adopted by other states under this Compact, it shall disclose in its return to this state the nature and extent of the inconsistency; however, the taxpayer shall not be required to disclose any inconsistency in reporting which arises from an agreement for equitable adjustment under section 18 of Article IV.'"

Reg. IV. 2(b): Definition of "Taxpayer."

No comment.

Reg. IV. 2(c): Application of Article IV.

No comment.

Reg. IV. 2.(d): Two or More Businesses of a Single Corporation

This regulation came under strong attack by the C.O.S.T. Committee, an ABA committee member, the T.E.I., and others. It was argued that the Uniform Act did not author ze any single corporation as being engaged in more than one "trade or business" and in any event it is addressed to UDITPA Section 18 problems. It was further suggested that the underlying unitary argument is available to taxpayer and state alike, without any specific regulation. The State of California answered the argument of the ABA committee member as follows:

> "The contention is made that it is doubtful whether the Uniform Act authorizes the division of one corporate entity into more than one trade or business. While the Uniform Act does not specifically authorize such a division, it cannot be said that it prohibits such division. The fact of the matter is that the Uniform Act is silent on that matter. If such a division is prohibited, there may well be a constitutional problem because of taxing extraterritorial values since the business activity of one business group may not have any connection with the taxing state. It should be noted also that the Commissioners on Uniform State Laws (NCCUSL) included a prefatory note to Section 1(a) which states: 'This definition refers to "the" taxpayer's trade or business as if he had one business. It is not intended by this language to require a taxpayer having several "businesses" to use the same allocation and apportionment methods for the businesses. The language permits separate treatment of different businesses of a single taxpayer. Section 18 clearly permits separate treatment.'"

Further comment of the business community pertained to alleged difficulties of compliance. Another comment indicated that the tests provided for in the regulation are subjective, arbitrary, and conducive to selective determinations by examiners.

<u>Reg. IV. 3: Taxable in Another State</u>

Even though this is a crucial regulation, there was very limited comment submitted. The C.O.S.T. Committee and the statement submitted by an ABA member suggested the following addition to the last sentence of this proposed regulation:

> "For the purposes of Regulation IV 16 (a) (2) only, the taxpayer will be deemed to be taxable in the state of the purchaser with respect to all sales of tangible personal property to customers located in the Commonwealth of Puerto Rico, any Territory or Possession of the United States and any foreign

country or political subdivision thereof."

Another statement referred to the importance of this provision to the business community and their lack of enthusiasm over the so-called "origin-throwback rule" and suggested that the present language be retained.

David D. Sarver, from Illinois, offered the following comment in regard to this question:

> "Reg. IV.3.(a) deals with 'taxability in another state.' Again, the definition of 'taxable in another state', like the definition of 'business income' comes in two parts; and again, sufficient weight has not been given to one part of that definition. Current regulations stress only jurisdiction to impose a tax; not the fact that a tax law does exist and the taxpayer's paying a tax under it. I'll read the definition of 'taxability in another state.' 'The taxpayer is taxable in another state if 1) in that state he is subject to a net income tax or franchise tax measured by net income, franchise tax for the privilege of doing business, or a corporate stock tax, or 2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not subject the taxpayer to such a tax.' The current regulations give recognition only to the second part of that definition. In order to recognize that there are two parts to the definition, I think it should be read so that the first part of the definition applies to those cases where a corporation income tax or a similar sort of tax does exist, and the second part of the definition should be applied to those states where there is no corporation income tax or similar tax in existence.
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> "I would like to quote from the Illinois regulations. 'A taxpayer is subject to one of the specified taxes in 1) a particular state only if he is subject to such tax by reason of income-producing activities in such state. For example, a corporation which pays a minimum franchise tax in order to qualify for the privilege of doing business in the state is not subject to tax by that state within the meaning of 1). The amount of such minimum tax there has no relation to the corporation's activities within such state. Further, a taxpayer claiming to be taxable in another state under the tests set forth in 1), must establish not only that under the laws of such state he is subject to one of the specified taxes, but that he in fact pays such tax. If the taxpayer is subject to one of the taxes specified in 1), but does not, in fact, pay such a tax, such taxpayer may not claim to be taxable in a state imposing such tax under the tests set forth in 2).

"'On the other hand, if a taxpayer is not subject in a given state to any of the taxes specified in 1), but such taxpayer establishes that his activities in such state are such as to give that state jurisdiction to subject him to a net income tax; then, under tests set forth in 2), the taxpayer is taxable in such state notwithstanding the fact that such state has not enacted legislation to subject him to tax.'

"The regulation continues on and deals with Public Law 86-272, and then gives some examples.

"Current regulations deal with the problems of the volunteer taxpayer shipping goods into a state who is not in fact jurisdictionally subject to tax in that state, but does in fact pay a tax. He cannot claim to be taxable in a state although in effect he was filing a return, and paying a tax based on business activity rather than a qualification tax. I think that the volunteer problem is one that has been significantly overestimated. First, I think that volunteering to pay a tax in a state if that tax has a low rate is nothing more than good tax planning. Second, I think that volunteering to pay a tax in a state where you may not be jurisdictionally subject to tax reduces the impact of the throwback rule which most businesses are opposed to. I do not mean to say that a person can volunteer to pay a tax in a state where he's not doing business, but if he is shipping goods into a state, selling in a state, requiring considerable and significant business activity in a state merely because Public Law 86-272 exempts him, he waives exemption under 86-272 and pays the tax, then I believe he should be treated as 'taxable in another state.' If the current concept in the proposed regulations is retained, then the use of the jurisdictional test exclusively must be retained; I suggest that the regulations set a standard which the taxpayer could use for showing that he was subject to jurisdiction in another state; that that standard would be a ruling from a state taxing department that the state would not have jurisdiction to subject him to a tax.

The statement presented on behalf of the state of Michigan by Mr. Abramczyk suggested the following changes:

"* * * Reg. IV.3.(a) dealing with 'taxable in another state' is, in our eyes, very, very equivocal. We would like to remove the ambiguity; first, by including in subsection 1 the words 'and pays' after the word 'to' in the phrase 'in another state the taxpayer is subject to.' In other words, we say it should read, 'if by reason of business activity in another state, the taxpayer is subject to and pays' one of the types of taxes specified in Article IV.3(1). In addition to that, we would strike the last phrase in that section beginning with the word 'regardless' and ending with the word 'taxpayer' and substitute the following language, 'Even though the state has not enacted such a tax.' In conjunction with this, Reg. IV.3.(c) should contain the following addition after the words 'United States', at the end of the first sentence therein: 'Even though the state has not enacted such a tax.'"

Reg. IV. 10.(a): Property Factor: In General

The provision in Regulation IV. 10.(a) which excludes from the property factor property used in the production of nonbusiness income was criticized by the C.O.S.T. Committee.

Reg. IV. 10.(b): Property Factor: Property Used for the Production of Business Income

This regulation was criticized by the C.O.S.T. Committee and by a member of the ABA, as pertains to the examples and the business-nonbusiness differentiation.

Reg. IV. 10.(c): Property Factor: Consistency in Reporting

It is argued by some business representatives that the consistency language should not apply to the disclosure of any inconsistency in reporting which arises from an agreement for equitable adjustment under Section 18 of Article IV.

Reg. IV. 10.(d): Property Factor: Numerator

There was objection to the inclusion of the value of mobile or movable property on the basis of total time within the taxing state during the tax period. It is argued that no provision in the Uniform Act justifies this regulation. It was further objected to on the basis of compliance burdens.

Reg. IV. 11.(a): Property Factor: Valuation of Owned Property

Several persons objected to the use of determining "original cost" by reference to the basis of property for federal income tax purposes. It was argued that this would result in compliance difficulties for those taxpayers employing group or mass asset accounts for federal tax purposes. It was argued that these businesses could not identify what portion of a group asset account is located in a particular state. These spokesmen recommended that original cost as shown on the books and records of a taxpayer be substituted for original cost for federal income tax basis purposes. California answered these arguments as follows:

> "The use of the initial federal tax basis as 'original cost' of property is considered the most appropriate approach to insure that all states will use the same property valuation figure. Such federal tax information is ordinarily readily available. This is especially true of recently acquired property. If the state in which property is located which is included in group asset accounts is not ascertainable, a reasonable allocation of such property to the states involved would undoubtedly be acceptable. Moreover, the allocation for such order property need only be determined once."

Reg. IV. 11.(b): Property Factor: Rented Property

It was suggested that Examples (ii) and (iii) be revised in order to reflect that the rental income described in the examples is to be classified as nonbusiness income, rather than as business income.

Reg. IV. 12: Property Factor: Averaging Property Values

No comment.

Reg. IV. 13.(a): Payroll Factor, in General

The same comment was proffered as in regards to Regulation IV. 10.(c).

Reg. IV. 13.(b): Payroll Factor; Numerator

No comment.

Reg. IV. 13.(c): What is Compensation

No comment.

Reg. IV. 14.(a): Payroll Factor; What is an Individual

No comment.

Reg. IV. 14.(b): Payroll Factor; What is Compensation Paid in this State

No comment.

Reg. IV. 15.(a): Sales Factor; Sales made in General Business Operations

Substantial business opposition was expressed over the inclusion of federal and state excise taxes in gross receipts. The reasons given for the objections were: 1) The inclusion of these taxes distorts the sales factor and apportionment result since these taxes do not reflect receipts from which profits are derived; 2) the inclusion of these tax items will cause difficult compliance problems inasmuch as they are segregated from other receipts on the books and records of the taxpayer and said segregation is not by state; and 3) the excise taxes are not taxpayer receipts (the taxpayer acts as a collection agent or conduit only in reference to these tax receipts).

California answers these arguments as follows:

> "The suggestion is made that federal and state excise taxes (including sales taxes) should be excluded from the sales factor because they would increase taxpayer compliance and distort the apportionment of income between the states which differ as to rates of sales and excise taxes. State and federal excise taxes including sales taxes should be included in the receipts factor if passed on to the buyer or included in the selling price since Section 1(g) of UDITPA defines 'sales' as meaning all gross receipts. Taxes passed on or included in the sales price clearly fall within the statutory definition of 'sales.'"

<u>Reg. IV. 15.(b): Sales Factor: Sales Incidental to General Business Operations</u>

There was some objection to including in the sales factor for apportionment purposes gross receipts derived from business activities or transactions "incidental to [taxpayer's] principal business activity." (Bracketed material added) In addition, the same comment concerning the consistency requirement was made here as was made in reference to Reg. IV. 10.(c) and Reg. IV. 13.(a).

<u>Reg. IV. 15.(c): Sales Factor: Sales Made in Other Types of Business Activity</u>

No comment.

<u>Reg. IV. 15.(d): Sales Factor: Numerator</u>

Inclusion of interest, carrying charges and returns and allowances in gross receipts was also criticized. California answered this argument as follows:

> "The ABA Committee comments suggest that interest income, service charges, carrying charges, or time price differential

charges, incidental to sales of tangible personal property be excluded from the sales factor.

"The inclusion of interest or service charges in gross receipts is in accordance with the statutory definition of sales (Section 1(g)) as meaning gross receipts. Such receipts are assigned to the state in which the sale of the property is assigned. Any difficulties arising because of this provision can be solved on an equitable basis under the authority granted in Section 18 of UDITPA."

There was one comment submitted on the scope of Reg. IV. 10, 13 and 15 (the property, payroll and sales factors). This comment is as follows:

"In these sections, there is repeatedly emphasized the concept of eliminating values not associated with the 'production of business income', rather than seeking to clarify apportionment provisions of the Compact. Inclusion of such language, together with consistency requirements discussed earlier, are incompatible with the Compact and should be deleted. Since the main thrust of these regulations is to treat with all income, except dividend income, as business income subject to apportionment, it necessarily follows that minimal tax liabilities would be involved in such adjustments. Therefore, such adjustments simply do not warrant the minuscule and detailed analysis that would be necessary in order to properly eliminate such values. It is therefore recommended that the phrase 'to produce business income' and comparable phrases appearing in these sections be deleted."

<u>Reg. IV. 16.(a):</u> <u>Sales Factor: What Sales of Tangible Personal Property are in this State.</u>

One comment offered in reference to Reg. IV. 16.(a) is as follows:

"In the last statement of the rule, along with the example, sales of goods shipped into a state where taxpayer is not taxable when shipped from a supplier in a state where taxpayer is likewise not taxable are assigned nevertheless to a state from which the salesman operated. The language of the Compact does not support the assignment of the sales described in this statement and its example, nor did the majority of the Committee (state and business representatives) agree to its inclusion. Legal and theoretical considerations do not support the 100% accountability of sales concept. Since the Compact law does not deal with the described type of transaction, it is beyond the propriety of a clarifying regulation to attempt to legislate in this manner. Therefore, the last statement of the rule, along with its example, should be deleted."

Reg. IV. 16.(5): Sales Factor; Sales to United States Government

It was suggested that the definition of sales to the United States Government as proposed is too restrictive and should be amended to include sales made to a prime contractor, where the prime contractor is authorized to act as agent for the United States Government. California commented to this statement as follows:

> "The provision in the regulation defining U. S. Government sales to be only sales for which the U. S. Goverment makes direct payments to the seller was obviously devised for ease in administration. The suggested broadening of the rule would make the determination of U.S. Government sales extremely complicated and may well result in substantial litigation. It is, therefore, not warranted."

Reg. IV. 17.(a): Sales Factor; Numerator: Sales other than Sales of Tangible Personal Property

There was an objection to the example in paragraph (3) on the basis that the example erroneously included in the sales factor intangibles which do not represent an integral part of the taxpayer's regular trade or business operations. In reference to paragraph (5), the following comment was offered:

> "In addition to the lack of Committee deliberation on the concept of a two factor formula for apportionment of gross receipts from intangible property, this section is inconsistent with other sections of the regulations as well as the Compact. There is no basis in the Compact language to support the use of a two factor property and payroll factor for assigning gross receipts from intangible personal property. It is recommended that this section be deleted in its entirety."

RECOMMENDATIONS

Reg. IV. 1. (a)(1): Business and Nonbusiness Income.

This regulation, in substance, repeats the statutory definition. No change is recommended.

Reg. IV. 1. (a)(2): Business and Nonbusiness Income; Application of Definitions.

As indicated in the Synopsis of the Hearing Proceedings, there were extensive comment and differences of opinion expressed in the classification of income as either "business income" or "nonbusiness income."

Inasmuch as business income is subject to apportionment and nonbusiness income is subject to specific allocation to the taxpayer's commercial domicile, at least as pertains to rents and royalties from real or tangible personal property, capital gains, interest, dividends, and patent or copyright royalties, this classification problem is of fundamental significance. Most of the comments were critical of many of the examples and the distinctions drawn in the regulations between various classes of income, such as income from dividends, royalties, interest and capital gain.

It was argued by those wishing a narrowed definition of "business income" that all classes of income should be treated as nonbusiness income unless the activities of the taxpayer constituted a necessary and essential part of the principal business activity of the taxpayer.

In so arguing, the proponents of a narrow definition of "business income" relied heavily upon the concept employed in the regulations that activity other than a taxpayer's principal business activity does not generate business income. In order for any investment activity or investments to give rise to business income, they argue that it is necessary to establish that the investments, the activity giving rise to the investments, and the income derived from the investments constitute an essential and necessary integral part of the principal business of the taxpayer. The proponents of a narrow definition further argued that intangible income, such as interest, dividends and royalties, was historically taxed at the commercial domicile of the corporation; that UDITPA was drafted to conform with this historical viewpoint; and that the commercial domicile constitutes the only source of intangible investment income.

The proponents of the narrow interpretation of "business income" were generally dissatisfied with the regulations treatment of "business income" except as to dividend income. Thus, most of their comments were to bring the regulations dealing with rents, royalties and interest, etc., in conformity with the requirement that the income-producing activity constitutes an activity which is an essential and necessary integral part of the principal business activity of the taxpayer.

Inasmuch as the major source of intangible income is either interest or dividends, spokesmen for a narrow interpretation of business income zeroed in on the regulations' treatment of interest income. In fact, that constituted the sole subject matter in the statement submitted on behalf of Sperry & Hutchinson.

Spokesmen for the states of Michigan and Illinois rejected, as contrary to the statute, the principal business activity test and the essential and necessary integral part test which was relied upon, in varying degrees, by the draftsmen of the proposed regulations. These states did agree that the regulations did erroneously distinguish between various classes of income such as interest and dividends.

Spokesmen on behalf of the state of California alone supported the distinction made by the regulations between dividend income and interest income, rents and royalties, patents and copyrights, etc.

The statutory language clearly requires that income generated by regular transactions and activities conducted by the taxpayer in carrying on his trade or business operations be classified as business income. The language does not permit interest from investments to be treated any differently than dividends from investments. It is this language which was adopted by the states when they adopted UDITPA. This language must be relied upon by states' attorneys and administrators in the enforcement of their respective income tax statutes. The Regulation concerning business vs. non-business income cannot be drawn to conform to the historical position of any particular state, even though that position is required to be adhered to by that particular state. True uniformity cannot be achieved by statutory language or by administrative rule. It can be achieved only when the language of the statute and any regulation in conformity therewith is interpreted and applied by a tribunal whose decision can constitute precedent for all of the states. Of necessity, California must abide by the judicial precedent of <u>Southern</u>

Pacific Co. v. McColgan, and Michigan must resolve the business income question in accordance with the unitary concept as developed in Cleveland-Cliffs Iron Co. v. Mich. Dept. of Revenue.

The statutory standard requires that all income from investments which constitute an integral part of the taxpayers' regular business activities be treated as business income, irrespective of whether the source of that income is interest from bonds, deposits or loans, dividends, gains on the disposition of tangible or intangible property or patents, copyrights or royalties, etc. The critical element in the proper characterization of income as "business income" or nonbusiness income" is identification of those activities and transactions which constitute the taxpayer's trade or business. For example, if the investment of money and the utilization of the investment, including the income derived therefrom, is a regular part of the taxpayer's business operations, the statutory language characterizes income from these investments as "business income." To require income from such investments to be treated as "nonbusiness income" is contrary to the statutory language and would place the compact states in an indefensible legal posture. Surely, a taxpayer who regularly and systematically carries on investment activity can establish, to the satisfaction of any fair-minded judge, that the income derived therefrom, which is used by the taxpayer in his business operations, is income received by him as an integral part of his regular trade or business operations.

The distinction in the regulations between business and nonbusiness income assumes that income from passive investments and particular intangible investments is a result of some kind of business activity, and that this business activity constitutes the generating source of this income. You are thus immediately enmeshed in a useless chase and meaningless fiction as pertains to large blocks of income which arise from passive investments to the extent you try to isolate and attribute passive income to a source or activity apart from the activities and places where the taxpayer carries on his regular business operations. Where passive investments, and income derived therefrom, constitute a part of a taxpayer's integrated or unitary business operations, it is reasonable and logical to attribute income from these passive sources to those places where the taxpayer carries on his regular business operations. The essential question here is the relationship of the investments and the income derived therefrom to the regular trade or business operations of the taxpayer. It is the concept of "business situs" rather than the concept of "commercial domicile" that is significant here. This does not mean that a taxpayer's trade or business could not consist solely of investment activities, in, for example, intangibles. In that event, it is logical and probably constitutionally required that this income be taxed at the place where the intangibles are held and utilized by the taxpayer. This place normally would be the taxpayer's commercial domicile. In this situation, the "business situs" and the "commercial domicile," and whatever activity there is associated with passive investment, takes place at a specific location. Hence, the rationale is assigning "nonbusiness" income to the commercial domicile.

The attached regulation spells out a uniform interpretation for application of the statutory language, irrespective of the nature or source of the income. It eliminates the employment of different standards to classify different species of income or different kinds of investments. There is eliminated the referred-to tests which are not supported by the statutory language. Furthermore, the attached regulation requires intangible income, which arises out of and is connected with the taxpayer's regular trade or business operations, to be apportioned to those states where the taxpayer in fact carries on his regular trade or business operations. The recommended regulation will not permit the wealth of business operations to be siphoned off and specifically allocated to the paper home of a paper taxpayer.

It is my recommendation that Reg. IV. 1.(a)(2) be deleted and the attached Reg. IV. 1.(a)(2) be substituted. The statutory language does not support distinct and separate tests and treatment of varying classes of income in determining whether or not different income constitutes business income. Furthermore, the statutory language does not support the "principal business activity test" employed throughout Reg. IV. 1.(a)(2). The statute defines business income either as (1) income arising from transactions and activities in the regular course of the taxpayer's trade or business; or (2) 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.

Reg. IV. 1. (a)(3). Proration of Deductions.

The proration of deductions is predicated on the proposition that a taxpayer may have deductions which are applicable both to business and nonbusiness income and to more than one "trade or business." It also requires a consistency in the proration of any deductions in a taxpayer's reports to a state which the taxpayer reports under Article IV of the Compact. In order to conform this regulation to the deletion of Reg. IV. 2.(d), the phrase "more than one 'trade or business'" and the phrase "trades or businesses" are deleted from this regulation.

Reg. IV. 2.(a): Apportionment and Allocation of Income Generally.

No change recommended.

Reg. IV. 2.(c): Application of Article IV.

This regulation apparently interprets the phrase "business activity" as used in Section 2 to refer to both business and nonbusiness income. However, in order for the language of Section 2 to be applicable, the taxpayer must have income which is taxable in more than one state. Business activity should be construed as activity which produces business income. It is recommended that the last sentence of this regulation be stricken and the second sentence be changed to read: "Income from business activity includes only business income."

Reg. IV. 2.(d): Two or More Businesses of a Single Corporation.

The question of whether or not a single corporation engages in more than one "trade or business" is closely related to the question of whether or not two or more corporations are conducting a single "trade or business." None of the provisions of Article IV are specifically addressed to either of these problems. There is nothing in Section 2 of UDITPA to indicate that the phrase "business activity" encompasses only a part of the business of a taxpayer.

Reg. IV. 3.(a): <u>Taxable in Another State: In General</u>

There is involved in the concept "taxable in another state" three different sections of Article IV, namely, Sections 2, 3 and 16. Section 2 permits a taxpayer having income from "business activity which is taxable both within and without this state" to allocate and apportion his net income as provided in other provisions of Article IV. Section 3 defines what is "taxable in another state" for purposes of allocation and apportionment of the taxpayer's income. Section 16 attributes sales of tangible personal property to the state of origin if "the taxpayer is not taxable in the state of the purchaser."

The question to be resolved in all three sections is what is meant by the word "taxable." Apparently the Section 3 definition of "taxable in another state" is applicable in the determination of two questions: First, when the taxpayer is permitted to allocate and apportion his income; and second, when certain sales of the taxpayer are to be attributed to the state of origin rather than to the destination state.

The regulations are not clear in the application of the two separate tests set forth in the definition of "taxable in another state" in Section 3, nor is the regulation clear in the application of this concept to the phrase "business activity" as used in Section 2. The regulation as written poses the following unanswered questions:

1) If another state imposes a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, can the taxpayer claim he is taxable in that state even though he pays no tax to that state?

2) If the taxpayer pays a tax to another state on his activities which give rise only to "nonbusiness income," is he taxable in another state for business income apportionment purposes?

3) If a taxpayer is exempt from a state's net income tax, franchise tax measured by net income, franchise tax for the privilege of doing business, or a corporate stock tax (whichever is applicable), does this exemption remove him from the first definitional test of Section 3 and require sales of tangible property to be attributable to that state for Section 16 purposes?

4) Does the imposition by the state of one of the taxes set forth in the first part of the definition of "taxable in another state" in Section 3 render inapplicable the jurisdictional standard contained in the second part of Section 3?

5) If a taxpayer is engaged in two or more trades or businesses but carries on only one of these trades or businesses in another state, is he nevertheless taxable in the other state in reference to his other trades or businesses and how does the throw-back rule under Section 16 operate under such circumstances?

6) The same definition of "taxable" is not applied to the sales factor regulation (Reg. IV. 15.) as is applied to the taxability question in this regulation.

It would appear there should be some congruence between income sources and the allocation and apportionment rules. Business activity giving rise to "nonbusiness income" should not constitute a basis for the apportionment of "business income" from business activities carried on solely in another state. Business activity results in business income, not "nonbusiness income."

Turning specifically to the language of Section 3, it appears that it sets forth two distinctly different standards in determining when a taxpayer is taxable in another state. The first standard applies in all circumstances where the other state imposes any of the enumerated taxes, and under those circumstances the second standard has no application at all. On the other hand, the second standard, namely, "jurisdiction to subject a taxpayer to a net income tax," is applicable only in those states which do not impose a net income tax, a franchise tax measured by a net income, a franchise tax for the privilege of doing business or a corporate stock tax. Furthermore, "subject to a net income tax" in the first standard would require full compliance with the requirements of the states imposing one of those taxes.

It is recommended that this regulation makes it crystal clear that the first part of the statutory definition of "taxable in another state" refers to taxes which are in fact imposed upon and required to be paid by the taxpayer. The phrase"subject to" was used in the first part of the definition of "taxable in another state" as an objective standard of payment and not to a theoretical jurisdictional standard. The theoretical jurisdictional standard is set forth in the second part of the definition of "taxable in another state." Thus, the employment of the language "jurisdiction to subject" rather than the phrase "subject to." For example, if the United Kingdom in fact imposes a net income tax on foreign corporations doing business within its borders, and the taxpayer does not pay or comply with the United Kingdom tax statute, he is not "taxable in another state" for Section 3 purposes, for, under those circumstances, the jurisdictional test (standard 2) is inoperative.

In conformity with the above analysis of the statutory language, the following changes are suggested to Reg. IV. 3.:

Reg. IV. 3.(a): Taxable in Another State

No recommended change.

Reg. IV. 3.(b):

It is recommended that the following language be added to the first sentence of this regulation to conform to the first test used in the statutory standard: "and is required to and pays a tax based on its business activities in another state."

Reg. IV. 3.(c):

It is recommended that the last sentence of the first paragraph and the example be stricken and that the following language be added to the first sentence: "but the state does not impose any of the taxes set forth in Article IV. 3.(1)."

Reg. IV. 10.(a): Property Factor; in General.

This regulation does not come to grips with the question of whether or not the word "and" in the phrase "owned or rented and used" is to be construed in the disjunctive or in the conjunctive. In other words, must property be owned and used during the tax period in order to be included in the property factor. I have been informed by Professor Pierce that the word "and" was considered by the Commissioners on Uniform State Laws to be used in the disjunctive sense. Thus, all tangible personal property owned by the taxpayer was in the property tax base and all tangible personal property rented and used by the taxpayer was to be in the tax base.

This regulation, in distinguishing between property used for the production of business and nonbusiness income, refers to property used and would therefore appear to require that the property be owned and used or rented and used for the tax period for the production of business income. If property which is owned by the taxpayer is included in the property factor, you have available a more simple, direct objective test in determining what property is included in the property factor. Certainly, the phrase "used during the tax period to produce business income," particularly as to property owned by the taxpayer, raises serious administrative and compliance problems. The objections to eliminating from the property factor property used to produce nonbusiness income is compounded where the use concept is also applied to property used in the production of business income.

I have no recommendation concerning this question except that the phrase "owned or rented and used" be specifically defined and then applied in accordance with the definition. The technical references to the definition of "business income" should be corrected so that the second sentence reads "See Article IV. 1(a) and Regulations IV. 1.(a) and IV. 1.(a)(2) for the definition of business income." It should also be noted that the statute does not require the property to be used to produce income.

Reg. IV. 10.(b): Property Used for the Production of Business Income.

This regulation assumes that the word "used" in Article IV. 10. applies to both rented and owned property and property "actually used or is available for or capable of being used" for the production of business income. The examples under 10.(b) are a refinement of the use concept. It is therefore recommended that IV. 10.(b) be deleted at the present time. In the event this regulation is not deleted, then the examples should be changed to conform to Reg. IV.1.(a) and Reg. IV. 1.(b), which regulations define business income.

Reg. IV. 10.(c): Property Factor: Consistency in Reporting.

It is recommended that this regulation be renumbered 10.(b). The consistency requirement contained in this regulation is extremely important. Clearly, the numerators and the denominator should be arrived at by the employment of the same standard and the standard, either as to the numerator or the denominator, should not vary from state to state.

Reg. IV. 10.(d): Property Factor: Numerator.

No recommended change, except to change (d) to (c).

Reg. IV. 11.(a): Property Factor: Valuation of Owned Property.

No recommended change.

Reg. IV. 11.(b): Property Factor: Rented Property

It is recommended that the examples following the first paragraph be deleted. These examples deal with the question of what constitutes business or nonbusiness income, which subject matter is subject matter for regulations IV.1.(a) and IV.1.(b).

Reg. IV.12: Property Factor: Averaging Property Values.

No change recommended.

Reg. IV. 13.(a): Payroll Factor: In General.

I recommend the removal of the examples (i) and (ii) under subsection .15(3). These examples are addressed, in part at least, to what constitutes business or nonbusiness income, which is the subject matter of Regulations IV. 1(a) and IV.1(b).

It is recommended that .20(4) be deleted in its entirety. It is written on the assumption that Public Law 86-272 has the effect of exempting from taxation certain income rather than precluding any income to be attributable to the state where jurisdiction is lacking because of Public Law 86-272. Furthermore, it adds nothing to the statutory language.

Reg. IV. 13.(b): Payroll factor: Numerator.

It is recommended that all of this regulation after the second paragraph be deleted, inasmuch as the tests in Regulation IV. 14, are controlling and are so stated in the second sentence of Regulation IV. 13.(b).

Reg. IV. 13.(c): <u>What is Compensation.</u>

No change is recommended.

Reg. IV. 14.(a): <u>Property Factor: What is an Individual</u>

It is recommended that that portion of this regulation following the first sentence be deleted, inasmuch as there must be congruence between what is compensation and what is an employee and it need not be separately considered other than in general terms. Furthermore, either the federal definition controls or the common law definition controls.

Reg. IV. 14.(b): <u>Payroll Factor; What is Compensation Paid in this State.</u>

No change recommended.

Reg. IV. 15.(a): <u>Sales Factor; Sales made in General Business Operations.</u>

No change recommended. The statute defines gross receipts and requires the inclusion of all gross receipts of a taxpayer without any exception.

Reg. IV. 15.(b): <u>Sales Factor; Sales Incidental to General Business Operations.</u>

Article IV. 16. of the Compact and Section 15 of UDITPA define the sales factor as the total sales of the taxpayer. Any adjustment in the sales factor occasioned by substantial amount of gross receipts arising from an incidental or occasional sale, so long as it is a part of the trade or business to which the apportionment formula is being applied, must be made under Section 18 of UDITPA or Article IV. 18. of the Compact.

It is, therefore, recommended that Regulation IV. 15.(b) be deleted except the consistency-in-reporting provisions contained in the last paragraph. In conformity with this deletion, the regulation should be captioned "Sales Factor; Consistency in Reporting."

Reg. IV. 15.(c): <u>Sales Factor; Sales Made in Other Types of Business Activity.</u>

No recommended change.

Reg. IV. 15.(d): <u>Sales Factor; Numerator.</u>

No change except delete the word "generally" in the first sentence.

Reg. IV. 16.(a): <u>Sales Factor: What Sales of Tangible Personal Property are in this State.</u>

It is recommended that the last two paragraphs be deleted as being beyond the scope of the statutory language.

Reg. IV. 16.(b): <u>Sales Factor; Sales to United States Government.</u>

No recommended change except to eliminate the phrase "as a general rule" from the last sentence of the first paragraph and to delete the last paragraph. The phrase "as a general rule" simply creates ambiguity and detracts from the positive statement and the specific example pertaining to that statement. The last paragraph appears to be inconsistent with the statutory language; hence, the recommendation for its deletion.

Reg. IV. 17. (a): Sales Factor; numerator; Sales other than Sales of Tangible Personal Property.

.10 (1) In General:

No recommended change.

.15 (2) Income Producing Activity; Defined:

Delete (d).

.30 (3) Income Producing Activity; Location:

Delete. There is no provision in the statute for the assigning of income-producing activity as done in this regulation.

.40 (4) Costs of Performance; Defined:

No recommended change except to re-number .30 (3) because of the deletion of .30 (3) in the proposed draft.

.45 (5) Application:

In the first sentence, strike out the word "if" and the phrase "do not constitute a principal source of business income and such receipts." Delete from the last sentence in Example (i)(1) the phrase "are business income and for the purpose of the sales factor." In Example (ii), cross out the following in the last sentence: "are business income and for purposes of the sales factor." These changes are made to provide for the differentiation between business and nonbusiness income in Regulations IV. 1.(a) and IV. 1.(b).

.50(b) No recommended change.

.55(a) No recommended change.

.60(b) No recommended change

.65(c) Delete because in part repetitious and in part employing an apportionment rule not provided for by the statute.

.70(d) Delete as setting forth an apportionment formula not provided for by statute.

Suspension of the Arbitration By-Laws: No recommended changes.

SUMMARY OF RECOMMENDATIONS

The foregoing Recommendations were made after careful consideration of the material submitted in conjunction with the hearing on the proposed regulations and with the understanding that the regulations must follow and be an amplification of the statutory language of Article IV of the Compact. Specific objective tests were used to the extent possible to achieve maximum desirable uniformity.

The proposed regulations and recommendations pertaining thereto are still deficient in not dealing with Section 18 UDITPA problems and those associated with the unitary and combination concepts. Answers to these problems are inexorably involved in the application of any allocation or apportionment rules.

I trust that the analysis of the hearings and the proposed recommendations will be of help to the Multistate Tax Commission in its efforts to promulgate advisory rules in implementing the language of Article IV of the Multistate Tax Compact.

Respectfully submitted,

William D. Dexter,
Hearing Officer

May 26, 1971

Proposed Regulation IV. 1.(a)(2) - Business and Nonbusiness Income: Application of Definitions

Article IV(1)(a) defines "business income." The term "business income" means income from any source arising from transactions and activities in the regular course of a trade or business. The critical element in the proper characterization of income as "business income" or "nonbusiness income" is identification of those activities and transactions which constitute the taxpayer's trade or business. In general, the activities and transactions of a taxpayer will be considered a "trade or business" if there is evidence to indicate that such activities and transactions were dependent upon or contributed to each other and to the operations of the taxpayer as a whole. The term "trade or business" is used in several sections of the Internal Revenue Code for federal income tax purposes, and this term, as used in Article IV(1)(a), in general, has the same meaning as when used in the Internal Revenue Code. For example, a particular activity will presumptively constitute part of a taxpayer's trade or business if the taxpayer, for federal income tax purposes, is able to deduct expenses incurred therein under § 162 of the Internal Revenue Code which provides for a deduction of certain "trade or business" expenses.

If the above standard is inconclusive, a determination of whether the activities and transactions of a taxpayer constitute a "trade or business" will turn on the facts of each case. There can be no ultimate definition of business income because the applicability of the term turns upon all the facts and circumstances pertaining to what constitutes the taxpayer's "trade or business."

In order for income from an activity and transaction to be classified as "nonbusiness income," it must be income arising out of or directly attributable to occasional, isolated, unusual or sporadic activity of the taxpayer and not income on which the taxpayer relies, or could reasonably rely, in the conduct of any part of his trade or business.

The classification of income by the labels occasionally given to such income, such as manufacturing income, income derived from sales activities, interest income, dividend income, income from the sale of property, income from copyrights, income from patents, income from royalties, operating income, non-operating income, income from short term investments, foreign source income, etc. is of no aid in determining whether that income is business or nonbusiness income. In every instance the relationship of the income producing activity or transaction to the total business activities and transactions of the taxpayer is controlling.

Because a taxpayer's trade or business is usually the sum of all related activities and transactions that it regularly engages in for profit, it is improper to single out any particular activity as constituting a taxpayer's "principal" trade or business and thereby limit the scope of the taxpayer's regular trade or business operations. All activities generating income on other than an isolated, unusual or sporadic basis, which income is used in the operations of the taxpayer, will constitute elements of the taxpayer's trade(s) or business(es) and concomitantly give rise to business income.

MULTISTATE TAXATION

MULTISTATE TAX COMMISSION APPORTIONMENT REGULATIONS ADOPTED UNDER ARTICLE IV OF COMPACT

(Uniform Division of Income for Tax Purposes Act)

The following regulations, indicated by a key symbol (O—ᴨ), were adopted by the Multistate Tax Commission on September 10, 1971. They are subject to adoption by each member state in accordance with its own laws and procedures.

[¶ 6100] General.—The regulations numerical references are to Article IV of the Multistate Tax Compact and its subsections.

O—ᴨ [¶ 6120] Reg. IV. 1. (a)(1). Business and Nonbusiness Income. Article IV. 1. (a) defines "business income" as income arising from transactions and activities in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. In essence, the business income of the taxpayer is that portion of the taxpayer's entire net income which arises from the conduct of the taxpayer's trade or business operations. For purposes of administration of Article IV, the income of the taxpayer is business income unless clearly classifiable as nonbusiness income under Article IV. 4. to IV. 8. and the regulations thereunder.

Nonbusiness income means all income other than business income.

O—ᴨ [¶ 6130] Reg. IV. 1. (a)(2) Business and Nonbusiness Income—Application of Definitions.—Article IV(1)(a) defines "business income." The term "business income" means income from any source arising from transactions and activities in the regular course of a trade or business. The critical element in the proper characterization of income as "business income" or "nonbusiness income" is identification of those activities and transactions which constitute the taxpayer's trade or business. In general, the activities and transactions of a taxpayer will be considered a "trade or business" if there is evidence to indicate that such activities and transactions were dependent upon or contributed to each other and to the operations of the taxpayer as a whole. The term "trade or business" is used in several sections of the Internal Revenue Code for federal income tax purposes, and this term, as used in Article IV(1)(a), in general, has the same meaning as when used in the Internal Revenue Code. For example, a particular activity will presumptively constitute part of a taxpayer's trade or business if the taxpayer, for federal income tax purposes, is able to deduct expenses incurred therein under § 162 of the Internal Revenue Code which provides for a deduction of certain "trade or business" expenses.

If the above standard is inconclusive, a determination of whether the activities and transactions of a taxpayer constitute a "trade or business" will turn on the facts of each case. There can be no ultimate definition of business income because the applicability of the term turns upon all the facts and circumstances pertaining to what constitutes the taxpayer's "trade or business."

.10 [Nonbusiness income.] In order for income from an activity and transaction to be classified as "nonbusiness income," it must be income arising out of or directly attributable to occasional, isolated, unusual or sporadic activity of the taxpayer and not income on which the taxpayer relies, or could reasonably rely, in the conduct of any part of his trade or business.

The classification of income by the labels occasionally given to such income, such as manufacturing income, income derived from sales activities, interest in- come, dividend income, income from the sale of property, income from copyrights, income from patents, income from royalties, operating income, nonoperating in- come, income from short term investments, foreign source income, etc. is of no aid in determining whether that income is business or nonbusiness income. In every instance the relationship of the income producing activity or transaction to the total business activities and transactions of the taxpayer is controlling.

.15 [Activities and transactions control.] Because a taxpayer's trade or business is usually the sum of all related activities and transactions that it regularly engages in for profit, it is improper to single out any particular activity as constituting a taxpayer's "principal" trade or business and thereby limit the scope of the taxpayer's regular trade or business operations. All activities generating income on other than an isolated, unusual or sporadic basis, which income is used in the operations of the taxpayer, will constitute elements of the taxpayer's trade(s) or business(es) and concomitantly give rise to business income.

.20 [Investment activity.] Because of the regularity with which most corporate taxpayers engage in investment activities, because the source of capital for such investments arises in the ordinary course of a taxpayer's business, because the income from such investments is utilized in the ordinary course of the taxpayer's business and because such investment assets are used for general credit purposes, income arising from the ownership or sale or other disposition of such investments is presumptively business income. Such presumption may be rebutted if the taxpayer can prove that such investment is an insignificant, irregular and unusual source of income.

.30 [Activities included.] The term "trade or business" is not limited to the carrying on of ordinary industrial or commercial activities. The term includes, for example, the professions, the arts, athletic activities, wagering, etc.

[¶ 6140] Reg. IV. 1. (a)(5). Proration of Deductions. Any allowable deduction that is applicable both to business and nonbusiness income of the taxpayer shall be prorated to those classes of income in determining income subject to tax. The taxpayer shall be consistent in the proration of such deduction or deductions in filing returns or reports to all income tax states to which the taxpayer reports under Article IV of this Compact or the Uniform Division of Income for Tax Purposes Act.

[¶ 6145] Reg. IV. 2. (a). Apportionment and Allocation of Income Generally. When a taxpayer has income from sources within this state as well as income from sources outside this state, the division of income and the resulting determination of the portion of the taxpayer's entire net income which has its source in this state shall be determined pursuant to the allocation and apportionment provisions set forth in Article IV. In such cases, the first step is to determine which portion of the taxpayer's entire net income constitutes "business income" and which portion constitutes "nonbusiness income." The various items of nonbusiness income are then directly allocated to specific jurisdictions pursuant to the provisions of Article IV. 4. to IV. 8. The business income of the taxpayer is divided between the jurisdictions in which the business is conducted pursuant to the property, payroll and sales apportionment factors set forth in Article IV. 9. to IV. 17. The sum of (1) the items of nonbusiness income directly allocated to this state, plus (2) the amount of business income attributable to this state by the apportionment formula constitutes the amount of the taxpayer's entire net income which is subject to tax under the income tax laws of this state.

.10 [Income classification.] The taxpayer shall classify income as business or nonbusiness income on a consistent basis. In the event the taxpayer is not consistent in its reporting it shall disclose in its return to this state the nature and extent of the inconsistency.

.15 [Apportionment.] The word "apportionment" generally refers to the division of net income between jurisdictions by the use of a formula containing apportionment factors, and the word "allocation" generally refers to the assignment of net income to a particular jurisdiction.

[¶ 6146] Reg. IV. 2. (b). Definition of "Taxpayer". [Each state should insert the definition in Article II. 3. or the definition in its own tax laws.]

[¶ 6147] Reg. IV. 2. (c). Application of Article IV. A taxpayer must have income from business activity taxable by this state and at least one other state, to allocate and apportion income. Income from business activity includes only business income.

[¶ 6150] Reg. IV. 3. (a). Taxable in another state: in general. A taxpayer is "taxable in another state" if it meets either one of two tests: (1) If by reason of business activity in another state the taxpayer is subject to one of the types of taxes specified in Article IV. 3. (1), namely: A net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; or (2) If another state has jurisdiction to subject the taxpayer to a net income tax, regardless of whether or not that state imposes such a tax on the taxpayer.

[¶ 6152] Reg. IV. 3. (b). Taxable in another state: when a corporation is "subject to" a tax under Article IV. 3. (1). (1) A taxpayer is "subject to" one of the taxes specified in Article IV. 3. (1), only if it carries on business activities in another state. If the taxpayer voluntarily files and pays one or more of such taxes when not required to do so by the laws of that state or pays a minimal fee for qualification, organization or for the privilege of doing business in that state, but

(a) does not actually engage in business activities in that state, or

(b) does actually engage in some activity, not sufficient for nexus, and the minimum tax bears no relation to the corporation's activities within such state, the taxpayer is not "subject to" one of the specified taxes within the meaning of Article IV. 3. (1) and is therefore not "taxable" in another state.

Example: State A has a corporation franchise tax measured by net income, for the privilege of doing business in that state. Corporation X files a return and pays the $50 minimum tax, although it carries on no activities in State A. Corporation X is not "taxable" in State A.

.10 (2) The concept of taxability in another state is based upon the premise that every state in which the taxpayer is engaged in business activities may impose an income tax even though every state does not do so. In states which do not, other types of taxes may be imposed as a substitute for an income tax. Therefore, only those taxes enumerated in Article IV. 3. (1) which may be considered as basically revenue raising rather than regulatory measures shall be considered in determining whether the taxpayer is "taxable" in another state.

Example (1): State A requires all nonresident corporations which qualify or register in State A to pay to the Secretary of State an annual license fee or tax for the privilege of doing business in the state regardless of whether the privilege is in fact exercised. The amount paid is determined according to the total authorized capital stock of the corporation; the rates are progressively higher by bracketed amounts. The statute sets a minimum fee of $50 and a maximum fee of $500. Failure to pay the tax bars a corporation from utilizing the state courts for enforcement of its rights. State A also imposes a corporation income tax. Nonresident Corporation X is qualified in State A and pays the required fee to the Secretary of State but does not carry on any activities in State A other than utilizing its courts. Corporation X is not "taxable in" State A.

Example (ii): Same facts as Example (i) except that Corporation X is subject to and pays the corporation income tax. Payment is prima facie evidence that Corporation X is "subject to" the net income tax of State A and is "taxable" in State A.

Example (iii): State B requires all nonresident corporations qualified or registered in State B to pay to the Secretary of State an annual permit fee or tax for doing business in the state. The base of the fee or tax is the sum of (1) outstanding capital stock, and (2) surplus and undivided profits. The fee or tax base attributable to State B is determined by a three factor apportionment formula. Nonresident Corporation X which operates a plant in State B, pays the required fee or tax to the Secretary of State. Corporation X is "taxable in" State B.

Example (iv): State A has a corporation franchise tax measured by net income for the privilege of doing business in that state. Corporation X files a return based upon its business activities in the state but the amount of computed liability is less than the minimum tax. Corporation X pays the minimum tax. Corporation X is subject to State A's corporation franchise tax.

[¶ 6155] **Reg. IV. 3. (c). Taxable in Another State; When a State has Jurisdiction to Subject a Taxpayer to a Net Income Tax.** The second test, that in Article IV. 3. (2), applies if the taxpayer's business activities are sufficient to give the state jurisdiction to impose a net income tax under the Constitution and statutes of the United States but that state does not impose any of the taxes set forth in Article IV. 3. (1). Jurisdiction to tax is not present where the state is prohibited from imposing the tax by reason of the provisions of Public Law 86-272, 15 U.S.C.A. §§ 381-385. In the case of any "state" as defined in Article IV. 1. (h), other than a state of the United States or political subdivision of such state, the determination of whether such "state" has jurisdiction to subject the taxpayer to a net income tax shall be made as though the jurisdictional standards applicable to a state of the United States applied in that "state."

[¶ 6170] **Reg. IV. 10. (a). Property Factor; In General.** The property factor shall include all real and tangible personal property owned or rented and used during the tax period to produce business income. The term "real and tangible personal property" includes land, buildings, machinery, stocks of goods, equipment, and other real and tangible personal property used in connection with the production of business income but does not include coin or currency. See Article IV. 1. (a), IV. 1. (a)(1) and IV. 1. (a)(2) for definition of "business income." Property used in connection with the production of nonbusiness income which is allocated in accordance with Article IV. 4. to IV. 8., shall be excluded from the factor. Property used in connection with both the production of business and nonbusiness income shall be included in the factor only to the extent the property was used in connection with the production of business income. The method of determining that portion of the value to be included in the factor will depend upon the facts of each case. The property factor shall include the average value of property includable in the factor. See Reg. IV. 12.

[¶ 6175] Reg. IV. 10. (b). Property Factor; Consistency in Reporting. The taxpayer shall be consistent in the valuation of property and in excluding or including property in the property factor in filing returns or reports to all income tax states to which the taxpayer reports under Article IV of this Compact or the Uniform Division of Income for Tax Purposes Act. In the event the taxpayer is not consistent in its reporting it shall disclose in its return to this state the nature and extent of the inconsistency.

[¶ 6185] Reg. IV. 10. (c). Property Factor; Numerator. The numerator of the property factor shall include the average value of the taxpayer's real and tangible personal property in this state during the tax period used, is available for use, or is capable of being used for the production of business income. Property in transit between locations of the taxpayer to which it belongs shall be considered to be at the destination for purposes of the property factor. Property in transit between a buyer and seller which is included by a taxpayer in the denominator of its property factor in accordance with its regular accounting practices shall be included in the numerator according to the state of destination. The value of mobile or movable property such as construction equipment, trucks or leased electronic equipment which are located within and without this state during the tax period shall be determined for purposes of the numerator of the factor on the basis of total time within the state during the tax period. An automobile assigned to a traveling employee shall be included in the numerator of the factor of the state to which the employee's compensation is assigned under the payroll factor or in the numerator of the state in which the automobile is licensed.

[¶ 6190] Reg. IV. 11. (a). Property Factor; Valuation of Owned Property. Property owned by the taxpayer shall be valued at its original cost. As a general rule "original cost" is deemed to be the basis of the property for federal income tax purposes (prior to any federal adjustments) at the time of acquisition by the taxpayer and adjusted by subsequent capital additions or improvements thereto and partial disposition thereof, by reason of sale, exchange, abandonment, etc.

Example (i): On January 1, 1960, taxpayer acquired a factory building in this state at a cost of $500,000 and on July 1, 1961, expended $100,000 for major remodeling of the building. Taxpayer files its return for 1968 on the calendar year basis. Depreciation deduction in the amount of $22,000 was claimed on the building for its return for 1968. The value of the building includable in the numerator and denominator of the property factor is $600,000 as the depreciation deduction is not taken into account in determining the value of the building for purposes of the factor.

Example (ii): In 1970, X Corporation merges into Y Corporation in a tax-free reorganization under the Internal Revenue Code. At the time of the merger, X Corporation owns a factory which X built in 1965 at a cost of $1,000,000. X has been depreciating the factory at the rate of two percent per year, and its basis in X's hands at the time of the merger is $900,000. Since the property is acquired by Y in a transaction in which, under the Internal Revenue Code, its basis in Y's hands is the same as its basis in X's, Y includes the property in Y's property factor at X's original cost, without adjustment for depreciation, i.e., $1,000,000.

Example (iii): Corporation Y acquires the assets of Corporation X in a liquidation by which Y is entitled to use its stock cost as the basis of the X assets under § 334(b)(2) of the 1954 Internal Revenue Code (i.e. stock possessing 80 percent control is purchased and liquidated within two years). Under these circumstances, Y's cost of the assets is the purchase price of the X stock, prorated over the X assets.

If original cost of property is unascertainable, the property is included in the factor at its fair market value as of the date of acquisition by the taxpayer.

Inventory of stock of goods shall be included in the factor in accordance with the valuation method used for federal income tax purposes.

Property acquired by gift or inheritance shall be included in the factor at its basis for determining depreciation for federal income tax purposes.

[¶ 6195] Reg. IV. 11. (b). Property Factor; Rented Property. Property rented by the taxpayer is valued at eight times the net annual rental rate. The total annual rental rates received by the taxpayer from subrentals. In exceptional cases this may result in a negative value or a clearly inaccurate valuation. In those instances any other method which will properly reflect the value may be required by the department or may be requested by the taxpayer but in no case shall the net annual rental rate be less than an amount which bears the same ratio to the total annual rental rate paid by the taxpayer as the property net annual rental rate is the total annual rental rate paid by the taxpayer, less used by the taxpayer bears to all the value of rental property.

The "annual rental rate" is the amount paid as rental for the property for a 12-month period, or the "annual rent." Where property is rented for less than a 12-month period, the net rent paid for the actual period of rental shall constitute the "annual rental rate" for the tax period. However, where a taxpayer has rented property for a term of 12 or more months and the current tax period covers a period of less than 12 months due, for example, to a reorganization or change of accounting period, the net rent paid for the short tax period shall be annualized. If the rental term is for less than 12 months, the rent shall not be annualized beyond its term. Rent shall not be annualized because of the uncertain duration when the rental term is on a month to month basis.

Example (i): Taxpayer A which ordinarily files its returns based on a calendar year is merged into Taxpayer B on April 30. The net rent paid under a lease with 5 years remaining is \$2,500 a month. The rent for the tax period January 1 to April 30 is \$10,000. After the rent is annualized the net rent is \$30,000 (\$2,500 × 12).

Example (ii) Same facts as in Example (i) except that the lease would have terminated on August 31. In this case the annualized net rent is \$20,000 (\$2,500 × 8).

"Annual rent" is the actual sum of money or other consideration payable, directly or indirectly, by the taxpayer or for its benefit for the use of the property and includes:

(1) Any amount payable for the use of real or tangible personal property, or any part thereof, whether designated as a fixed sum of money or as a percentage of sales, profits or otherwise.

Example: A taxpayer, pursuant to the terms of a lease, pays a lessor \$1,000 per month as a base rental and at the end of the year pays the lessor one percent of its gross sales of \$400,000. The annual rent is \$16,000 (\$12,000 plus one percent of \$400,000 or \$4,000).

(2) Any amount payable as additional rent or in lieu of rents, such as interest, taxes, insurance, repairs or any other items which are required to be paid by the terms of the lease or other arrangement, and does not include amounts paid as service charges, such as utilities, janitor services, etc. If a payment includes rent and other charges unsegregated, the amount of rent shall be determined by consideration of the relative values of the rent and the other items.

Example (i): A taxpayer, pursuant to the terms of a lease, pays the lessor \$12,000 a year rent plus taxes in the amount of \$2,000 and interest on a mortgage in the amount of \$1,000. The annual rent is \$15,000.

Example (ii): A taxpayer stores part of its inventory in a public warehouse. The total charge for the year was $1,000 of which $700 was for the use of storage space and $300 for inventory insurance, handling and shipping charges, and C.O.D. collections. The annual rent is $700.

"Annual rent" does not include incidental day-to-day expenses such as hotel or motel accommodations, daily rental of automobiles, etc.

Leasehold improvements shall, for the purposes of the property factor, be treated as property owned by the taxpayer regardless of whether the taxpayer is entitled to remove the improvements or the improvements revert to the lessor upon expiration of the lease. Hence, the original cost of leasehold improvements shall be included in the factor.

[¶ 6209] Reg. IV. 18. Property Factor; Averaging Property Values. As a general rule the average value of property owned by the taxpayer shall be determined by averaging the values at the beginning and ending of the income year. However, the [tax administrator] may require or allow averaging by monthly values if such method of averaging is required to properly reflect the average value of the taxpayer's property for the tax period.

Averaging by monthly values will generally be applied if substantial fluctuations in the values of the property exist during the tax period or where property is acquired after the beginning of the tax period or disposed of before the end of the tax period.

Example: The monthly value of the taxpayer's property was as follows:

January	$2,000
February	2,000
March	3,000
April	3,500
May	4,500
June	10,000
	$25,000

July	$15,000
August	17,000
September	23,000
October	25,000
November	13,000
December	2,000
	$95,000
TOTAL	$120,000

The average value of the taxpayer's property includable in the property factor for the income year is determined as follows:

$$\$120,000 \div 12 = \$10,000$$

[¶ 6210] Reg. IV. 13. (a). Payroll Factor; In General. (1) The payroll factor shall include the total amount paid by the taxpayer for compensation during the tax period.

.10 (2) The total amount "paid" to individuals is determined upon the basis of the taxpayer's accounting method. If the taxpayer has adopted the accrual method of accounting, all compensation properly accrued shall be deemed to have been paid. Notwithstanding the taxpayer's method of accounting, at the election of the taxpayer, compensation paid to employes may be included in the payroll factor by use of the cash method if the taxpayer is required to report such compensation under such method for unemployment compensation purposes. The taxpayer shall be consistent in the treatment of compensation paid in filing returns or reports to all income tax states to which the taxpayer reports under Article IV of this Compact or the Uniform Division of Income for Tax Purposes Act. In the event the taxpayer is not consistent in its reporting it shall disclose in its return to this state the nature and extent of the inconsistency.

.16 (3) The payroll factor includes only compensation which is attributable to the business income subject to apportionment. The compensation of any individual whose activities are connected primarily with nonbusiness income shall be excluded from the factor.

[¶ 6220] Reg. IV. 13. (b). Payroll Factor: Numerator. The numerator of the payroll factor is the total amount paid in this state during the tax period by the taxpayer for compensation. The tests in Article IV. 14. to be applied in determining whether compensation is paid in this state are derived from the Model Unemployment Compensation Act.

[¶ 6230] Reg. IV. 13. (c). What is Compensation. The term "compensation" means wages, salaries, commissions and any other form of remuneration paid to employes for personal services. Payments made to an independent contractor or any other person not properly classifiable as an employe are excluded. Only amounts paid directly to employes are included in the payroll factor. Amounts considered paid directly include the value of board, rent, housing, lodging, and other benefits or services furnished to employes by the taxpayer in return for personal services provided that such amounts constitute income to the recipient under the federal Internal Revenue Code. In the case of employes not subject to the federal Internal Revenue Code, e.g., those employed in foreign countries, the determination of whether such benefits or services would constitute income to the employes shall be made as though such employes were subject to the federal Internal Revenue Code.

[¶ 6235] Reg. IV. 14. (a). Payroll Factor: What is an Individual. The term "individual" means (1) any officer of a corporation, or (2) any individual who, under the usual common-law rules applicable in determining the employer-employe relationship, has the status of an employe.

[¶ 6240] Reg. IV. 14. (b) Payroll Factor: What is Compensation Paid in this State. Compensation is paid in this state if any one of the following tests, applied consecutively, are met:

.10 (1) The individual's service is performed entirely within the state.

.15 (2) The individual's service is performed both within and without the state, but the service performed without the state is incidental to the individual's service within the state. The word "incidental" means any service which is temporary or transitory in nature, or which is rendered in connection with an isolated transaction.

.20 (3) If the individual's services are performed both within and without this state, the individual's compensation will be attributed to this state:

(i) if the individual's base of operations is in this state; or

(ii) if there is no base of operations in any state in which some part of the service is performed, but the place from which the service is directed or controlled is in this state; or

(iii) if the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed but the individual's residence is in this state.

The term "base of operation" is the place of more or less permanent nature from which the employe starts his work and to which he customarily returns in order to receive instructions from the taxpayer or communications from his customers or other persons or to replenish stock or other materials, repair equipment, or perform any other functions necessary to the exercise of his trade or profession at some other point or points. The term "place from which the service is directed or controlled" refers to the place from which the power to direct or control is exercised by the taxpayer.

[¶ 6245] Reg. IV. 15. (a). Sales Factor; Sales made in General Business Operations. Article IV. 1. (g) defines the term "sales" to mean all gross receipts of the taxpayer not allocated under paragraphs of Article IV. Thus, for the purposes of the sales factor, the term "sales" means generally all gross receipts derived by a taxpayer from transactions and activities in the course of its regular trade or business operations which produce business income within the meaning of Article IV. 1. (a).

In the case of a taxpayer whose business activity consists of manufacturing and selling or purchasing and reselling goods or products, "sales" includes all gross receipts from the sales of such goods or products (or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year) held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. Gross receipts for this purpose means gross sales, less returns and allowances, and includes all interest income, service charges, carrying charges, or time-price differential charges incidental to such sales. Federal and state excise taxes (including sales taxes) shall be included as part of such receipts if such taxes are passed on to the buyer or included as part of the selling price of the product.

[¶ 6250] Reg. IV. 15. (b) Sales Factor; Consistency in Reporting: In including or excluding gross receipts, the taxpayer shall be consistent in the treatment of such gross receipts in filing returns or reports to all income tax states to which the taxpayer reports under Article IV of this Compact or the Uniform Division of Income for Tax Purposes Act. In the event the taxpayer is not consistent in its reporting it shall disclose in its return to this state the nature and extent of the inconsistency.

[¶ 6255] Reg. IV. 15. (c). Sales Factor: Sales Made in Other Types of Business Activity. As applied to a taxpayer engaged in business activity other than the manufacturing and selling or purchasing and reselling of property, "sales" include the gross receipts from the taxpayer's business activity.

If the business activity consists of providing services, such as the operation of an advertising agency, or the performance of equipment service contracts, research and development contracts, "sales" includes the gross receipts from the performance of such services including fees, commissions, and similar items.

If the business activity is the renting of real or tangible personal property, "sales" includes the gross receipts from the rental, lease, or licensing the use of the property.

If the business activity is the sale, assignment, or licensing of intangible personal property such as patents and copyrights, "sales" includes the gross receipts therefrom.

[¶ 6260] Reg. IV. 15. (d). Sales Factor; Numerator. The numerator of the sales factor will include the gross receipts from sales which are attributable to this state, and includes all interest income, service charges, carrying charges, or time-price differential charges incidental to such sales regardless of the place where the accounting records are maintained or the location of the contract or other evidence of indebtedness.

[¶ 6265] Reg. IV. 16. (a). Sales Factor; What Sales of Tangible Personal Property are in this State. Gross receipts from the sales of tangible personal property (except sales to the United States Government; see Reg. IV. 16. (b)) are in this state:

.10 (1) If the property is delivered or shipped to a purchaser within this state regardless of the f.o.b. point or other conditions of sale; or

.15 (2) if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and the taxpayer is not taxable in the state of the purchaser.

Property shall be deemed to be delivered or shipped to a purchaser within this state if the recipient is located in this state, even though the property is ordered from outside this state.

Example: The taxpayer, with inventory in State A, sold $100,000 of its products to a purchaser having branch stores in several states including this state. The order for the purchase was placed by the purchaser's central purchasing department located in State B. $25,000 of the purchase order was shipped directly to purchaser's branch store in this state. The branch store in this state is the "purchaser within this state" with respect to $25,000 of the taxpayer's sales.

Property is delivered or shipped to a purchaser within this state if the shipment terminates in this state, even though the property is subsequently transferred by the purchaser to another state.

Example: The taxpayer makes a sale to a purchaser who maintains a central warehouse in this state at which all merchandise purchases are received. The purchaser reships the goods to its branch stores in other states for sale. All of taxpayer's products shipped to the purchaser's warehouse in this state is property "delivered or shipped to a purchaser within this state".

The term "purchaser within this state" shall include the ultimate recipient of the property if the taxpayer in this state, at the designation of the purchaser, delivers to or has the property shipped to the ultimate recipient within this state.

Example: A taxpayer in this state sold merchandise to a purchaser in State A. Taxpayer directed the manufacturer or supplier of the merchandise in State B to ship the merchandise to the purchaser's customer in this state pursuant to purchaser's instructions. The sale by the taxpayer is "in this state".

When property being shipped by a seller from the state of origin to a consignee in another state is diverted while enroute to a purchaser in this state, the sales are in this state.

Example: The taxpayer, a produce grower in State A, begins shipment of perishable produce to the purchaser's place of business in State B. While en route the produce is diverted to the purchaser's place of business in this state in which state the taxpayer is subject to tax. The sale by the taxpayer is attributed to this state.

If the taxpayer is not taxable in the state of the purchaser, the sale is attributed to this state if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state.

Example: The taxpayer has its head office and factory in State A. It maintains a branch office and inventory in this state. Taxpayer's only activity in State B is the solicitation of orders by a resident salesman. All orders by the State B salesman are sent to the branch office in this state for approval and are filled by shipment from the inventory in this state. Since taxpayer is immune under Public Law 86-272 from tax in State B, all sales of merchandise to purchasers in State B are attributed to this state, the state from which the merchandise was shipped.

[¶ 6276] Reg. IV. 16. (b). Sales Factor: Sales to United States Government. Gross receipts from the sales of tangible personal property to the United States Government are in this state if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state. For the purposes of this regulation, only sales for which the United States Government makes direct payment to the seller pursuant to the terms of its contract constitute sales to the United States Government. Thus, sales by a subcontractor to the prime contractor, the party to the contract with the United States Government, do not constitute sales to the United States Government.

Example (i): A taxpayer contracts with General Services Administration to deliver X number of trucks which were paid for by the United States Government. The United States Government is the purchaser.

Example (ii): The taxpayer as a subcontractor to a prime contractor with the National Aeronautics and Space Administration contracts to build a component of a rocket for $1,000,000. The sale of the subcontractor to the prime contractor is not a sale to the United States Government.

[¶ 6280] Reg. IV. 17. (a). Sales Factor; Numerator; Sales other than Sales of Tangible Personal Property.

.10 (1) In General. Article IV. 17. contains provisions for including gross receipts from transactions other than sales of tangible personal property in the numerator of the sales factor. Under this section gross receipts are attributed to this state if the income producing activity which gave rise to the receipts is performed wholly within this state. Except as provided in subparagraph (5) (B) of this regulation under "Application", *infra*, if the income producing activity is performed within and without this state such receipts are attributed to this state if the greater proportion of the income producing activity is performed here, based on costs of performance.

.20 (2) Income Producing Activity; Defined. The term "income producing activity" means the act or acts directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit. Such activity does not include activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor. Accordingly, the income producing activity includes but is not limited to the following:

(A) The rendering of personal services by employes or the utilization of tangible and intangible property by the taxpayer in performing a service.

(B) The sale, rental, leasing, or licensing the use of or other use of real property.

(C) The rental, leasing, licensing the use or other use of tangible personal property.

.30 (3) Costs of Performance; Defined. The term "costs of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer.

.40 (4) Application. (A) Receipts from sales other than sales of tangible personal property are included in the denominator of the receipts factor (see Reg. IV. 15. (b)). Such receipts are in this state if:

(a) the income producing activity is performed wholly within this state; or

(b) the income producing activity is performed both in and outside this state and a greater proportion of the income producing activity is performed in this state than in any other state, based on costs of performance.

Example (i): The taxpayer is engaged in the heavy construction business in which it uses cranes, tractors, and earth-moving vehicles. The taxpayer makes short-term rentals of the equipment when not needed on any project. The taxpayer rented some of the equipment to A for three weeks. The equipment was used by A for two weeks in this state and one week in State X. The taxpayer's direct costs in connection with the equipment during the rental period was $500 each week. Accordingly, the greater proportion of such costs was incurred in this state. All of the rental receipts are business income and for purposes of the sales factor are included in the numerator for this state.

Example (ii): Taxpayer, whose commercial domicile is in this state, manufactures and sells industrial chemicals. Taxpayer owns patents on certain of its products. The taxpayer licensed the production of the chemicals in foreign countries in return for which the taxpayer receives royalties which constitute a relatively minor amount of its income. The royalties are business income and for relatively minor amount of its income. The royalties are included in the numerator for the state of the taxpayer's commercial domicile.

.50 (B) Except as provided by special apportionment formulas (including special formulas the use of which has been continued or adopted by the [tax administrator] since enactment of Article IV [or the Uniform Division of Income for Tax Purposes Act] receipts from sales other than sales of tangible personal property which constitute a principal source of business income shall be attributed to this state in accordance with the following:

.55 (a) Gross receipts from the sale, lease, rental or other use of real property are in this state if the real property is located in this state.

.60 (b) Gross receipts from the rental, lease, licensing the use of or other use of tangible personal property shall be assigned to this state if the property is within this state during the entire period of rental, lease, license or other use. If the property is within and without this state during such period, gross receipts attributable to this state shall be based upon the ratio which the time the property was physically present or was used in this state bears to the total time or use of the property everywhere during such period.