

# Arizona - Court decides that gain on the disposition of assets yields business income

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## In brief

An Arizona Court of Appeals held that gains on the disposition of assets were business income under Arizona statute. The court found that Arizona law provides two independent tests for determining business income, each addressing different economic realities. [[\*Harris Corporation et. al. v. Arizona Department of Revenue, Court of Appeals of Arizona, No.1 CA-TX 11-0006 \(11-26-2013\)\*](#)]

## In detail

Harris Corporation (“Harris”) is a Delaware corporation providing voice, data and video telecommunications products and services. It filed a consolidated Arizona corporate income tax return for tax years June 30, 1997 to June 30, 2001 reflecting three categories of income at issue: (1) gain recognized on the sale of business lines, (2) proceeds from the sale of a subsidiary business unit, (3) and gains reported by its consolidated subsidiaries. Harris treated the income, expenses, and losses from these business operations as “business income,” but treated gains on their dispositions as “non-business income.” Following an audit, the Department proposed an assessment based on classifying the gains as business income. Harris protested the assessment

and subsequently appealed to the Arizona Tax Court, which granted summary judgment in favor of the Department of Revenue. Harris appealed to the Arizona Court of Appeals.

The appeals court found that the Arizona legislature enacted a modified version of the Uniform Division of Income for Tax Purposes Act (“UDITPA”). Under Section 43-1131 of Arizona law, business and nonbusiness income is defined as follows:

- “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.

- Nonbusiness income” means all income other than business income.

The court noted that several states adopting these UDITPA definitions have recognized that business income includes two alternative definitional clauses: the “transactional” test from the first clause, “income arising from transactions and activity in the regular course of the taxpayers trade or business;” and the “functional” test from the second clause, “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.

The court's review of case law, however, revealed that courts are divided on the interpretation of this statute. Some courts have held that income is business income if it satisfies either the transactional or functional test. Other courts have held that the second clause merely describes examples of income within the definition.

Looking at the plain language of the statute, the court found the language "suggests that the Arizona legislature intended to address different economic realities in the two clauses." The court rejected Harris' argument that the conjunction "and" as well as the words "and includes" are words of limitation so that the second clause is merely a subset of the first clause.

Turning to the meaning of the second clause the court noted that "integral" means "of, relating to, or serving to form a whole; essential to completeness." The court found the second clause applies to income-producing property if the acquisition, management and disposition of the property is essential or related to the taxpayer's regular trade or business. Interpreting the second clause in this light, the court found the sale of property will constitute business income "if the control and use of the property is closely related to the taxpayer's regular trade or business."

Harris argued that the use of "and" in the second clause requires that the disposition as well as the acquisition and management of property must be integral parts of the taxpayer's regular trade or business. The court rejected that position, finding the context of the statute does not require that each element - acquisition, management and disposition - be integral to the taxpayer's regular trade or business. The court noted that the independent definitions in the second clause also comport with the legislative purpose

included within the comments in UDITPA and is consistent with the Department's regulations.

Harris further argued that final dispositions through liquidation do not qualify as business income under either the transactional or functional test. The court concluded that a "liquidation exception" is inconsistent with its interpretation of the definition of business income and the reach of the functional test. The inconsistency arises because Harris' proposed exception "focuses on the nature of the transaction, rather than on the relationship between the property sold and the taxpayer's regular trade or business operations." One must look beyond the regularity of the transaction and consider whether the use or disposition of the property forms an integral part of the taxpayer's business.

The court further deemed irrelevant how the proceeds of liquidation are used under the functional test. "The key inquiry under the functional test should be the relationship of the assets acquired, managed or disposed of to the taxpayer's *existing* business at the time the income was realized, not to some future business operations that may be funded by the proceeds from the property."

Finally, the court noted that Harris' interpretation would result in lack of symmetry. Assets would be depreciated and expenses would be deducted prior to the disposition of the assets, yet upon sale gains would become nonbusiness income under the liquidation exception.

Applying these principles to the gains taxpayer received on its assets, most of which were underperforming, the court addressed each category of income separately.

### ***Gain on sale of business lines***

- Harris argued that sale of business lines were "unique transactions" and did not give rise to business income within the meaning of the transactional test. Additionally, Harris contended that the functional test was not satisfied because ceasing business operations is not furthering business operations.
- The Department conceded that Harris' subsidiaries were engaged in "multiple unrelated businesses" but contended that gains on property dispositions qualify as business income so long as Harris had reported interest and gains from those assets as business income during the time it held them.
- The court noted that the assets at issue were part of Harris' business prior to their sale and produced business income while they were held. Since no liquidation exception applies, the court concluded that proceeds from the various lines of business were business income under the functional test.
- In addition, the court noted that Harris "regularly acquired and disposed of product lines," thereby also satisfying the transaction test.

### ***Proceeds from sale of subsidiary business unit***

- Harris challenged the Department's refusal to recognize non-business income from the disposition of the Lanier business unit. Harris spun off 90 percent of the Lanier operations after selling off a product line at a gain. It later sold its remaining 10 percent share at a loss. The court held that

Harris' characterization of the spin-off gains as nonbusiness income was inconsistent with its earlier income characterizations. Prior to spin-off, income from this business unit was recognized as business income on the Arizona consolidated tax return. In addition, when the remaining 10 percent was sold, Harris treated the loss as a component of business income.

- The court found the gain constituted business income because Harris used Lanier in its trade or business during the time it held the asset.

### ***Gains from the subsidiaries***

- Harris reported various gains from its subsidiaries' sale of product lines and their royalty and interest income as nonbusiness income. Harris analyzed the transactions as though it did not perform these transactions in its regular course of business. The court found this approach defeats the intent of the consolidated election. The court found no basis for including a subsidiary in a consolidated return and then excluding all its income as nonbusiness income because its business is unrelated to the parent's business.
- When looking at the royalty income, the court concluded it also

qualified as business income because the purpose of acquiring and holding the patent rights was related to the trade or business operations.

### ***The takeaway***

The issue of whether there are two independent tests to determine business income has been litigated in many states for many years. The recent trend is for states to legislatively define business income as all income apportionable under the US Constitution. The Multistate Tax Commission is considering amending UDITPA to clarify that there are two separate tests and also to expand the definition to include income apportionable under the US Constitution.

### ***Let's talk***

If you have any questions regarding the Harris decision, please contact:

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