COURT OF APPEALS
STATE OF ARIZONA
DIVISION ONE

Nos. 1 CA-TX 11-0006 and 1 CA-TX 11-0008

HARRIS CORPORATION, ET. AL.,
Plaintiffs-Appellants,

v.

ARIZONA DEPARTMENT OF REVENUE,
Defendant-Appellant.

FIRST DATA CORPORATION, ET AL.,
Plaintiffs-Appellants,

v.

ARIZONA DEPARTMENT OF REVENUE,
Defendant-Appellant.

JOINT *AMICUS CURIAE* BRIEF OF MULTISTATE TAX COMMISSION IN SUPPORT OF ARIZONA DEPARTMENT OF REVENUE

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TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES

Arizona Cases:

Cases from Other Jurisidictions:

Statutes and Regulations:

Constitutional Provisions:

Other Authorities:

I. INTERESTS OF *AMICUS CURIAE*

This brief is submitted by *amicus curiae* Multistate Tax Commission ("the Commission") in support of Respondent and Appellee State of Arizona, Department of Revenue ("the Department") in two cases currently before the Court concerned with the correct application and interpretation of the provisions of the Uniform Division of Income for Tax Purposes Act ("UDITPA"). *See* 7A *Uniform Laws Annotated* 147-193 (West Publishing 2002). We write to address a primary question before the Court in both cases: whether capital transactions may give rise to "business income" by meeting a stand-alone "functional test" under Section 1(a) of UDITPA, codified as A.R.S. § 43-1131-1.

The Commission files this brief to express its critical interest in the uniform interpretation of this provision consistent with the policies and practices of every other state which has a UDITPA-based corporate income tax.[1] The Commission submits that the Arizona Tax Court correctly determined that the subject transactions generated income which met the "functional test" of "business

[1] This brief is filed by the Commission, and not on behalf of any Commission member state other than Arizona.

income" under § 1(a) of UDITPA, because in each case the property generating the income was an integral part of the Appellant's regular trade or business operations.

The Commission is the administrative agency for the Multistate Tax Compact ("Compact"), which became effective in 1967. (See RIA *State & Local Taxes: All States Tax Guide* ¶ 701 *et seq*. (2005).) Forty-seven states and the District of Columbia are now members of the Commission. Nineteen of those jurisdictions have adopted the Compact by statute.[2] Article IV of the Compact incorporates UDITPA almost word for word. Article VII of the Compact charges the Commission with interpretation of UDITPA through promulgation of model regulations, and pursuant to that authority, the Commission has promulgated model regulations for the interpretation of "business income."

The Multistate Tax Compact was proposed to the states in 1966 by the National Association of Attorneys General, the Council of State Governments, and the National Legislative Council as a means to reform state taxation of interstate commerce, in direct response to threatened Congressional preemption of state

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[2] The Compact member states are Alabama, Alaska, Arkansas, Colorado, Hawaii, Idaho, Kansas, Michigan, Minnesota, Missouri, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah, Washington, and the District of Columbia. Six states are "sovereignty" members and 23 states, including Arizona, are "associate" member states. http://www.mtc.gov/AboutStateMap.aspx.

corporate income tax apportionment statutes. BNA Tax Management, *Multistate Tax Portfolio,* Income Taxes, *The Distinction Between Business and Non-Business Income,* ¶ 1140.02.D (1996). The stated purposes of the Compact are to:

1. Facilitate proper determination of state and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes;
2. Promote uniformity or compatibility in significant components of tax systems;
3. Facilitate taxpayer convenience and compliance in the filing of tax returns or other phases of tax administration; and
4. Avoid duplicative taxation.

Compact, Article 1.

The potential for increased uniformity through the Compact and UDITPA was central to preserving the states' sovereignty in the face of threatened federal preemption. *See, e.g.*, H.R. Rep. No. 89-952, Pt. VI, at 1143 (1966).

The rationale for uniformity in state taxation has not diminished since the middle of the last century, as the scope and volume of multi-jurisdictional business has expanded considerably. Meanwhile, Congress continues to consider preemption of state taxing authority based on claims that interstate commerce is excessively burdened by non-uniform taxation. *See*, *e.g.*, H.R. 1439, 112th Congress, *The Business Activities Tax Simplification Act of 2011*.

Arguably, no provision of UDITPA's statutory framework is of more importance in achieving the goal of uniform taxation of multi-jurisdictional income

than the "business income" definition, which controls the type of income that will be divided among taxing jurisdictions. Inconsistency in applying this apportionment standard among states would significantly increase the likelihood of over-taxation and under-taxation of income. Those problems are entirely avoidable by properly construing UDITPA's business income definition in a manner which is consistent with state tax jurisdictional limits embodied in the unitary business principle, as interpreted by Arizona Administrative Code § R15-2D-503 (formerly designated A.A.C. § R15-2-1131 (1986)) and the Commission's model regulations.

II. STATEMENT OF THE CASE

A. Course of Proceedings for *Harris Corporation & Subsidiaries v. Department of Revenue*.

The Arizona Department of Revenue ("the Department") audited Harris Corporation ("Harris") for tax years ending 6/30/97 through 6/30/01 and issued an assessment for unpaid corporate income tax, which was protested (Index of Record ("IR") 15, ¶ 4.) After a hearing, the Department's hearing officer upheld those portions of the Department's assessment which had not been previously resolved. (IR 15, ¶ 10.) Taxpayer appealed to the Arizona Tax Court. (IR 1.) The parties filed several motions and cross-motions for summary judgment. (IR 14, 21, 25, 33, 42, 57, 61.) By way of two minute entries, the Tax Court upheld the majority

of the assessment, except for one matter which was subsequently settled, and entered judgment in the Department's favor on May 16, 2011. (IR 54, 69, 74.) Harris filed an appeal to this Court on June 2, 2011. (IR 75.)

B. Course of Proceedings for *First Data Corporation & Subsidiaries v. Arizona Department of Revenue*.

The Department audited First Data Corporation and Subsidiaries ("First Data") for tax years 1999 through 2002 and issued an assessment in June of 2007. (IR 1, ¶ 30; IR 6, ¶19.) The principal basis for the assessment was the Department's determination to re-classify the treatment of gains from a 1999 disposition of a wholly-owned subsidiary, First Data Investor Services Group, Inc. ("FDISG") from "non-business income" to "business income." (IR 1, ¶ 31; IR 6, ¶ 20.) The Department's hearing officer upheld the assessment in July of 2009. (IR 1, ¶¶ 36-7; IR 6, ¶ 22.) First Data appealed that decision to the Arizona Tax Court. (IR 1.) The parties filed cross-motions for summary judgment (IR 32), and the Tax Court granted the Department's motion and denied First Data's motion, incorporating the Tax Court's previous minute orders on *Harris Corporation*, referenced above, into that decision. (IR 32 at n.1, Exhibits A & B.) The Tax Court entered final judgment for the Department on August 11, 2011 (IR 36) and First Data filed its appeal to this Court on August 23, 2011. (IR. 38.)

C. Statement of Facts for *Harris Corp. & Subsidiaries v. Arizona Department of Revenue.*

Harris is a Delaware corporation with its commercial domicile in Florida. (IR 1, ¶¶1, 2.) Harris elected to file its returns in Arizona on a consolidated basis pursuant to A.R.S. § 43-947(F). Under this election, a consolidated group must include the income and losses of all corporations in the consolidated group, even if the business lines of those corporations lack a connection ("nexus") with the state. (IR 15, ¶3.) Harris and its consolidated subsidiaries frequently acquired and sold off various business assets and business interests during the audit period. (IR 15, ¶ 13, 18, 22, 26, 28; IR 34, ¶¶ 10, 11, 16-22, 28-33, 37-42, 47-49, 53; IR 60, ¶ 5.) Harris treated the income, expenses and any losses from the *operation* of these business interests as "business income", but it treated the gains on the dispositions as "non-business" income. (IR 15, ¶¶ 14-24; IR 60, ¶¶ 4, 5, 8.) Interest income and income from foreign currency transactions were treated as allocable income, although the record does not disclose that Harris ever treated the *expenses* necessary to generate such income as "non-business" expenses on its returns. (IR 34, ¶¶ 9-11, 15-19, 26.)

The Appellee classifies the disputes as involving three categories of income (*D.O.R. Harris Answer Brief*, pp. 4-9), and the Commission follows those classifications below. Falling into the first identified category are transactions

undertaken by the parent corporation, e.g., gains recognized on the contribution of assets to a joint venture with General Electric (IR 15, ¶ 15). The second category is income from the sale of the Lanier Medical Transcription line of business. (IR 60, ¶¶ 4, 5, 8.)

The last category includes: (a) royalties received from patent rights acquired by Harris Semiconductor Patents, Inc., when Harris purchased General Electric's semiconductor business (IR 34, ¶ 14); and (b) income from the sale of stock and other assets by some of the Harris consolidated subsidiaries engaged in investment activities. (IR 34, ¶¶ 15-19, 26-32, 37-41, 45-49, 52-53.)

Harris contends that even though it elected to file on a consolidated basis, in order to apportion the income generated from these capital transactions, the state must still demonstrate that the income had a unitary connection to business lines *operating in Arizona*, as opposed to demonstrating a connection to business lines *included on the consolidated return*. *See Harris Reply Brief*, pp. 7-13. The Department of Revenue contends that the relevant inquiry under a consolidated return is whether the assets were an integral part of the regular business of any entity included on the consolidated return. *See* Arizona Corp. Income Tax Ruling 94-12. For purposes of this brief, your *amicus* assumes that the Department of Revenue's ruling correctly interprets Arizona law.

D. Statement of Facts for *First Data Corporation v. Arizona Department of Revenue*.

First Data is a Delaware corporation which had its commercial domicile in Georgia during 1999, the year in which it sold FDISG. (IR 1, ¶6; IR 6, ¶3.) First Data is engaged in the business of providing "electronic payment services." (First Data's Opening Brief, p. 6), and filed a combined return in Arizona including FDISG on that return. (IR 11, ¶¶ 6-7; IR 14, ¶¶ 2, 7.) It should be noted that the taxpayers filed two different types of Arizona corporate income tax returns, unitary reporting and consolidated reporting. First Data filed a unitary combined report. A unitary business may consist of part of a corporation, one corporation, or many corporations. A.A.C. § R15-2D-401(B). If the unitary business consists of more than one corporation, the includable corporations comprising the unitary business file a combined return. *Id*. Harris Corporation elected to file a consolidated return under A.R.S. § 947.

FDISG provided "back office processing services" for the mutual fund industry (First Data's *Opening Brief*, p. 7); it was sold to PNG Bank Corporation in December of 1999 for approximately $1.1 billion. (IR 1, ¶¶ 18-19.) The after-tax proceeds from the sale (approximately $750 million) were used to buy back some of First Data's outstanding stock. (IR 28, ¶¶ 1, 4.) First Data and FDISG's buyer elected to treat the sale as a sale of assets by FDISG and not a sale of stock by First

Data (IR 1, ¶ 21, IR 6, ¶ 12), as is permitted by Internal Revenue Code § 338(h)(10).

III. STATEMENT OF ISSUES PRESENTED

1. Whether the Arizona Tax Court was correct in holding that there is a separate "functional test" for business income under the Uniform Division of Income for Tax Purposes Act (UDITPA), A.R.S. §§ 43-1131 through 43-1150.

2. Whether the Arizona Tax Court correctly declined to recognize a so-called "exception" to the "functional test" for business income in situations where the taxpayers disposed of an entire business or business segment in "extraordinary" transactions.

IV. ARGUMENT

A. UDITPA'S BUSINESS INCOME DEFINITION CONTAINS BOTH A TRANSACTIONAL AND A FUNCTIONAL TEST.

1. Introduction.

States imposing income-based taxes on a multistate business enterprise are required to use some means to fairly determine an appropriate amount of the entity's income attributable to the state. *See generally*, *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267, 273 (1978) (states are given wide latitude in devising reasonable formulas for division of income.). UDITPA, which Arizona adopted in 1983, employs two methods to divide the income of multistate corporations among

taxing jurisdictions in a fair and constitutionally-acceptable manner. "Business income" is *apportioned* among the states by a formula which uses in-state percentages of three quantifiable "factors"--property, payroll and sales--as a proxy for determining in-state earnings.[3] All income which is not business income is considered "non-business income", which is *allocated* to a particular state or states.

UDITPA's business income definition, codified as A.R.S. § 43-1131-1, provides in relevant part:

> Unless the context of the definition requires otherwise:
>
> 1. "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

A.R.S. § 43-1131-4 provides that: "non-business income" means all income other than business income."

The taxpayers in both appeals contend that this definition contains a single test, called the "transactional test," which includes only income from transactions

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[3] All states which impose income-based taxes on corporations use a similar system, although many states, including Arizona, now accord more weight to the "sales" factor. A.R. S. § 43-1139 (2003). UDITPA's three-factor formula has been called "something of a benchmark by which other formulas are judged." *Container Corporation of America, Inc. v. Franchise Tax Board*, 463 U.S. 159, 170 (1983).

and activities occurring in the "regular course" of the taxpayer's trade or business, embodied in the first nineteen words of the statute, with the phrase following "and includes" intended to merely "illustrate" (*Harris Brief in Chief*, pp. 16, 23; *First Data Brief in Chief*, p. 23) the operation of the transactional test. Your *amicus* suggests that UDITPA's business income definition in fact embodies two separate tests, either of which, if met, would require the income to be included in "business income" and apportioned. We agree that the first 19 words of the definition embody the "transactional" test, and provide that income arising from transactions and activities in the regular course of the taxpayer's business operations, such as sales of inventory and services, is business income. But the second clause, beginning after "and includes" is not merely illustrative. It is an alternative "functional test", and provides that income arising from the disposition of property which was "integrally" connected to the taxpayer's regular business is also business income.

The great majority of courts have recognized that UDITPA's business income definition is susceptible to more than one interpretation and have accordingly determined that resort to extrinsic evidence is appropriate in determining legislative intent; in each instance in which the courts have looked at the statute's context and purpose, the courts have concluded that the definition

encompasses a separate "functional" test. As explained below, the unusual phraseology of that test--which has generated extensive litigation over the years--is actually a term of art, borrowed from pre-UDITPA California decisions applying the unitary business principle in a statutory context. Those cases established the principle that income arising from transactions involving "unitary" business assets should be apportioned, regardless of whether the transaction was considered "unusual" or "in the regular course of …business." *See Hoechst-Celanese v. Franchise Tax Board*, 22 P.3d 324 (Cal. 2001); *Appeal of Borden*, 77 SBE 007, Cal. Tax Rptr. (CCH) ¶ 205-616, 1977 WL 3818 (1977), *available at*: http://www.boe.ca.gov/legal/pdf/77-sbe-007.pdf.

The operation of a separate "functional" test to include income from capital transactions is explicitly set forth in the official comments to UDITPA, and is followed in a model regulation issued by the Multistate Tax Commission in 1974 and subsequently adopted by Arizona as Arizona Administrative Code § R15-2D-503 (1986) and in numerous other states.[4]

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[4] The Commission's regulation was significantly expanded in 2003 to explicitly recognize the existence of two tests; Arizona continues to follow the original regulation which provides that income from the sale of assets used in the business generates business income. The 2003 version is available here:

By incorporating a separate "functional" test, UDITPA's business income definition results in income being apportioned or allocated in a manner which is more consistent with the full extent of states' jurisdiction to tax under the U.S. Constitution, and in particular, in a manner which is more consistent with the application of the "unitary business principle" to multistate income.

The taxpayers make no claim that their "transactional-only" interpretation of the business income definition would result in a reasonable assignment of income. Their interpretation would lead to inconsistent sourcing of income flows versus the expenses related to that income, distorting the amount of income properly attributable to the states. It should not be surprising, therefore, that in virtually every state in which the courts have chosen to overlook the context and legislative history of UDITPA in favor of a self-referencing "plain-meaning" interpretation, the legislatures have quickly responded by amending their laws to reverse those holdings.

Every state with a corporate income-based tax is now on record as recognizing the "functional" test in UDITPA through regulation or case law, or provides for full apportionment of unitary income via statute. *See* Appendix A.

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http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/AllocaitonandApportionmentReg.pdf.

Given this high degree of uniformity among the states, a decision by this court to adopt the taxpayers' "transactional-only" interpretation would likely result in both tax gaps and double-taxation of income amounts.

Further, because the functional test is addressed to the relationship between assets and the taxpayer's business, there is no textual basis in the statute or policy basis for what has been termed the "liquidation exception" to the functional test; it is simply a reiteration of the transactional test applied to capital transactions deemed by the courts to be particularly unusual or infrequent.

2. The Transactional and Functional Tests Together Reflect the Constitutional Extent of the States' Taxing Powers.

The overarching context for the distinction between "business" and "non-business" income in UDITPA is the scope of the states' taxing jurisdiction under the Due Process Clause (U.S. Const., Amend. XIV) and the Commerce Clause (U.S. Const., Art. 1, Sec. 8). As a *constitutional* matter, both types of income identified in the business income definition--(1) income arising from transaction and activity the regular course of the taxpayer's trade or business (the "transactional" test) and (2) income from property that was an integral part of the taxpayer's trade or business operations (the "functional" test)—may be subject to taxation on an apportioned basis

In *Mobil Oil v. Vermont*, 445 U.S. 425 (1980), the Court held that dividends arising from the taxpayer's ownership of a foreign corporation were subject to apportionment, where the taxpayer failed to demonstrate that its foreign operations were not a "part of [its] integrated petroleum enterprise." 445 U.S. at 439. In so holding, the Court supported the notion that apportionment may obtain for both operating ("transactional") income and income arising from capital transactions such as dividend distributions:

> So long as dividends from subsidiaries and affiliates reflect profits derived from a functionally integrated enterprise, those dividends are income to the parent earned in a unitary business… and accordingly it ought not to affect the apportionability of income the parent receives.

Id. at 440-441.

In *ASARCO, Inc. v. Idaho State Tax Comm.*, 458 U.S. 307, 330 (1982), the Court noted that there is no constitutional basis for a distinction between dividends, capital gains such as those at issue in these appeals, and other types of income for purposes of determining apportionability under unitary taxation analysis. Income from the disposition of unitary assets would meet the "functional" test under UDITPA, and would accordingly be subject to apportionment in accordance with constitutional principles, because property that is used in the unitary business would be an "integral part of" the taxpayer's "regular business."

By contrast, where income arises from dispositions of property which was not part of the taxpayer's "functionally integrated enterprise" (*i.e.*, not part of its unitary business) that income cannot constitutionally be taxed on an apportioned basis. *See ASARCO, Inc. v. Idaho State Tax Comm.*, 458 U.S. 307 (1982) (capital gains and dividends from non-unitary subsidiaries could not be apportioned); *Allied-Signal, Inc. v. Director, Division of Taxation,* 504 U.S. 768 (1992) (income arising from a sale of investment assets which lacked connection to the taxpayer's unitary business conducted in New Jersey could not be subject to apportionment in that state). *Accord, MeadWestvaco Corp. v. Illinois Dept. of Revenue,* 553 U.S. 16 (2008) (capital gains arising from sale of non-unitary division).[5] Income from the disposition of non-unitary assets would likewise not meet the "functional" test under UDITPA, because the property would not have been an "integral part of" the taxpayer's regular business, and would accordingly be subject to allocation.

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[5] In the *Harris* appeal (*Reply Brief*, p. 8), the taxpayer erroneously suggests that the Court declined to allow apportionment of the gain from the sale of MeadWestvaco's Lexis division even though the taxpayer was filing on a "consolidated basis." 553 U.S. at 22. But Illinois only allows filing on a unitary combined basis. *See* 35 ILCS 5/502(e). The Court held that the taxpayer's paper business and the Lexis division were not unitary even though they were held in a single corporation; the Court's *dicta* was simply intended to distinguish the operation of Illinois' combined filing system from separate-entity filing regimes.

Income from assets used in the taxpayer's unitary business *should* be apportioned regardless of the frequency with which such income is realized, as it would be under the "functional" test, because, as the Court noted in *Exxon v. Wisconsin*, 447 U.S. 207, 229 (1980), and in *Mobil Oil*, state allocation premised on the *situs* of property or domicile should yield to taxation based on apportionment under the unitary business principle:

> There is no reason in theory why that power [of a domiciliary state to tax dividend income] should be exclusive when the dividends reflect income from a unitary business, part of which is conducted in other States. In that situation, the income bears relation to benefits and privileges conferred by several States. *These are the circumstances in which apportionment is ordinarily the accepted method.*

Mobil Oil, 445 U.S. at 445-6. (Emphasis supplied.)

Noting the obvious connection between the treatment of income under UDITPA and the constitutional scope of state taxing power, the Court in *Allied-Signal* recognized that the unitary business principle and UDITPA's definition of business income were "quite compatible." 504 U.S. at 786.

In contrast, there is no constitutional equivalent for the distinction between "usual" and "irregular" capital transactions which would obtain under the taxpayers' reading of the business income definition.

3. The Language of the "Functional Test" is Taken From California Cases Applying the Unitary Business Principle in Apportioning Income from "Extraordinary" Transactions.

The connection between the "business income" definition in UDITPA and the scope of apportionment under the unitary business principle was recognized long before *Allied Signal* and is unsurprising, since the definition was drawn from California cases applying the unitary business principle.

Soon after UDITPA was adopted by California in 1967, one of the principal reporters to the NCCUSL efforts, John Warren, and Frank Kessling, both former California tax officials, co-authored a detailed, two part law review article explaining the operation of the Act. Kessling & Warren, *The Uniform Division of Income for Tax Purposes Act, Part 1*, 15 U.C.L.A. L. Rev. 156 (1967). In that article, the authors note:

> [T]he Uniform Act sharply distinguishes between business income which is to be apportioned by formula and non-business income which is to be allocated…This distinction is in line with existing California practice *except that the terms which have been in use here are 'unitary income' and 'non-unitary income.'*

Id. at pp. 163-4. (Emphasis added.)

Prior to California's adoption of UDITPA in 1965, California's Administrative Code Title 18, Regulation 25101 provided that "income from property which is not a part of, or connected to the taxpayer's unitary business, is

excluded from the income of the unitary business which is subject to allocation [apportionment] by formula", *cited in, Appeal of W.J. Voit Rubber Corp*., 64 SBE 048 (1964), *available at* http://www.boe.ca.gov/legal/pdf/64-sbe-048.pdf. In *Voit*, the State Board of Equalization held that income arising from the disposition of a rubber factory constituted apportionable income under California law. Summarizing the holdings of a number of pre-UDITPA cases that had recognized a separate "functional" basis for apportionment, the board wrote:

> The underlying principle in these cases is that *any* income from assets which are integral parts of the unitary business is unitary income. It is appropriate that all returns from property which is developed or acquired and maintained through the resources of and in furtherance of the business should be attributed to the business as a whole.

Id. at p. 52.

The source of the functional test's somewhat enigmatic language was identified in an early decision by the California State Board of Equalization holding that gains from the disposition of the taxpayer's western-states dairy business gave rise to apportionable income under UDITPA. *Appeal of Borden*, 77 SBE 007, 1977 WL 3818 (3/3/77). The Board in that case found that a significant number of pre-UDITPA California cases had employed the exact wording of what would become known as the functional test, without reference to an overarching transactional test,

in holding that capital gains and other "non-inventory" transactions constituted "unitary" income under California law:

> In deciding which of these constructions ["transactional-only" or "transactional" and "functional"] is correct, it is helpful to recall the concept of "unitary income" under prior California law. Under prior law income from tangible or intangible property was considered unitary income, subject to apportionment by formula, **if the acquisition, management, and disposition of the property constituted integral parts of the taxpayer's unitary business operations.** (*Appeal of Houghton Mifflin Co.*, Cal. St. Bd. of Equal., March 28, 1946; *Appeal of International Business Machines Corp.*, Cal. St. Bd. of Equal., Oct. 7, 1954; *Appeal of National Cylinder Gas Co.*, Cal. St. Bd. of Equal., Feb. 5, 1957.) Where that requirement was satisfied, income from such assets was considered unitary income even if it arose from an occasional sale or other extraordinary disposition of the property.

77 SBE at pp. 23-4. (Emphasis supplied.)

In 2001, the Supreme Court of California followed the path established in the *Borden* case in a seminal decision which carefully traced the foundations of the "functional test" while providing a comprehensive review of the statute's purpose and context. *Hoechst-Celanese v. Franchise Tax Board*, 22 P.3d 324 (Ca. 2001). The court concluded that the legislative history of UDITPA "strongly supports" the existence of a separate functional test. *Id*. at 334. The court, citing Peters, *The Distinction Between Business Income & Non-Business Income*, 25 So. Cal. Tax Inst. 251, 272-3 (1973), noted that the original drafts of UDITPA did not include a business/non-business income distinction, but John Warren suggested that the

scope of apportionable income was so broad it would raise constitutional concerns. *Id*. It was Warren's suggestion to make a business/non-business distinction based on State Board of Equalization cases, and the commissioners of the National Council of Commissioners on Uniform State Laws ("NCCSUL"), the organization which authored UDITPA, ultimately agreed. The court then noted that:

> These SBE decisions consistently applied an *independent* functional test when determining whether income constituted business income. In doing so, the SBE used language virtually identical to the language in the second clause of the statutory definition.

Hoechst-Celanese at 334-5.

The court also noted the case of *Appeal of Marcus-Lesoine*, 2 SBE 338, 340-1 (1942), where the SBE held that interest income from conditional sales contracts should have been apportioned, rather than allocated to California, because the "acquisition, management and liquidation of the intangibles constituted integral parts of the corporation's regular business operations." http://www.boe.ca.gov/legal/pdf/42-sbe-017.pdf.[6] Almost identical language was used by the SBE in holding that the incidental sale of copyright royalties

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[6] Significantly, there was no "disposition" or "liquidation" of the conditional sales contracts as the term was later applied by some courts in finding a "liquidation exception" for capital gains because a "disposition" would rarely occur in the regular course of business. *See, e.g., Lennox, Inc. v. Tolson,* 548 S.E.2d 513 (N.C. 2001).

constituted unitary income subject to apportionment under California law. *Appeal of Houghton Mifflin Corp,* 3 SBE 344 (1946), http://www.boe.ca.gov/legal/pdf/46-sbe-003.pdf. The same formulation was used in *Appeal of International Business Machines Corp.*, 6 SBE 005 (1954), where the Board wrote:

> We have previously held that income from such intangibles is subject to [apportionment] where the acquisition, management and disposition of the intangibles constitute integral parts of the owner's regular business operations. [citations omitted]. Here, the business machines and equipment upon which the patents were obtained were developed for use in Appellant's regular business operations. The expenses…were all expenses of its regular business operations. Under such circumstances, the exploitation of the patents by licensing their use in foreign countries also constitutes, in our opinion, an integral part of Appellant's regular business activities.

Appeal of IBM, p. 6. http://www.boe.ca.gov/legal/pdf/54-sbe-013.pdf.

Although the SBE did not use verbatim phraseology in every case, it is clear that prior to the states' rapid adoption of UDITPA beginning in the mid-1960's, the concept was well-established that sales of assets used in a taxpayer's unitary business generated apportionable income, regardless of the frequency or "unusual-ness" of such sales. *See, e.g., Appeal of American Airlines, Inc.,* 52 SBE 32 (1952) (forced disposition of airplanes for military use by government), http://www.boe.ca.gov/legal/pdf/52-sbe-032.pdf.; *Appeal of Wesson Oil and Snowdrift Sales Co.*, 57 SBE 002 (1957), http://www.boe.ca.gov/legal/pdf/57-sbe-002.pdf. (bulk sale of 47% of inventory); *Appeal of American President Lines,*

Ltd., 61 SBE 005 (1961), http://www.boe.ca.gov/legal/pdf/61-sbe-005.pdf. (forced disposition of vessel to government on emergency basis); *Appeal of Velsicol Chemical Corp.*, Cal. 65 SBE 040 (1965) (one-time sale of patent rights), http://www.boe.ca.gov/legal/pdf/65-sbe-040.pdf.

In each of these cases, the Board rejected any notion that the form of or non-recurring nature of particular transactions should result in allocation. Instead, the SBE's entire focus was on the relationship of the assets to the taxpayer's unitary business.

The terms of the business income definition are thus properly understood as specialized words of art, intended to reflect the Act's adherence to California jurisprudence which had established that income from "extraordinary" transactions generated apportionable income if the capital assets were used in (integral to) the taxpayer's unitary business. *Hoechst-Celanese,* 22 P.3d at 335; *Accord*, *Jim Beam Brands, Inc. v. Franchise Tax Board*, 133 Cal. App. 4th 574, 34 Cal. Rptr.3d 874 (Ca. App. 1 Dist. 2005); *Polaroid Corp. v. Offerman*, 507 S.E.2d 284, 295 (N.C. 1998) (recognizing origins of business income's "functional" test in pre-UDITPA California case law), *partially rev'd*, *Lenox, Inc. v. Tolson*, 548 S.E.2d 513 (N.C. 2001); *Gannett Satellite Information Services, Inc. v. Montana*, 201 P.3d 132 (Mont. 2009) (same).

4. The Business Income Definition Should be Construed to Effectuate UDITPA's Purpose of Achieving Fair Apportionment, Expressed in Administrative Regulations and Official Comments Recognizing the "Functional" Test; Applying a "Plain-Meaning" Interpretation Without Reference to the Remainder of the Comprehensive Statutory System is Inappropriate.

The taxpayers argue that UDITPA's definition of business income contains only a single transactional test, established by the first 19 words of the statute, with the second clause being "plainly an illustration" of the first part of the sentence. (First Data Opening Brief, p. 23; *Accord*, Harris Opening *Brief*, pp. 13, 16, 23.) The taxpayers insist that this court is bound to give statutory phrases a "plain meaning" interpretation where possible, and that the plain meaning of the statute favors the existence of a single transactional test. Echoing the Alabama's Supreme Court's arguments in *Ex Parte Uniroyal Tire Co.*, 779 So.2d 227 (Ala. 2000), the taxpayers read "and includes" as the equivalent of "including", so that everything following that phrase must also meet the previous "transactional test" limitations. *Harris Opening Brief*, pp. 22-24; *First Data Opening Brief*, pp. 21-22. While the Alabama court's parsing of the statute has been justly criticized, *see May Department Stores v. Indiana*, 749 N.E.2d 651, 662 (Ind. Tax Ct. 2001), the more fundamental error was the court's failure to consider that the statute may reasonably be susceptible to more than one interpretation, justifying resort to extrinsic means to ascertain legislative intent. The court made no effort to consider

UDITPA's business income definition in the broader context of state taxation or the remainder of the statute, ignored the history of the Act, and entirely dismissed the expertise of those charged with administering the state's tax programs.

In marked contrast to the approach taken in *Ex Parte Uniroyal*, *supra*, the *Hoechst-Celanese* and *Gannett* courts considered: (a) how the interpretation of UDITPA's business income definition would impact the states' efforts to achieve uniformity; (b) considered the well-documented history of the statute, including the Official Commentary of the drafters; (c) considered the constitutional basis for apportioning income from assets used in unitary businesses, and (d) gave credence to long-standing administrative regulations adopted by their respective states. The Commission respectfully suggests that the analysis undertaken by the courts in California and Montana is the better approach to statutory construction and the approach more in accordance with Arizona statute and precedent.

In *Tobel v. State*, 189 Ariz. 168, 174, 939 P.2d 801, 807 (App. 1997) this court recognized that:

> We give effect to the statutory language in accordance with its commonly accepted meaning unless the statute provides a definition or 'it appears from the context that a special meaning was intended.' *State v. Reynolds*, 170 Ariz. 233, 234, 823 P.2d 681, 682 (1992) (quoting *Mid Kansas Fed. Sav. & Loan Ass'n of Wichita v. Dynamic Dev. Corp.*, 167 Ariz. 122, 128, 804 P.2d 1310, 1316 (1991). If an ambiguity exists, "the court may examine a variety of factors including the language used, the

> context, the subject matter, the effects and consequences, and the spirit and purpose of the law."

Similarly, Arizona Revised Statutes § 1-213 provides in relevant part:

> Technical words and phrases and those which have acquired a peculiar and appropriate meaning in the law shall be construed according to such peculiar and appropriate meaning.

As discussed previously, UDITPA's business income definition is a technical phrase with a peculiar and appropriate meaning—as a reflection of the application of the unitary business principle--which has, rightly or wrongly, proven susceptible to more than one interpretation.

In *Walgreen Arizona Drug Co. v. Arizona Dept. of Revenue*, 209 Ariz. 71, 73, 97 P.3d 896, 898 (App. 2004), this court noted that UDITPA's definitional section begins with the proviso: "[u]nless the context otherwise requires" and went on to hold that one of those definitions had a specialized meaning in the context of a formulary apportionment system. This court accordingly rejected a "plain-meaning" interpretation of the definition of "sales", choosing to rely instead upon an interpretation which furthered the broader purposes of UDITPA in effectuating a fair distribution of income. 97 P.3d at 902. This court also relied upon the Department of Revenue's expertise and regulatory guidance issued by the Commission in determining that "sales" did not include the gross amount of overnight transactions: "We [ ] recognize that an agency's interpretation of a statute

that it implements is entitled to great weight", *citing, Ariz. Water Co. v. Ariz. Dep't of Water Resources,* 208 Ariz. 147, 154–55, 91 P.3d 990, 997–98 (2004). *Id*. at 900-01. Given the complexity of multistate taxation laws and jurisprudence, the *Walgreen* court was entirely justified in deferring to the expertise of the agencies charged with administering those laws in a consistent and fair manner.

In addition to the clear evidence that UDITPA's business income definition was intended as a technical phrase, above, a second critical aspect of UDITPA's context which was considered in *Hoechst-Celanese* and *Gannett* are the Act's official comments. In two separate places, those comments provide without limitation, that "[i]ncome from the disposition of property used in a trade or business of a taxpayer is includable within the meaning of business income." 7A *Uniform Laws Annotated*, Comments to §§1(a) &1(g), Cumulative Annual Pocket Part, pp. 85-86 (West-Thompson 2002). *Accord, Texaco-Cities Services Pipeline Co. v. McGraw,* 695 NE 2d 481, 486 (Ill. 1998) ("The adoption of the functional test also comports with the legislative history and purpose behind the Act. The test was adopted directly from the comments underlying the UDITPA, which predate the enactment of our act.").

The suggestion in Harris Corporation's *Opening Brief* (pp. 17-19) that these official comments should be ignored because the Arizona legislature may have

been unaware of them is unavailing. The claim of legislative ignorance is particularly unavailing where the Commission had promulgated model regulations in accordance with those official comments in 1974, almost a decade before Arizona adopted UDITPA, specifying that income from assets used in the taxpayer's unitary business constituted business income. The MTC's pre-2003 Model Apportionment Regulation (adopted verbatim by the Arizona Department of Revenue in 1986, *see* A.A.C. § R15-2D-503) provided in part that:

> As a general rule, gain or loss from the sale, exchange or other disposition of real or tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used to produce business income. However, the gain or loss will constitute nonbusiness income if such property was subsequently utilized principally for the production of nonbusiness income or otherwise was removed from the property factor.
>
> MTC Apportionment Regulations, reg. IV.1.(c)(2), *Prentice-Hall State and Local Taxes*, All States Unit ¶ 6130.15, *cited in*, *Appeal of Borden*, 77 SBE 007 (1977).

It is difficult to believe that the Arizona legislature adopted a uniform Act intended to bring conformity to state tax administration without being aware of the content of model regulations interpreting that Act.

As in *Walgreen*, this court's analysis of the business income definition should be informed by the Act's purpose of preventing distortions of income. In his treatise on state taxation, Hellerstein & Hellerstein, *State Taxation*, ¶ 9.05[2][e]

(p. 9-73) (Warren, Gorham & Lamont, 3rd Ed. 2003), Professor Walter Hellerstein identifies what he terms a "strong" and "compelling" case for the recognition of the functional test based on established principles for income taxation:

> As a matter of state tax policy, there is much to be said for the adoption of a functional test. If a taxpayer used an asset in a trade or business, there is no reason as a matter of principle why income generated by the disposition of that assets should be treated any differently from the income the asset generated while used in the trade or business…
>
> Moreover, insofar as the gain from the disposition represents recoupment of expenses deducted from apportionable income while the property was used in the business (e.g., depreciation, advertising, research and development expenses), it lends additional support to adoption of the functional test. It would be incongruous (and, from the state's standpoint, inequitable) for a taxpayer to be able to reduce in-state apportionable income through depreciation or other deductions while the asset is being used in the trade or business and then, when the asset is sold, to avoid "recapture" of that income in the state by treating the income…as "non-business" income.

Id. at pp. 9-72-73.[7]

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[7] The taxpayers place great reliance on Hellerstein's conclusion that despite the strong policy reasons supporting the functional test, he doesn't see it in the plain language of the statute. *Id*. at 9-72. The extent of the treatise's adoption of a "transactional-only" interpretation is called into question by this *caveat* three paragraphs later:

"As the Illinois Supreme Court pointed out in *Texaco-Cities Service* [*v. Illinois*, 695 N.E.2d 481 (Ill. 1998)], the functional test is supported by the legislative history of UDITPA. The drafters' comments…do provide a source of guidance in interpreting a statute that may be regarded as ambiguous with respect to the functional test." *Id*.

As Hellerstein notes, a taxpayer can defer income recognition as it incurs expenses to build its business, deducting expenses related to property used in the unitary business, thus reducing the amount of income subject to apportionment. If the property was sold in the "regular" course of business, those expenses would be "recaptured" when the gain is apportioned to the states where the expenses were previously deducted. But if the gain is *allocated* because the transaction was "unusual", a single state would capture all of the deferred income while the states which had previously allowed expense deductions on an apportioned basis would be unable to recapture the deferred income. In *Amerada Hess Corporation v. Director, Div. of Taxation,* 490 U.S. 66, 67 (1979), the Supreme Court held that unitary expenses should be subject to the same rules of apportionment as unitary income to prevent the distortion of income assigned to a given state. An interpretation of UDITPA which results in systematic distortions of income by artificially separating income and expenses is not the likely intent of the Arizona legislature.

When examining laws in the context of state tax policies and purposes, Professor Hellerstein's opinions rightfully command great respect. When it comes to parsing the "plain meaning" of a statute, however, he brings no more expertise to the task than any other student of the English language.

5. The Grammatical Structure of the Business Income Definition is Consistent with the Existence of Two Separate Tests.

Because the business income definition has proven itself to be susceptible to more than one interpretation, resort to extrinsic aids for construing the statute is justified. But the Appellee makes a compelling case that the syntax and grammatical structure of the definition is only consistent with the existence of two separate tests. *See Harris Answering Brief*, pp. 23-29. The Appellee notes that each clause is independent of the other, such that reading the second clause as dependent on the first would render much of the language redundant or contradictory. Reading the definition as a single transactional test would improperly conflate "activities in the *regular course* of …business" with activities which are "integral" (i.e., necessary) to the taxpayer's regular business.

The definition can be read to make grammatical sense if it understood that the intended subject of each clause is "business income" and not "transactions", so that the statute reads: "business income means income arising from transactions and activity in the regular course of the taxpayer's trade or business and [business income] includes…"

The great majority of courts have in fact adopted this interpretation of the business income definition. *See, e.g., Gannett Satellite Information Network, Inc. v. State, Department of Revenue,* 201 P.3d 132 (Mont. 2009) (capital gains);

Hoechst Celanese Corp. v. Franchise Tax Board, 22 P.3d 324 (Ca. 2001) (income from pension reversion); *Polaroid v. Offerman,* 507 S.E.2d 284 (N.C. 1998) (proceeds from patent infringement suit) *partially rev'd, Lenox, Inc. v. Tolson,* 548 S.E.2d 513 (N.C. 2001); *Simpson Timber Company v. Oregon Department of Revenue,* 953 P.2d 366 (Or. 1998) (condemnation proceeds); *Texaco Cities Service Pipeline Co. v. McGraw,* 695 N.E.2d 481 (Ill. 1998) (capital gains); *Pledger v. Getty Oil Exploration Company,* 831 S.W.2d 121, 124-5 (Ark. 1992) (interest on notes held to be non-business income); and *District of Columbia v. Pierce Associates, Inc.,* 462 A.2d 1129 (D.C. 1983) (insurance proceeds subject to apportionment as business income). Under the majority's reading of the business income definition, both clauses of the definition are given effect and are complementary in that each clause references a different type of income-generating activity and applies an appropriate test for each.

All of the cases cited by the taxpayers as supporting the single transactional test have eschewed analysis of the *purpose* of the business income definition, and share the uncomfortable fact that the legislatures in those states have felt compelled to overturn these judicial constructions in every instance. *See, e.g., Ex Parte Uniroyal Tire Co.,* 779 So.2d 227 (Ala. 2000) (overturned in one year: Act 2001-113, 4th Special Session, p. 1178, codified at Sec. 40-27-1.1, Alabama Code

1975); *Phillips Petroleum Co. v. Iowa Dept. of Revenue*, 511 N.W.2d 608, 610 (Iowa 1993) (overturned in two years: Iowa Code § 422.32; Laws 1995, Ch. 141.); *Blessing-White Inc. v. Zehnder*, 768 N.E.2d 332 (Ill. App. 1 Dist. 2002) (recognizing "functional" test but holding that complete liquidation of business resulted in non-business income, overturned in two years: Il. Legis. 93-840 (2004), 35 Ill. Comp. Stat. Ann. 5/1501(a)(1), defining " 'business income' " as "all income that may be treated as apportionable business income under the Constitution of the United States"); *Lenox, Inc. v. Tolson*, 548 S.E.2d 513 (N.C. 2001) (recognizing "liquidation exception" to functional test, overturned in one year: N.C. Legis. 2002-126 §30G.1.(a)("Apportionable income" means all income that is apportionable under the United States Constitution."); *Laurel Pipeline Co. v. Board of Finance*, 642 A.2d 472 (Pa. 1994) (recognizing two tests but holding that liquidation of pipeline constituted non-business income, overturned in seven years, P.L. 353, No. 23, § 5 (2001) "business income includes all income which is apportionable under the Constitution of the United States" 72 Pa. Stat. A. Title 72, § 7401(3)(2)(a)(1)(A).); *General Care v. Olsen*, 705 S.W.2d 642 (Tenn. 1986) (overturned in six years: 1993 Tenn. Pub. Acts § 282, Tenn. Code Ann. § 67-4-2004(4)); *Kemppel v. Zaino*, 746 NE.2d 1073 (Ohio 2001) (overturned in one year: Ohio Acts 2002, S. 261, amending, Ohio Rev. Code Ann. § 5747.01(B)).

The taxpayers argue that a similar course of misconstruction followed by legislative reversal must necessarily be followed in Arizona before UDITPA may be applied in a rational manner here. (*Harris Opening Brief*, pp. 37-38; *First Data Opening Brief*, pp. 34-36). Your *amicus* suggests that such a course is unnecessary because, as shown above, the language is ambiguous and this court may consider the "context, the subject matter, the effects and consequences, and the spirit and purpose of the law." *Tobel v. State*, *supra,* 939 P.2d at 807. And as shown above, all of these considerations favor recognition of a functional test.

In addition, it bears mention that the taxpayers' proposed "plain meaning" interpretation wouldn't produce rational results even when applied to regularly-occurring transactions, including the sale of "property" from inventory.

Under a reading of the statute which has the second clause "exemplifying" the transactional test, sales of *services* arising "in the regular course" of the taxpayer's trade or business would generate business income, while sales of "*property*", including inventory, would be subject to apportionment only if the *acquisition, management and disposition* of the property also constituted *integral parts* of the regular trade or business operations. There is no reason to believe that the drafters of UDITPA, or the Arizona legislature, intended that income from the sale of services in the ordinary course of business would be apportioned more

frequently than simultaneous sales of property to the same customer, yet that would be the result of a literal reading of the statute. Whatever else the second clause does, it is not merely provide an "example" of what income falls under the transactional test—if the second clause relates to the first, it would establish an *additional* standard for apportioning income from sales of "property." *Accord, Kroger Company v. Dept. of Revenue*, 673 N.E.2d 710, 713-14 (Ill. App. 1996) ("The second clause…contains a different definition, not one which simply clarifies."). Statutes should not be construed in a manner which produces irrational results. *Arizona Dept. of Revenue v. S. Point Energy Ctr., LLC,* 228 Ariz. 436, 268 P.3d 387, 390 (Ct. App. 2011).

6. UDITPA's Business Income Definition Should be Construed to Foster Uniformity in Application to Avoid Double Taxation and "Tax Gaps"; Construing the Statute "in Favor of" the First Taxpayer to Appear Before the Court Could Have the Opposite Effect for Other Taxpayers.

While the taxpayers urge this Court to apply what they consider to be a "plain-meaning" interpretation, they also--rather inconsistently--urge the Court to give effect to one extrinsic means of interpretation, the presumption that statutes should be construed in favor of the taxpayer if they are susceptible to more than one interpretation. (*First Data Opening Brief*, pp. 16-18; *Harris Opening Brief*, pp. 16-20.) Whatever the merits of this *dictum* as a substantive rule of

interpretation, as opposed to a rule of decision, it has no application in the context of *apportionment* statutes. Construing an apportionment statute in favor of the first taxpayer to reach the courthouse steps could work to the disadvantage of other taxpayers whose circumstances are different. The Supreme Court of Ohio succinctly summarized the problem with this approach in *UBS Financial Services, Inc. v. Levin,* 893 N.E.2d 811 (Ohio 2008), writing:

> To construe the ambiguous term, we must ascertain the rule of construction that we should apply. UBS urges that the apportionment formula "define[s] subjects of taxation," in which case any ambiguities must be resolved in favor of the taxpayer. [citation omitted]
>
> We disagree. Former R.C. 5725.14 does not define the subjects of taxation; instead, it sets forth the method for determining the Ohio share of an interstate business. ***Any particular construction of the apportionment formula might cut in favor of a taxpayer in one case but against a taxpayer in the next.*** For example, if UBS happened to conduct its underwriting and market-making activity in Ohio, UBS's proposed construction would lead to a greater rather than a lesser tax liability than does the Tax Commissioner's construction. As a result, logic militates against applying the… principle in this context.
>
> 893 N.E.2d at 817. (Emphasis added.)

Two cases cited in the *Harris Opening Brief* (pp. 20-21, 38-40) clearly illuminate the negative consequences which would befall some Arizona taxpayers if ARS 43-1131-1 were to be construed "in favor of" these taxpayers. *Ex Parte Uniroyal Tire Company,* 779 So.2d 227 (Ala. 2001) concerned a taxpayer who sought to treat capital gain from the sale of an out-of-state partnership as non-

business income, in which case the gains would be allocated to another state. The court cited the doctrine that tax statutes "should be construed most strictly against the taxing authority and most favorably for the taxpayer" as a basis for concluding that Alabama's business income definition contained only a transactional test. *Id.* at 230. Soon after the court handed down its ruling, the Alabama legislature amended the business income definition to explicitly provide for a functional test. Act 2001-1113, 4th. Spec. Session, p. 1178.

The legislative reversal of *Uniroyal* came too late, however, to help the taxpayer in *Ex Parte Alabama Department of Revenue,* 69 So.3d 144 (Al. 2010), another case cited by the taxpayers in support of their "transactional only" claims. In that case, Kimberly-Clark Corporation had sold a paper mill and adjacent timberlands in Alabama for $600 million in 1997, prior to the statutory change, apportioning the income from the sale in part to Alabama. Relying on the "transactional-only" interpretation established in *Uniroyal,* the state argued that the entire gain was required to be allocated to Alabama as non-business income, and issued an assessment of almost $21 million, a three-fold increase over what the taxpayer's liability would have been on an apportioned basis. The Alabama Supreme Court upheld the higher assessment based on its earlier decision in *Uniroyal.* The dissent argued in vain that the allocation of the entire gain to

Alabama would result in double-taxation, since the taxpayer had apparently paid tax on an apportioned basis in other states. 69 So.3d at 154.

Construing A.R.S. § 43-1131-1 in favor of the taxpayers in this appeal, who have out-of-state commercial domiciles and property, will not favor taxpayers with commercial domiciles in Arizona, because capital gains from the sales of intangible unitary property would then be allocated in full to Arizona under A.R.S. § 43-1137. But those same gains would likely be subject to tax on an apportioned basis in other states in which that corporation conducted its unitary business. Similarly, a taxpayer disposing of tangible unitary assets located in Arizona would be exposed to the risk of multiple taxation, since the gains would be taxed in full by Arizona on an allocated basis and would be taxed on an apportioned basis in other states. *See* Hellerstein, *The Business-Nonbusiness Income Distinction and the Case for its Abolition*, 92 State Tax Notes 1714, 1725 (9/3/01) (concluding that a state's allocation of "unitary" capital gains under the transactional test would inevitably lead to double taxation); *Accord, Gannett Satellite*, 201 P.3d at 137 ("This scenario highlights the strong policy reasons that support interpreting Sec. 15-31-302(1), MCA to include both the transactional test and an independent functional test.").

The taxpayers thus tell only part of the story when they suggest (*First Data Opening Brief*, pp. 14-17; *Harris Opening Brief*, pp. 18-20) that a "transactional-only" interpretation would reduce tax liabilities. A "transactional-only" interpretation would reduce *their own* tax liabilities since no other state would attempt to tax the income on an allocated basis while that income that would escape taxation on an apportioned basis in Arizona. It would have the opposite effect on Arizona-domiciled businesses; income would be allocated to Arizona while also taxed on an apportioned basis in other states.

The principal rule of construction which should be applied by this court is the rule identified by the legislature when it adopted UDITPA in 1983: "This Act shall be so construed as to effectuate its general purpose to make uniform the laws of those states which enact it." A.R.S. § 43-1149. As set forth above, by regulation or statute, in every state which imposes income-based taxes on corporate activity, capital gains from the disposition of assets used in the taxpayer's unitary business are subject to apportionment. See Appendix A.

B. THERE IS NO TEXTUAL OR POLICY BASIS FOR A "LIQUIDATION EXCEPTION" TO THE FUNCTIONAL TEST

The taxpayers make an alternative argument that even if this Court recognizes that UDITPA's business income definition includes a functional test, some or all of the transactions at issue in these appeals would fall under what it

terms the "liquidation exception" which has been recognized by several courts. *See, e.g., American States Insurance Co. v. Hamer*, 816 N.E. 2d 659 (Ill. App. 2004); *Laurel Pipe Line Co. v. Commissioner*, 642 A.2d 472 (Pa. 1994) (sale of pipeline which had been withdrawn from business use three years prior to sale); *Canteen Corp. v. Commissioner*, 818 A.2d 594 (Pa. Cmwlth. 2003) (construing prior law); *ABB C-E Nuclear Power, Inc. v. Director of Revenue*, 215 S.W.3d 85 (Mo. 2007). Your *amicus* suggests that the courts which have recognized a "liquidation exception" were simply applying the transactional test (after acknowledging the existence of two separate tests), because in every case the question has come down to whether a particular *transaction* occurred in the regular course of business. *See Jim Beam Brands, Inc. v. Franchise Tax Board*, 133 Cal. App. 4th 514, 34 Cal. Rtpr. 3d 874 (Cal. App. 1st. Dist. 2005)(holding that recognition of a "functional" test in *Hoechst-Celanese* precluded recognition of a "liquidation exception" because the functional test turns on the relationship of the assets to the unitary business).

The genesis for the "transactional-only" line of authority may be traced to *Western Natural Gas v. McDonald*, 446 P.2d 781 (Ks. 1968), a case which involved the complete liquidation of the taxpayer's oil and gas business and the dissolution of the corporation which had carried on that business. The question

before the court was whether, under the state's recent adoption of UDITPA, capital gains representing the value of leaseholds in Kansas should have been apportioned or allocated to the taxpayer's commercial domicile in Texas. Deciding the case as a matter of first impression, the Kansas Supreme Court applied a "plain language" analysis to the statute without recognizing the possibility of a separate functional test. The court did not consider the legislative history of the Act or its relationship to principles of income taxation. Instead, the court referenced a decision under the Kansas Bulk Sales Law which held that a bulk sale of inventory was not a sale "in the ordinary course of trade or business" and determined that UDITPA's business income definition should be construed in accordance with the state's rules for bulk sales. 446 P.2d at 782.

Without further analysis, the court concluded that the business income definition turned solely on the nature of the transactions giving rise to income:

> The controlling factor by which the statute identifies business income is the nature of the particular transaction giving rise to the income. To be business income the transaction and activity must have been in the regular course of taxpayer's business operations.
>
> *Id.*

The court then listed a number of considerations it deemed relevant to its determination that this *transaction* was not in regular course of business, which later courts have attempted to apply as if they were set forth in a statute:

> This sale by Western included all of its assets. A complete plan of liquidation was carried out requiring the affirmative vote of the stockholders. The sale was not made in the regular course of taxpayer's business operations when measured by its former practices. It had not sold oil and gas leases. The sale contemplated cessation rather than operation of the business.

Id.

The *Western Natural Gas* case served as the foundation for the determination seven years later by the New Mexico Court of Appeals that "partial liquidations" also constituted non-business income. *McVean & Barlow, Inc. v. New Mexico Bureau of Revenue*, 543 P.2d 489 (N. M. App. 1975). *McVean* involved the disposition of one of the taxpayer's two lines of business (the "big-inch pipeline" business) undertaken in order to buy out one of the corporation's principal shareholders. In a 2-1 decision, the Court of Appeals noted that the partial liquidation was a "very unusual transaction" which "changed the basic nature of [the] business", and thus, the sale of the business "did not constitute an integral part of the regular trade or business operations of the taxpayer." 543 P.2d at 524.

The significance of *McVean* is two-fold: it expanded the holding of *Western Natural Gas* far beyond the true liquidation and cessation of a corporation's business, and it established the precedent of purporting to apply a separate functional test while actually applying the transactional test.

The dissent in *McVean* strongly criticized the majority for failing to understand that the functional test "is not how frequent the sales are, nor how substantial the income from them may be, but rather what the relationship of the property sold is to the business." 453 P.2d at 492. The dissent continued that the language from *Western Natural Gas* endorsed by the majority was:

> a critically inaccurate paraphrase of the statutory requirement that the transaction involving the property be 'an integral part of the taxpayer's regular trade or business.' By pulling income from tangible and intangible property into business income, the legislature has shown its intent to include more than income from inventory within the term. Once it is conceded that non-inventory items are to be included, the frequency and regularity with which a business produces income from these collateral sources is irrelevant.[8]
>
> 543 P.2d at 492.

In *Appeal of Borden*, above, the California SBE criticized the failure of the courts in *Western Natural Gas* and *McVean* to do anything more than parse the words of the statute. The Board wrote:

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[8] New Mexico now recognizes the functional test for business income. Just four years after *McVean*, the Court of Appeals unanimously upheld the application of the functional test in apportioning gains from the disposition of mineral leases. *Tipperary Corp. v. New Mexico Bureau of Revenue*, 595 P.2d 1212 (N.M. App. 1979). *Accord, Kewanee Industries v. Reese,* 845 P.2d 1238 (N.M. 1993) (recognizing transactional and functional test under UDITPA). New Mexico subsequently amended its definition of business income to eliminate any potential for reliance on the *McVean* court's "partial liquidation" exception. NMSA 1978, § 7-2-2A; Laws of New Mexico 1999, Ch. 47.

> We are aware that recent decisions in Kansas and New Mexico have rejected the functional test for business income under those states' versions of the Uniform Act. *Western Natural Gas Co. v. McDonald,* 446 P.2d 781 (Ks. 1968); *McVean & Barlow, Inc. v. Bureau of Revenue,* 543 P.2d 489 (N.M. App. 1975). Since the Uniform Act is intended "to make uniform the law of those states which enact it" [citation omitted], these decisions are entitled to great weight in determining the proper construction of section 25120. In reaching their decisions, however, the Kansas and New Mexico courts did not consider the fact that the Uniform Act's definition of "business income" was derived from prior California law. Nor did they examine the uniform regulations interpreting that definition, and in fact the decisions are directly contrary to the regulations of the Multistate Tax Commission. Under these circumstances we do not find the opinions of the Kansas and New Mexico courts persuasive and therefore respectfully decline to follow their decisions.
>
> 77 SBE at 25-26.

Despite the early criticism of the *Western Natural Gas* and *McVean* decisions for ignoring the context, history, administrative interpretation and purpose of UDITPA, the two cases have often been cited as precedent for recognition of the so-called "liquidation exception" to the functional test, even though neither court applied the functional test to the facts before it.

Some of the cases recognizing a "liquidation exception" have involved true liquidations of small "family" corporate entities, with subsequent distribution of the proceeds to individual shareholders. *See, e.g., Kemppel v. Zaino,* 746 N.E.2d 1073 (Ohio 2001)(subchapter-S corporation dissolved); *Blessing-White, Inc. v. Zehnder,* 768 N.E.2d 332 (Ill. App. 1 Dist. 2002) (same). But more often, the

"liquidation exception" has been applied in the context of transactions intended, as here, to further the on-going corporate business activities through reallocation of resources into more profitable lines of business. Because there is no textual or policy basis for the criteria identified in *Western Natural Gas* and *McVean*, the application of the transactional test (or the "exception" to the functional test) to capital transactions is unpredictable. For instance, in *Kimberly-Clark Corp. v. Alabama Department of Revenue*, 69 So.3d 15 (Ala. App. 2008), the Alabama Court of Appeals applied the transactional test in holding that income from a disposition of timberlands should be considered business income because the taxpayer had frequently acquired and sold such properties as timber was depleted. The Alabama Supreme Court disagreed, noting that the disposition was of a greater magnitude than prior disposition and was part of a larger corporate divestiture strategy. *Ex Parte Alabama Department of Revenue*, 69 So.3d 144 (2010). Writing in dissent, Chief Justice Cobb noted:

> The majority opinion turns KC's corporate strategy of reducing its internal pulp production from 80% to 30% on its head. Rather than analyzing the sale in this case as one in furtherance of the business of KC *because* it was in line with its new business strategy, the majority opinion analyzes the sale as incident to "a major shift in corporate strategy," and thus "extraordinary."

69 So.3d at 155.

Similar confusion exists in applying the *Western Natural Gas/McVean* criteria as to whether gains were returned to shareholders or reinvested in an on-going business. *See, e.g., Lenox v. Tolson*, 548 S.E.2d 513, 521 (N.C. 2001), *Parker, dissenting:*

> In this case the sole shareholder to whom the proceeds were distributed was the parent corporation of plaintiff. Hence, the question remains as to whether the proceeds were used in furtherance of the unitary business."

The contours of the rule are so nebulous precisely because there is no statutory foundation for an exception to the functional test; the "exception" is entirely a judicial construct based on a decades-long misapprehension of the meaning and purpose of the UDITPA business income definition. Unsurprisingly, in almost every state in which the courts have embarked upon this rudderless journey, the legislature has responded by clarifying the existence and application of the functional test to non-inventory transactions.[9]

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[9] Missouri is the only state in which a "liquidation exception" established by case law has not been overturned by statute. In *ABB C-E Nuclear Power, Inc. v. Director of Revenue*, 215 S.W.3d 85, 87 (Mo. 2007), the court held, without analyzing the statute or its purpose, that because a 338(h)(10) disposition was considered a "liquidation" for federal tax purposes, the gain must be treated as non-business income under *Western Natural Gas* and its progeny.

The so-called "liquidation exception" amounts to nothing more than a determination to apply the transactional test to capital gains, and should not be followed by this Court.

V. CONCLUSION

UDITPA's business income definition is based upon the permissible scope of apportionment under the unitary business principle; the application of that principle to apportionment of capital gains, interest and royalties depends on the relationship of those assets to the taxpayer's business; it does not turn on the frequency of particular transactions or the subsequent use of proceeds. Once the connection between the business income definition and apportionment of unitary business income is recognized, it becomes clear that income from capital transactions involving unitary property gives rise to business income under A.R.S. § 43-1131.

For the reasons set forth above, the Commission urges this court to uphold the determinations of the Arizona Tax Court that UDITPA's business income definition contains both a transactional and a functional test, and that there is no "liquidation exception" in the functional test.

Respectfully submitted,

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APPENDIX A
STATE RECOGNITION OF FUNCTIONAL TEST UNDER UDITPA

(CCH SMART CHART; *Allocation and Apportionment; Business or Non—Business Determination* (CCH 2012)(Column six modified by *Amicus Curiae* to include additional statutory cites where available))

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
Alabama	Multistate Tax Compact	"[I]ncome arising from transactions or activity in the course of the taxpayer's trade or business; or income from tangible or intangible property if the acquisition, management, or disposition of the property constitute integral parts of the taxpayer's trade or business operations; or gain or loss resulting from the sale, exchange, or other disposition of real property or of tangible or intangible personal property, if the property while owned by the taxpayer was operationally related to the taxpayer's trade or business carried on in Alabama or operationally related to sources within Alabama, or the property was operationally related to sources outside this state and	Nonbusiness income means all income other than business income. Apply either a functional or a transactional test.		Alabama Code §40-27-1 Alabama Code § 40-27-1.1 Ala. Code § 40-27-1.IV.1 Ala. Code § 40-27-1.IV.4 Ala. Admin. Code r. 810–27–1–4-.01(a)

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
		to the taxpayer's trade or business carried on in Alabama; or gain or loss resulting from the sale, exchange, or other disposition of stock in another corporation if the activities of the other corporation were operationally related to the taxpayer's trade or business carried on in Alabama while the stock was owned by the taxpayer. A taxpayer may have more than one trade or business in determining whether income is business income			

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
Alaska	Multistate Tax Compact	Alaska Net Income Tax Act (ANITA) uses Multistate Tax Compact (MTC) allocation and apportionment method to calculate multinational corporation's earned income in Alaska	Nonbusiness income means all income other than business income. Apply either a functional or a transactional test.		Alaska Stat. §43.19.010 Art. IV(a) Alaska Stat. §43.19.010 Art. IV(e) Alaska Stat. §43.20.065 State, Dept. of Revenue v. OSG Bulk Ships, Inc., 961 P.2d 399 (Alaska 1998)
Arizona	Arizona conforms to the	Business income means all income arising from transactions in the regular	Nonbusiness income is all income other		Ariz. Rev. Stat.

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
	UDITPA provisions and MTC regulations regarding the definition of business and nonbusiness income.	course of a taxpayer's trade or business.	than business income. Arizona applies both the transactional and functional tests in determining whether a specific item of income constitutes business or nonbusiness income.		Ann. § 43-1131 Ariz. Admin. Code 15-2D-501 **See also** Ariz. Dept. of Rev., CTR 94-3 (April 14, 1994); Ariz. Dept. of Rev., CTR 94-12 (Nov. 15, 1994).
Arkansas	Arkansas conforms to the UDITPA provisions and	Business income includes all income arising from transactions and activities in the regular course of a taxpayer's trade or business.	Nonbusiness income is all income other than business income. Unitary		Ark. Code Ann. § 26-51-701 Ark.

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
	MTC regulations regarding the definition of business and nonbusiness income.		business principle will be used in determining whether income is business or nonbusiness. Under the unitary business principle, income is apportionable business income only if it is related to the unitary business carried on in the state.		Regs. § 2.26-51-701 Ark. Regs. § 3.26-51-701 Pledger v. Illinois Tool Works, Inc., 306 Ark. 134 (Ark. June 24, 1991), cert. denied 502 U.S. 958 (1991).
California	California generally conforms to the UDITPA provision	Income arising from transactions (see R&TC § 25120(a)) and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible	All income other than business income. Apply both a transactional or functional		Cal. Rev. & Tax Code §25120, 25120(d)

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
	s and MTC regulations regarding the definition of business and nonbusiness income.	property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.	test. For California purposes, the transactional and functional tests are two alternative tests and a finding of business income under either of these tests will result in the item being subject to apportionment.		*See* Hoechst Celanese Corp. v. FTB, 25 Cal. 4th 508 (2001) Cal. Franch. Tax Bd. Multistate Audit Technique Manual § 4010 (Oct. 1996)
Colorado	For corporations using the standard three–factor formula, Colorado conforms to the	Business income is the net income of the taxpayer arising from the transactions and activity in the regular course of a taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral	Nonbusiness income is all income other than nonbusiness income. Apply both a transactional and a functional test.	Prior to 2009, either followed UDITPA, or all net income was	Colo. Rev. Stat. §39-22-303.5 Colo. Rev. Stat. §24-60-1308 Atlantic

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
	UDITPA provisions and MTC regulations regarding the definition of business and nonbusiness income	parts of the taxpayer's regular trade or business operations		apportionable, depending on apportionment option selected	Richfield Co. v. State, 601 P.2d 628 (Colo. Oct. 10, 1979).
Connecticut	Corporation's entire net income is subject to apportionment.	No written guidance	No written guidance	State does not distinguish between business and nonbusiness income.	Conn. Gen. Stat. §12-218(c) Ruling 2003-3
Delaware	Delaware does not adopt the UDITPA		Rents, royalties, interest, and gains and losses from		Del. Code Ann. tit. 30, §1903(

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
	provisions and MTC regulations regarding business and nonbusiness income		the sale of capital assets and real property are allocated; other income is apportionable.		b)(1) – (b)(6)
District of Columbia	The District generally conforms to the UDITPA provisions and MTC regulations regarding the definitions of business and nonbusiness income	D.C. enacted legislation, D.C. Act 15-487, which took effect Dec. 7, 2004, amending D.C. Code Ann. § 47-1810.02 to define "business income" as all income which is apportionable under the U.S. Constitution	Nonbusiness income means all income other than business income. The District applies both a transactional and functional test in determining whether an item of income is business or nonbusiness income		D.C. Code Ann. §47-1810.01 D.C. Code Ann. §47-1810.02 D.C. Mun. Regs. § 122.13 District of Columbia v. Pierce Associates Inc.,

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
					462 A.2d 1129 (D.C. 1983)
Florida	Florida generally conforms to the UDITPA provisions and MTC regulations regarding the definition of business and nonbusiness income	Activities and transactions in the regular course of taxpayer's trade or business. Includes any amounts that could be included in apportionable income without violating the due process clause.	Nonbusiness income is defined as rents and royalties from real or tangible personal property, capital gains, interest, dividends, and patent and copyright royalties (net of all expenses directly or indirectly attributable thereto), to the extent that they do not arise from transactions and activities in the regular course of the		Fla. Admin. Code Ann. r. 12C-1.003 Fla. Stat. § 220.03 and 220.16. Fla. Admin. Code Ann. r. 12C-1.016.

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
			taxpayer's trade or business		
Georgia		All income except certain limited types of investment income.	GA does not use the term "non-business income." GA allocates investment income as well as gains or losses from the sale of assets not held, owned, or used in connection with the trade or business of the corporation. Apply either a transactional or functional test.		Ga. Code Ann. § 48-7-31(a). Ga. Code Ann. §48-7-31(d)
Hawaii	Hawaii conforms to the UDITPA provisions	The state has adopted a modified version of MTC Regs. IV.1.(c), which provides examples of business and nonbusiness income. Dividends, interest,	The state has adopted a modified version of MTC Regs. IV.1.(c),		Haw. Rev. Stat. §235-21

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
	regarding the definition of business and nonbusiness income	royalties, and gains received from a foreign corporation by a multistate taxpayer are business income subject to apportionment.	which provides examples of business and nonbusiness income. Dividends, interest, royalties, and gains received from a foreign corporation by a multistate taxpayer are business income subject to apportionment. Apply either a transactional or a functional test.		
Idaho	Follows UDITPA approach except that the definitio	Business income is defined as income arising from transactions and activity in the regular course of a taxpayer's trade or business and includes income from	All income other than business income. Idaho applies the		Idaho Code §63-3027 Idaho Regs. §

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
	n of "business income" includes income from property "acquisition, management, or disposition" and adds the words "or necessary" after the word "integral" in the functional test for business income and establishes a rebuttable presumption in favor of	the acquisition, management, or disposition of tangible personal property when such acquisition, management, or disposition constitute integral or necessary parts of a taxpayer's trade or business operation	transactional and functional tests in determining whether an item of income is business or nonbusiness income. Income that is unitary with a taxpayer's trade or business must be included in the apportionable base		35.01.01.330.02.b

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
	apportionment for gains, losses, interest, and dividends from securities.				
Illinois		The term “business income” is defined as “all income that may be treated as apportionable business income under the Constitution of the United States.”	All income other than business income and compensation. The amended definition of business income replaces the transactional and functional tests for business income for transactions or activities occurring on or after July 30, 2004.		35 ILCS 5/1501(a)(1)
Indiana	Indiana	Business income is all	All income		Ind.

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
	generally conforms to the UDITPA provisions and MTC regulations regarding the definition of business and nonbusiness income	income from transactions and activity in the regular course of the taxpayer's trade or business, including income from tangible and intangible property if the acquisition, management, and disposition of the property are integral parts of the taxpayer's regular trade or business.	other than business income; apply both a transactional and a functional test.		Code Ann. § 6-3-1-20 and 6-3-1-21. Ind. Admin. Code tit. 45, r. 3.1-1-29 Indiana Dept. of Rev., Admin. Decision, No. 94-0883 (Mar. 11, 1996)
Iowa	Iowa generally conforms to the UDITPA provisions regarding the definitio	Business income is all income arising from transactions and activity in the regular course of the taxpayer's trade or business; or income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral	Income not earned as part of a unitary business. Iowa applies the transactional test in determining whether an		Iowa Code §422.32

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
	n of business and nonbusiness income, but adds "operationally related" and "unitary business" tests.	parts of the taxpayer's regular trade or business operation.	item of investment income is business or nonbusiness income. Apply both the transactional test and functional test.		
Kansas	Kansas generally conforms to the UDITPA provisions regarding the definition of business income, except that taxpayers may elect that all	Income from transactions and activities in the regular course of taxpayer's trade or business. Income arising from transactions and activities involving tangible and intangible property or assets used in the operation of the taxpayer's trade or business. Income of the taxpayer that may be apportioned to this state under the provisions of the Constitution of the U.S. and laws thereof, except that a taxpayer may elect that all income constitutes business income. For tax years beginning on or	Any income other than business income. Apply both the transactional test and functional test.		Kan. Stat. Ann. §79-3271(a), as amended by 2008 H.B. 2434, effective July 1, 2008.

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
	income constitutes business income.	after Jan. 1, 2008, business income includes receipts that satisfy either the functional or transactional tests. For tax years beginning *before* Jan. 1, 2008, the state's definition of business income is limited to receipts that satisfy the transactional test.			
Kentucky	Kentucky generally conforms to the UDITPA provisions regarding the definition of business and nonbusiness income. In addition, the state generally conforms to the	"Business income" means income arising from transactions and activity in the regular course of a trade or business of the corporation and includes income from tangible and intangible property if the acquisition, management, or disposition of the property constitutes integral parts of the corporation's regular trade or business operations.	"Nonbusiness income" means all income other than business income Apply both the transactional and functional test.		Ky. Rev. Stat. Ann. §141.120(1)(a)-(e) 103 Ky. Admin. Regs 16:060, Sec. 2

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
	MTC regulations regarding the definition of business and nonbusiness income, with minor modifications.				
Louisiana	Louisiana does not conform to the UDITPA distinctions of business and nonbusiness income. All items of gross income, not	"Apportionable income" includes all items of gross income which are not properly includable in allocable income	"Allocable income" includes only the following: (1) Rents and royalties from immovable or corporeal movable property. (2) Royalties or similar revenue from the use of patents, trademarks, copyrights,		La. Rev. Stat. Ann. §47:287.92 La. Admin. Code tit. 61, §1130

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
	otherwise exempt, are segregated into two general classes designated as allocable income and apportionable income.		secret processes, and other similar intangible rights. (3) Income from estates, trusts, and partnerships. (4) Income from construction, repair, or other similar services.		
Maine	Entire net income subject to apportionment.	All unless non-apportionable	Those that are constitutionally excluded.		Me. Rev. Stat. Ann. tit. 36, §5211(1)
Maryland	A corporation's income "that is derived from or reasonably	All income is considered apportionable income provided it is generated from a unitary business operation.	None, all items are considered business income. Apply functional and transactional		Md. Code Ann. §10-402

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
	attributable to the part of its trade or business carried on in the state" is subject to the three-factor or the one-factor apportionment formula.		tests.		
Massachusetts	Massachusetts does not differentiate between "business" and "nonbusiness" income and seeks to apportion all	Full apportionment modified by *Allied-Signal.*	Investment income on nondomiciliary corporations is excluded from apportionable income base to the extent required by Allied-Signal. See TIR 92-5. Do not recognize		Mass. Gen. Laws ch. 63, §38 Mass. Reg. 830 CMR 63.38.1

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
	taxable net income generated from a unitary or related business operation (i.e., the "full apportionment principle").		nonbusiness income. Apply functional and transactional tests.		
Michigan	Michigan does not conform to the UDITPA distinctions of business and nonbusiness income and treats all income (i.e., modified	Business income means that part of federal taxable income derived from business activity. For MBT purposes, federal taxable income means taxable income as defined by IRC § 63, except that federal taxable income shall be calculated as if IRC § 168(k) [as applied to qualified property placed in service after 12/31/07] and IRC § 199 were not in effect. For a partnership or S corporation (or LLC federally taxed as such), business income includes payments and items	Not defined under MBT		Mich. Comp. Laws §206.661(2) Mich. Comp. Laws §208.41 Mich. Comp. Laws §208.1301(2)

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
	federal taxable income) as apportionable business income	of income and expense that are attributable to business activity of the partnership or S corporation and separately reported to the partners or shareholders.			
Minnesota	The state treats all income derived from carrying on a trade or business as apportionable income	All income other than that income that cannot constitutionally be apportioned to the state.	Income of a trade or business that cannot constitutionally be apportioned to the state; apply constitutional test.		Minn. Stat. §290.17
Mississippi	Mississippi generally conforms to the UDITPA provisions and MTC regulations	The state's “business income” definition uses a transactional or functional test to determine whether or not income earned by a nonresident is properly allocated to Mississippi. Business income is allocated to Mississippi if the income: Arises from transactions and activity in the regular	All nonbusiness income; non-US interest and dividends; U.S. government interest; apply either a transactional		Miss. Code. Ann. §27-7-23

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
	regarding business and nonbusiness income	course of the taxpayer's trade or business; or Is derived from property that was an integral, functional, necessary, or operative component of the taxpayer's trade or business.	or a function test.		
Missouri	Missouri conforms to the UDITPA provisions regarding the definition of business and nonbusiness income.	Business income means all 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.	Nonbusiness income is all income other than business income.		Mo. Rev. Stat. §32.200 Art. IV (1), (5)
Montana	Montana generally conforms to the UDITPA provisions and MTC regulations regardin	Business income means income arising from transactions and activities in the regular course of a 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	Nonbusiness income means all income other than business income. Apply transactional and functional test.		Mont. Code Ann. §15-31-302(1) Mont. Admin. R. 42.26.206(3)-(4)

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
	g business and nonbusiness income	taxpayer's regular trade or business operations.			Mont. Admin. R. 42.26.207
Nebraska	Nebraska does not conform to the UDITPA provisions or MTC regulations regarding the distinction between business and nonbusiness income.	The entire federal taxable income, as adjusted, of a unitary business operating within and without Nebraska is presumed to be subject to apportionment	None		Neb. Rev. Stat. §77-2734.06 (1)
New Hampshire	New Hampshire does not make a distinction	All income is business income unless excluded pursuant to federal constitutional law	New Hampshire has no nonbusiness income provision		N.H. Rev. Stat. Ann. §77-A:3, I

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
	between business and nonbusiness income. Instead, all of a taxpayer's gross business profits are subject to apportionment				
New Jersey	The New Jersey statute does not adopt the UDITPA distinctions of business and nonbusiness income and regards all	Operational income is defined as 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 and includes investment income that serves an operational function	No definitions for business and nonbusiness income. New Jersey has constitutional exclusion for "non-operational" income. Apply a transactional, functional, and		N.J. Stat. Ann. §54:10 A-6.1(a) See *Allied Signal v. Director,* 504 U.S. 768 (1992) and

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
	operational income as apportionable		operational test (did property serve an operational rather than investment function).		N.J. Stat. Ann 54:10A-6.1. See instructions on CBT-100, Schedule O.
New Mexico	New Mexico generally conforms to the UDITPA provisions and MTC regulations regarding the definition of business and nonbusiness income.	"Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and income from the disposition or liquidation of a business or segment of a business. "Business income" includes income from tangible and intangible property if the acquisition, management or disposition of the property constitute integral parts of the taxpayer's regular trade or business operations;	Nonbusiness income is all income other than business income. Apply transactional and functional test.		N.M. Stat. Ann. § 7–4–2 N.M. Admin. Code § 3.5.1.9
New	New	"Business income" means	All income is		N.Y.

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
York	York does not conform to the UDITPA provisions or MTC regulations regarding the definitions of business and nonbusiness income	entire net income minus investment income.	either business, investment, or subsidiary in nature. Stock ownership of more than 50% is subsidiary, less than 50% is investment.		Tax Law, §208(8)
North Carolina	North Carolina generally conforms to the UDITPA provisions and MTC regulations regarding the definitio	Effective 8/14/2003, North Carolina replaced the term "business income" with "apportionable income'. The state uses the term "apportionable income", which is defined as "all income that is apportionable under the U.S. Constitution.	Income from unrelated business activities that make up a discrete business enterprise is "nonbusiness income." Apply transactional and functional		N.C. Gen. Stat. §105-130.4(a)(1) Polaroid Corp. v. Offerman, 507 S.E.2d 284 (N.C.

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
	n of business and nonbusiness income.		tests.		Dec. 4, 1998), cert. denied, No. 98–1395 (May 3, 1999)
North Dakota	North Dakota conforms to the UDITPA provisions and the MTC regulations regarding the definition of business and nonbusiness income.	Business income means all income arising from transactions 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.	Nonbusiness income is all income other than business income. Apply both a transactional and a functional test.		N.D. Cent. Code §57-38.1-01(1) N.D. Admin. Code § 81-03-09-03
Ohio	Ohio adopted the UDITPA definitions of	“Business income” is income from transactions, activities, and sources in the regular course of a trade or business and includes income from real property, tangible	“Nonbusiness income” is all income other than business income. Apply both a		Ohio Rev. Code Ann. §5733.051

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
	business and nonbusiness income for franchise tax purposes	personal property, and intangible personal property if the acquisition, rental, management, and disposition of the property constitute integral parts of the regular course of a trade or business operation.	transactional and a functional test.		Ohio Rev. Code Ann. §5751.01 2000 WL 60231 (Ohio Bd.Tax. App.), 1
Oklahoma	Oklahoma's statute does not adopt the UDITPA provisions regarding business and nonbusiness income.				Okla. Stat. tit. 68, §2358(5)
Oregon	Oregon generally conforms to the UDITPA	"Business income" is income arising from transactions and activities in the regular course of the taxpayer's trade or business and includes	All income other than business income. Apply both a		Or. Rev. Stat. §314.610(1)

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
	provisions and MTC regulations regarding the definition of business and nonbusiness income	income from tangible and intangible property if the acquisition, management, use or rental and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. This includes sales of product or services, rents and royalties from real and tangible personal property, gains and losses from sales of assets, interest, dividends, patent and copyright royalties.	transactional and a functional test.		Or. Admin. R. 150-314.610(1)-(B)(3)
Pennsylvania	Pennsylvania conforms to the UDITPA provisions regarding the definition of business and nonbusiness income.	All income arising from normal and usual transactions; all income apportionable under the U.S. Constitution.	All other items of income. Apply both a transactional and a functional test.		72 P.S. §7401(3)2.(a)(1)(A) Welded Tube Co. of Am. v. Com., 101 Pa. Cmwlth. 32, 515 A.2d 988 (1986)
Rhode Island	All net income	All	None		R.I. Gen.

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
	subject to apportionment.				Laws §44-11-14(a)
South Carolina	South Carolina does not conform to the UDITPA provisions and MTC regulations regarding the definition of business and nonbusiness income.allocable if not connected with business; all other income apportionable.	Any income that is part of the taxpayer's unitary business.	Dividends received from corporate stocks and gains and losses from the sale of real property are always allocable, net of related expenses		S.C. Code Ann. §12-6-2250(b)

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
Tennessee	Tennessee version of the Uniform Act generally conforms to the UDITPA provisions and MTC regulations regarding the definition of business and nonbusiness income, but uses the terms business and nonbusiness earnings	Business earnings means earnings arising from transactions and activity in the regular course of a taxpayer's trade or business or earnings from tangible and intangible property if the acquisition, use, management or disposition of the property constitutes an integral part of the taxpayer's regular trade or business operations	Earnings which arise from the conduct of a trade (or trades) or business operations of a taxpayer are presumed to be business earnings, and the taxpayer must show by clear and cogent evidence that particular earnings are classifiable as nonbusiness earnings. Effective for fiscal years ending on or after July 15, 1993, Tennessee applies both a transactional and functional test in		Tenn. Code Ann. § 67-4-2004(1) Tenn. Code Ann. §67-4-2004(3) Tenn. Comp. R. & Regs. ch. 1320-6-1-.23. Associated Partnership I, Inc. v. Huddleston, 889 S.W.2d 190 (Tenn. 1994)

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
			determining whether an item of income is business or nonbusiness earnings.		
Texas	Texas does not adopt the UDITPA distinctions between business and nonbusiness income	Business income is all income except income that a state could not tax even if the corporation had nexus in that state.	Income a state could not tax even if the corporation had nexus in that state; constitutional standard.		Tex. Tax Code Ann. §171.106(a)
Utah	Follows UDITPA and MTC approach, with presumption that certain items are business income.	Business income means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations	All income that is not business income. Apply transactional or functional test.		Utah Code Ann. §59-7-302(1) Utah Admin. Code R865-6F-8(2)(b)-(c)
Vermo		The state relies *on Allied*	Receipts		Vt.

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
nt		*Signal v. Director, Division of Taxation* in determining whether an item of income is related to a taxpayer's business operations and, therefore, includable in the apportionable base	unrelated to regular business activities; apply either a transactional or a functional test.		Stat. Ann. tit 32, §5833 Vt. Code R. 1.5833-1(a)(2)
Virginia	Virginia's statute and regulations do not distinguish between "business" and "nonbusiness" income	Virginia does not distinguish business and nonbusiness income. Statute allocates only dividends, and apportions all other income. Taxpayers may request allocation of specific items of income under VA code 58.1-421 for which apportionment would be unconstitutional under *Allied Signal.*	Dividend income is allocated to the taxpayer's state of commercial domicile and all other income is apportioned.		Va. Code. Ann. §58.1-408
West Virginia	West Virginia generally conforms to the UDITPA definitions of business and nonbusin	Business income is defined as income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property or the rendering of services in	Nonbusiness income is all income other than business income		W. Va. Code §11-24-3a(1) W. Va. Code St. R. § 110-24-7.4.1.

State	State Standard	State Definition of Business Income?	State Definition of Nonbusiness Income?	Comments	Citations
	ess income	connection therewith constitute integral parts of the taxpayer's regular trade or business operations and includes all income which is apportionable under the Constitution of the United States.			
Wisconsin	Wisconsin does not adopt the UDITPA definitions of business and nonbusiness income.	All income except nonbusiness items.	Rents/royalties from nonbusiness property and income (gain/loss) from sale of nonbusiness property are allocated; all other income apportioned. Apply both a transactional and a functional test.		Wis. Stat. §71.25(5)(a)