

§ 3.08 UDITPA - Income Classification

"Business income" is subject to apportionment under UDITPA. "Nonbusiness income" is allocated to a specific situs state depending upon the source of the income. UDITPA defines business income 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 constitute integral parts of the taxpayer's regular trade or business." UDITPA defines nonbusiness income as "all income other than business income."

[1] Functional Test Based on Business Integration

Under the functional test, business income need not be derived from transactions or activities that are in the regular course of the taxpayer's trade or business. Income is characterized as business income if the property from which the income is derived is or was an integral, functional, or operative component used in the taxpayer's trade or business operations, or materially contributed to the production of business income of the trade or business. The focus is the relationship between the asset generating the taxable income and the business. The functional test is based on the second phrase contained in UDITPA's definition of business income. It states that business income includes income from "tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business."

Example:

Gain on the sale of a major piece of factory equipment by a manufacturer is business income under the functional test. The equipment was acquired and used in the taxpayer's regular trade or business.

The California Supreme Court examined whether pension plan assets reverting to a company constituted business income. In *Hoechst Celanese Corp. v. Cal. Franch. Tax Bd.*, the court concluded, under the functional test, that the term "regular" does not refer to the nature of the transaction and the "extraordinary nature or infrequency of the income-producing transaction is irrelevant." The court held that the income from the pension plan assets constituted business income because the taxpayer used the funds as an employee benefit which materially contributed to the company's production of business income. The court defined "integral" as the "organic unity" between the taxpayer's income-producing property and the taxpayer's business activities. Consequently, the court concluded that income is business income under the functional test if the taxpayer's acquisition, control and use of the property "contribute materially to the taxpayer's production of business income."

[2] Transactional Test Based on Business Activity

Under the transactional test, income is considered business income if it arises from transactions and activities in the regular course of a taxpayer's trade or business. This includes income from "[b]usiness deals and the performance of a specific function in the normal, typical, customary or accustomed policy or procedure of the taxpayer's trade or business." The focus is how the transaction relates to the taxpayer's regular trade or business.

The transactional test is based on the first phrase contained in UDITPA's definition of business income. It states that business income includes income from "income arising from transactions and activity in the regular course of the taxpayer's trade or business." Crucial factors considered under the transactional test are the frequency and regularity of the activity generating the income.

Example:

Gain on the sale of a major piece of factory equipment by a manufacturer is considered non-business income under the transactional test. The sale of the factory equipment is unusual and does not occur within the normal course of business.

[3] MTC Income Classification

The MTC's uniform regulations interpret UDITPA and presume income is business income. The regulations identify business income as consisting of any type or class of income. Business income is produced from any activity that meets the relationship described in either the "transactional" or "functional" tests. An item of income is nonbusiness income only if it does not meet the definitional requirements of business income. The MTC regulations also state that labels are of no aid in determining whether income is business or nonbusiness income.

[4] Dividends from Stock Acquired in a Business

Regulations promulgated by the MTC state that dividends are business income "where the stock with respect to which the dividends are received arises out of or was acquired in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the stock is related to or incidental to such trade or business operations."

Example:

The taxpayer receives dividends from the stock of a subsidiary which acts as a marketing center for products produced by the taxpayer. The dividends are business income.

In *Mobil Oil Corp. v. Comm. of Taxes*, the United States Supreme Court affirmed the lower court's decision that dividends received from subsidiaries engaged in a unitary business with the payee corporation constitute business income and that the nondomiciliary taxing state could apportion the dividend income. Conversely, dividends received from subsidiaries not engaged in a unitary business with the payee corporation constitute nonbusiness income.

Practice Tip:

In order to determine that dividends received from a subsidiary are business income, it must be determined that the business is unitary. That determination is generally based on the integration of operations.