What Ever Happened to Allocable Income? — Part II

by Lynn A. Gandhi

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In this installment of Smitten With the Mitten — the second in a three-part series on allocable income — Gandhi examines the Multistate Tax Commission's revisions to Article IV of the Uniform Division of Income for Tax Purposes Act, particularly the expansion of the definition of apportionable income through the broadening of the functional test, the comments received in response to the proposal, and its adoption.

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How Do I Work This?

In Part II of "Whatever Happened to Allocable Income?"[1] we will explore the period after Part I, which summarized the key U.S. Supreme Court decisions addressing allocable income — income not subject to apportionment.[2] Part II addresses the Multistate Tax Commission's revisions to Article IV of the Uniform Division of Income for Tax Purposes Act, particularly the expansion of the definition of apportionable income through the broadening of the functional test, the comments received in response to the proposed amendments, and their adoption. Such expansion may be suspect, and based upon specific facts could violate the principle of external consistency and the prohibition on extraterritorial taxation.

Background to Revised Model — Article IV

As discussed in Part I, Article IV of the Multistate Tax Compact was originally drafted by the Uniform Law Commission in 1957. In July 2015 the MTC adopted the Revised Model Compact Article IV that, among other changes, redefined the definition of business income.[3] In doing so, the definition of allocable income was directly affected. These amendments had been several years in the making. The project to revise UDITPA had first been publicly proposed by Joe Huddleston, the MTC's executive director, and Shirley Sicilian, the organization's general counsel, in a paper presented at the New York University Institute on State and Local Taxation in 2009.[4] The five UDITPA provisions that the authors believed merited the effort of undertaking such a review were: (1) sales factor sourcing for services and intangibles (section 17); (2) factor weighing (section 9); (3) definition of business income (section 1(a)); (4) definition of gross receipts (section 1(g)); and (5) the distortion relief provision (that is, alternative apportionment, section 18). Part II of this series on allocable income focuses on the revisions to UDITPA section 1(a) (referred to hereafter as the proposed model amendments).

Huddleston and Sicilian noted that the definition of business income had been "especially prone to litigation and/or the need

[1] Brian Eno, "Once in a Lifetime," Talking Heads, Jan. 1981.

[2] Lynn A. Gandhi, "Whatever Happened to Allocable Income?" *Tax Notes State*, Oct. 9, 2023, p. 85.

[3] The resolutions adopting the recommended confirming amendments to model Multistate Tax Compact Article IV are available on the MTC's website. The MTC is to be commended for its robust website, which provides notes, meeting minutes, studies, and other guidance free of charge.

[4] Joe Huddleston and Shirley Sicilian, "The Project to Revise UDITPA," From the Proceedings of the New York University Institute on State and Local Taxation (2009).

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for legislative clarification."[5] Finding that the existing language lacked clarity, the authors suggested the provision be amended and proposed several options for consideration. Options had previously been shared with the National Conference of Commissioners on Uniform State Laws.[6] The MTC's Executive Committee established a Uniformity Committee to commence work on draft revisions to Article IV. On December 12, 2012, the Executive Committee approved the proposed model amendments for public hearing, which was conducted in March 2013.

After consideration of the report of the hearing officer appointed to examine the proposed model amendments, the Executive Committee provided the Uniformity Committee an opportunity to consider the hearing officer's proposals and public comments. In March 2014, after review, the Uniformity Committee provided the Executive Committee its revised recommendations, which essentially were the same as its original recommendations. In May 2014 the Executive Committee approved the proposed model amendments, except for those relating to section 18, which were sent back to the Uniformity Committee with changes requested by the Executive Committee in accordance with the hearing officer's report. In July 2015 the MTC adopted Revised Model Compact Article IV.

Proposed Model Amendments and 'Business Income'

As adopted, revised Article IV jettisoned the term "business income" and replaced it with the term "apportionable income," defined as all income that is apportionable under the U.S. Constitution and is not allocated under the laws of this state, including:

a. income from transactions and activity in the regular course of the taxpayer's trade or business, and
b. income arising from tangible and intangible property if the acquisition, management, employment, development, or disposition of the property is or was related to the operation of the taxpayer's trade or business.

Among the most important changes in this new definition of apportionable income is that it explicitly references the Constitution as the standard for determining what income is subject to formulary apportionment. In doing so, one would expect recognition of existing Supreme Court precedent as there is no basis to claim that these guiding principles have lost their standing in state jurisprudence. Second, the revised Article IV clarifies that the commonly called transactional and functional tests are separate tests and should be treated as such. While there are instances in which income may meet both tests, there are numerous examples of when only one of the tests may be met. And third, the revised Article IV expanded the reach of the functional test by changing the requirement that the activity "constitute integral parts of the taxpayer's regular" business to a requirement that the activity merely be "related to the operation" of the business. By expanding the functional test, the proposed rules greatly expanded the definition of apportionable income and thus significantly limited what remains of allocable (or non-apportionable as renamed by the MTC) income.[7]

This shift to an enlarged definition of business income through an expansion of the functional test while at the same time narrowing the sales factor resulted in a quotient of what could be considered non-apportionable or allocable income.

[5] *Id.* at 15.

[6] *See* Robert A. Stein, *Forming a More Perfect Union: A History of the Uniform Law Commission* (2013).

[7] The proposed rules also significantly narrowed the definition of receipts to determine what goes into the receipts factor (or "sales factor" as it was previously called). The revised definition explicitly excludes receipts that give rise to income that would meet the functional test, but not the transactional test for apportionable income. Further, certain receipts are explicitly excluded from the receipts factor even if they gave rise to income that would meet the transactional test. This increases asymmetry between the tax base and the receipts factor as well as the risk of extraterritorial taxation that would violate the external consistency test. A topic for another column. Never a lack of subject matter, to quote Eno again, "same as it ever was."

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Expansion of the Functional Test

A comparison of the change to the functional test is best viewed side-by-side:

Prior Article IV.1(a): Business income	Proposed revisions to Article IV.1(a)[a]
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	income *arising* from tangible and intangible property if the acquisition, management, *employment, development*, ~~and~~ or disposition of the property ~~constitute integral parts of~~ *is or* was *related to the operation of* the taxpayer's ~~regular~~ trade or business ~~operations~~
[a]New language italicized, removed language struck.	

The MTC's reasoning for the proposed changes was memorialized in the memo prepared by Sicilian for Cory Fong, then-chair of the MTC. In discussing the changes to the definition of business income, the memo emphasized that many states have interpreted the current definition as providing two tests for identifying apportionable business income: a transactional test and a functional test. The transactional test focuses on the frequency and regularity of the transaction that produces the income, while the functional test focuses on "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."[8]

The memo further explained that notwithstanding the language used to define the two tests, some state courts have held that UDITPA provides only a transactional test, and under this minority view, the words "and includes" make the second clause (the functional test) a qualifying clause that serves to exemplify a type of income that is included only if it also fits within the first clause (the transactional test).[9] Following this interpretation, income from the sale of machinery used in a taxpayer's unitary business would be included in business income only if that type of machinery is sold regularly. For example, a car rental agency that routinely sells and replaces cars used in its rental fleet would treat income from such sales as business income. In states where the courts found that the definition contains only a transactional test, the legislatures generally followed up with a statutory amendment to add the functional test.[10]

The memo noted that there had been a legislative trend over the last few years to define business income simply as all income apportionable under the Constitution. In part, this trend was a reaction to judicial decisions holding that income arising from the liquidation of a business cannot be included in business income, if there is no longer any business.[11] The MTC's policy concern with this theory is the potential mismatch from allocating gain on the sale of a unitary asset after apportioning expenses, such as depreciation, associated with that same asset.[12]

The memo stated that although "the definition of business income is changing in many states through judicial interpretation and legislative amendment, there remains a high level of uniformity because states have moved largely in the same direction — toward maintaining a broad interpretation of business income." The critical question "is whether the model provision should be amended to clarify the existence of both a transactional and functional test, and to include gain from the sale of unitary business assets."[13]

The MTC's broad definition of business income was intended to include gains from liquidation of a unitary business, including a liquidation that is a deemed sale of assets under IRC section 338(h)(10), regardless of how, or

[8]Sicilian, "Multistate Tax Compact Article IV Recommended Amendments," Memo prepared for Cory Fong at 6 (May 3, 2012).

[9]*Id.* at 7 (citing, e.g., *Uniroyal Tire Co. v. State Department of Finance*, 779 So. 2d. 227 (Ala. 2000); *Appeal of Chief Industries Inc.*, 255 Kan. 640, 875 P.2d 278 (1994); *Phillips Petroleum Co. v. Department of Revenue and Finance*, 511 N.W.2d 608 (Iowa 1993); *Associated Partnership I Inc. v. Huddleston*, 889 S.W.2d 190 (Tenn. 1994)).

[10]Sicilian, *supra* note 8, at 7 (citing, e.g., Ala. H.B. 7 (Dec. 28, 2001), which amended Ala. Code section 40-27-1.1 after *Uniroyal Tire*, 779 So. 2d. 227; Iowa Code section 422.32, which was amended after *Phillips Petroleum*, 511 N.W.2d 608; and Kan. Stat. Ann. 79- 3271(a), which was amended after *Chief Industries*, 875 P.2d 278).

[11]*Id.* at 8 (citing *Lennox v. Tolson*, 353 N.C. 659 (2001); *Laurel Pipe Line Co. v. Commonwealth of Pennsylvania Board of Finance and Revenue*, 537 Pa. 205 (1994); *Kemppel v. Zaino*, 746 N.E.2d 1073 (Ohio 2001); *Blessing/White Inc. v. Zehnder*, 329 Ill. App. 3d 741 (2002)).

[12]Ironically, the MTC did not address the apportionment of income whose related prior expenses may have been allocated.

[13]Sicilian, *supra* note 8.

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whether, the gain is used in a taxpayer's business. Thus, to address confusion over how business income could include income from selling the business itself, the proposed amendments would rename business income as apportionable income.[14]

The memo then addressed the changes to the functional test, which were summarized as follows:

1. The list of activities which describe how property can become integrated into the business are expanded from "acquisition, management, and disposition" to explicitly list "employment" and "development."
2. The list of activities is connected with an "or" rather than an "and" to clarify that any single one of these activities is sufficient to integrate property into the taxpayer's business.
3. The word "regular" is deleted to eliminate any confusion as to whether the transactions must occur on a frequent basis.[15]
4. To require that the property be "related to the operation," rather than constitute an "integral part," of the taxpayer's trade or business, to avoid unnecessary interpretation of the term "integral."[16]

Hearing Officer Report

A public hearing was conducted on the proposed amendments, which was presided over by Richard Pomp,[17] who noted the effect of these changes to the business income test.[18] He concurred that the term "apportionable income" is more descriptive and informative than the term "business income," and that similarly, "non-apportionable income" is more descriptive and informative than "nonbusiness income."[19] Pomp asserted that the term "nonbusiness income" was misleading because the income being allocated was indeed income of a business. By eliminating the intermediate terms of business or nonbusiness income, the proposed recommendations would proceed directly to clarifying whether the income was apportionable or non-apportionable (that is, allocable) and hopefully reduce confusion.[20]

Second, Pomp concurred that deleting the word "includes" between Article IV.1(a)(i)(A) and proposed Article IV.1(a)(i)(B) would eliminate any confusion regarding whether the functional test was an independent test. The proposed amendment would make clear that there are two tests, and consistent with the deletion of the word "includes," the word "and" at the end of (A) should be changed to "or."[21]

Pomp noted the expansion of the functional test through the expanded definition adding "employment, development" and that deleting the word "and" and replacing it with "or," would clarify that the terms are in the disjunctive and not conjunctive.[22] Pomp also found that the replacement of the terms "regular" and "integral part," with "related to the operation" would eliminate confusion and provide that partial or full liquidations of a business will constitute

[14] *Id.* at 9.

[15] *Id.* This addressed the California Supreme Court's holding in *Hoechst Celanese*, in which the court found:

> in the transactional test — which focuses on the income-producing transaction — "regular" modifies "course of the taxpayer's trade or business" and makes the nature of the transaction relevant. In the functional test — which focuses on the income-producing property — "regular" modifies "trade or business operations" and follows the phrase "an integral part of." Consequently, "regular," as used in the functional test, does not refer to the nature of the transaction, and the extraordinary nature or infrequency of the income-producing transaction is irrelevant.

Hoechst Celanese Corp. v. Franchise Tax Board, 25 Cal. 4th 508, 530 (2001).

[16] Sicilian, *supra* note 8, at 9 (again referring to *Hoechst Celanese*, in which the court explained that interpreting "integral" as "contributing to" could be unconstitutionally broad, while interpreting "integral" as "necessary to" or "essential to" would be too restrictive since no asset would be sold if it were necessary or essential. The court found that "integral" should be construed somewhere between these two — e.g., "materially contributing to.") *Hoechst Celanese*, 25 Cal. 4th 508 at 530.

[17] Pomp is the Alva P. Loiselle Professor of Law at the University of Connecticut School of Law. I have often wondered about Loiselle, who graduated from the law school in 1943, and why the chair was endowed in his name. During his 28 years on the bench, Loiselle served on several of the Connecticut courts. He was a judge on the court of common pleas from 1952 to 1957. In 1957 he was appointed a judge of the superior court, where he served for 14 years and was the chief judge from 1970 to 1971. He was appointed an associate justice of the Connecticut Supreme Court in 1971. During his tenure, Justice Loiselle heard 1,551 cases and wrote 224 majority opinions, six concurring opinions, and 15 dissenting opinions. He also served as chair of the superior court rules committee. Quite a career.

[18] Pomp, "Report of the Hearing Officer, Multistate Tax Compact Article IV [UDITPA] Proposed Amendments," MTC (Oct. 25, 2013).

[19] *Id.* at 49.

[20] *Id.*

[21] *Id.*

[22] *Id.* at 51.

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apportionable income, which Pomp found to be constitutional and long overdue.[23]

Regarding the inclusion of property that was "related to the operation of the trade or business," which language lacked any temporal element or a bright-line measurement, Pomp noted that the absence of a time limit raised the possibility that property that had been used in the taxpayer's business operations, but had previously been held purely as an investment, would produce apportionable income on its sale. On this point, he found the proposed amendment to be inconsistent with MTC regulation IV.1(a)(5)(A), which provides that:

> Property that has been converted to nonbusiness use through the passage of a sufficiently lengthy period of time (generally, five years is sufficient) or that has been removed as an operational asset and is instead held by the taxpayer's trade or business exclusively for investment purposes *has lost its character as a business asset*. . . . Property that was an integral part of the trade or business is not considered converted to investment purposes merely because it is placed for sale.[24]

Another public comment questioned whether it is appropriate to include in apportionable income that which was related to the operation of the taxpayer's trade or business without a time limitation.[25]

In evaluating the proposed amendments, Pomp noted that the narrowing of the sales factor to include only the receipts received from transactions and activity in the regular course of the taxpayer's trade or business, while removing this language from the definition of business income, "introduces an interdependency between the transactional test and the receipts factor," which is later criticized, and was further affected by the adoption of a throwout rule in the context of market-based sourcing.[26]

Pomp found that the most controversial of the proposed changes was the incorporation of the constitutional standard to the definition of business income. Constitutional considerations are often part of the analysis of the existing definitions of the transactional and functional tests, for even if a taxpayer concludes that a transaction satisfies one of these tests, it must take the next step and ask whether that characterization is constitutional. Further, even if a transaction does not satisfy a statutory definition, it should also consider whether that finding is constitutionally mandated.[27]

Pomp concluded that as business income is expanded, litigation will likely focus on the terms in the definitions and whether that result would be constitutional. These arguments will probably be the same whether the definition of business income explicitly incorporates a constitutional standard.[28] Pomp stated that the real effect of including the constitutional standard will be in situations that do not neatly fall within the broadened definition of business income. He rejected eliminating the reference to the transactional and functional tests, finding that there is value in the predictability, guidance, and familiarity that they provide to non-attorney practitioners.

Regarding allocable income, Pomp noted two effects caused by the broadening of business income that the proposed amendments and the MTC failed to address. First, by broadening the definition of apportionable income, less income will be treated as non-apportionable (that is,

[23] *Id.* at 51-52. Public comments submitted by Sutherland, Asbill & Brennan LLP addressed, among the other proposed revisions, the termination of the "cessation of business" exception by including the phrase "is or was" in the functional test. The comments noted that courts have concluded that the liquidation accompanied by a cessation of business activity is an extraordinary and uncommon corporate event not typically occurring within the regular course of operations and therefore does not satisfy the transactional test, and cited in support *Lenox Inc. v. Tolson*, 353 N.C. 659, 548 S.E.2d 513 (2001) (holding a consumer products manufacturer earned nonbusiness income from the liquidation sale of one of its operating divisions); *Blessing/White Inc.*, 329 Ill. App. 3d 714 (holding that gain realized from complete liquidation of a corporation's capital assets followed by a distribution of proceeds to shareholders constituted nonbusiness income under the functional test); *Kemppel*, 91 Ohio St. 3d 420, 746 N.E.2d 1073 (holding that income arising out of the liquidation of assets followed by dissolution of the corporation was not business income because it was a one-time event that terminated the business); and *Laurel Pipe Line Co.*, 537 Pa. 205, 642 A.2d 472 (holding that taxpayer's gain from the liquidation of pipeline assets that had been idle for three years gave rise to nonbusiness income under the functional test).

[24] Pomp, *supra* note 18, at 52 (citing MTC Reg. IV.1(a)(5)(A)) (emphasis added).

[25] *See* public comment submitted by Peter L. Faber of McDermott Will & Emery.

[26] Pomp, *supra* note 18, at 52.

[27] *Id.* at 53

[28] *Id.* at 54.

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allocable) income. That will shift income away from states to which it was allocated, often the state of commercial domicile, to states in which it will now be apportioned. Second is the effect on states that disallow an expense deduction that relates to nontaxable income like IRC section 265. If more income is treated as apportionable income, these expense deductions should be permitted. If they are not, a further asymmetry will be created between apportionable income and disallowed expenses. Pomp concluded that broadening apportionable income would not only shift formerly allocated income from the states of allocation to the states in which the income would now be apportioned, but also shift deductions from offsetting allocable income to offsetting apportionable income.[29]

The Hearing Officer's Proposal

Pomp proposed that the MTC consider the following language for the definition of apportionable income:

> Art. IV.1(a) "Apportionable income" means:
>
> i. all income that is apportionable under the Constitution of the United States and is not allocated under the laws of this state, including but not limited to:
> ii. income related to the operation of the taxpayer's trade or business; or
> iii. income from tangible/intangible property if the acquisition, management, employment, development, or disposition of the property is, or was, *related to, or part of*, the operation of the taxpayer's trade or business.
>
> Art. IV.1(e) "Non-apportionable income" means all income other than apportionable income.[30]

Pomp's intent was to eliminate the terms that have no constitutional significance, that have led improperly to adverse results for the states, and that invite needless litigation and controversy. His proposed language was to further broaden the definition of apportionable income to reach future changes in the economy and business practices that he anticipated would develop to facilitate those changes. The constitutional standard would remain to test any resulting gray areas.[31]

So Where Does This Leave Us?

As noted, the MTC adopted the Revised Model Compact Act and the conforming amendments to Article IV and section 18 in July of 2015. In 2017 the MTC adopted conforming regulations. In completing this process, allocable income was significantly reduced, notwithstanding the categories of allocable income enumerated in UDITPA and addressed in Part I. By expanding the functional test of apportionable income to a point that was all encompassing and without addressing any temporal limitation regarding the sale of property that was previously related to the operation of a taxpayer's business, allocable income was eviscerated. This result was achieved with little discussion regarding the increased risk of violations of external consistency and extraterritorial taxation. How can income earned from the sale of enterprise value truly be considered as apportionable income and taxed based on a tax year measurement that may have occurred decades after the business had commenced and the value attained?

Part III will address "Where Are We Going" and the controversy and litigation since the revision to UDITPA Article IV and the issues now reoccurring as taxpayers seek the protection of constitutional safeguards. ■

[29] *Id.* at 57. Pomp concluded that it cannot be predicted whether taxpayers will benefit or not from these changes or the revenue effects on the states. Who remembers Karnak and Johnny Carson?

[30] *Id.* at 53-54 (emphasis added).

[31] *Id.* at 59. This assumes access to the courts. The limitation of review by an impartial court, à la not a state impact judiciary, is extremely limited. Again, a topic for another day.

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