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It's None of My Business! Arkansas Court Rules on Business v. Non-Business Income Distinction

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Income received by a multistate business is either "business income" or "non-business income." Although this labeling appears innocuous, the distinction between these two categories of income matters greatly to taxpayers and state departments of revenue alike. While business income is apportionable to the various states in which the taxpayer conducts business, non-business income is allocable to the taxpayer's state of domicile. Given the all-or-nothing result of a non-business income determination, many a state controversy stems from this definitional tug of war.

In *United States Beef Corporation v. Walther*, the issue was whether the capital gain received by the taxpayer from the sale of its Arby's and Taco Bueno franchises was business or non-business income under the laws of Arkansas. The facts of the case were that the taxpayer, domiciled in Oklahoma, received unsolicited offers to purchase the franchises. The franchises operated in several states, including Arkansas. Following the sale of the franchises, the taxpayer liquidated its business. The taxpayer argued that the capital gain was non-business income because it was in the business of acquiring and operating franchises, not disposing of them.

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The result in the case turned on the definition of business and non-business income under Arkansas law. The definition of “business income” included “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.” “Non-business” income was defined as income that is not “business income.” The court, applying prior precedent, made clear that whether income is business or non-business income is dependent on the application of the “transactional test” and “functional test.” The parties had stipulated that the transactional test was not an issue in the case. Thus, the court’s analysis was focused on the “functional test.”

The court explained that the income is “business income” under the functional test “if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations.” In the factual context of the case, the court framed the issue as whether the taxpayer was in the business of acquiring, managing, **and** disposing of the franchises. There was no question that the taxpayer had long been in the business of acquiring and managing franchises. However, the court held that the taxpayer was not in the business of disposing of franchises. As a result, the court determined that the capital gain was non-business income allocable to Oklahoma, the state of the taxpayer’s domicile. It is important to highlight that states differ on how they define the distinction between business and non-business income. Despite the fact that many share the same statutory language derived from the UDITPA, the analytical approaches vary widely. Some states rely solely on the transactional test while others, like Arkansas, employ both tests. Within each of these categories lies a spectrum of how broad or narrow the relevant test(s) is applied. Care must be taken to closely consider the laws of the several states in which a taxpayer does business. What is “business income” in one state may very well be “non-business” income in another.
