ARIZONA CORPORATE TAX RULING

CTR 94-3

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ISSUE:

When is the capital gain realized from the sale of a partnership interest held by a corporation treated as business or nonbusiness income of the taxpayer?

APPLICABLE LAW:

Arizona Revised Statutes (A.R.S.) § 43-1132.A provides that any taxpayer having income from business activity which is taxable both within and without Arizona shall allocate and apportion its net income as provided in the Uniform Division of Income for Tax Purposes Act (UDITPA). The statute further prescribes restrictions on the allocation and apportionment of the net income of a foreign corporation.

A.R.S. § 43-1131.1 and Arizona Administrative Code (A.A.C.) rule R15-2-1131.A define "business income" to mean 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 and A.A.C. R15-2-1131.A define "nonbusiness income" as all income other than business income.

A.A.C. R15-2-1131.B provides rules for determining whether particular income is business or nonbusiness income.

A.A.C. R15-2-1132.B defines apportionment, in part, as the division of business income between states by the use of a formula containing apportionment factors.

A.A.C. R15-2-1132.C defines allocation, in part, as the assignment of non-business income to a particular state.

A.R.S. § 43-1134 provides that capital gains, to the extent that they constitute nonbusiness income, shall be allocated as provided in A.R.S. § 43-1136.

A.R.S. § 43-1136 provides that capital gains and losses from the sale of intangible personal property are allocated to Arizona if the taxpayer's commercial domicile is in Arizona.

A.R.S. § 43-1139 and A.A.C. R15-2-1139 provide that all business income of the taxpayer shall be apportioned by use of the apportionment formula.

DISCUSSION:

A taxpayer that has net business income from activity within and without Arizona must apportion its business income by use of the apportionment formula. Nonbusiness income of the taxpayer must be allocated to a particular state. The treatment of the gain realized from the sale of a partnership interest depends upon its classification as business income or nonbusiness income of the taxpayer.

The definition of business income contained in A.R.S. § 43-1131.1 provides two alternative tests to determine whether income constitutes business income. The first test contained in the definition of business income is the *transactional test*, under which the question is whether the activity or transaction which gave rise to the income occurred "in the regular course of the taxpayer's trade or business."

The second test is the *functional test* which provides that income is business income if "the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."

A.A.C. R15-2-1131.B.1.b provides that gains or losses from the sale, exchange, or other disposition of real or tangible or intangible personal property constitutes business income **if the property was used in the taxpayer's trade or business while owned by the taxpayer**.

Therefore, when a taxpayer realizes a capital gain from the sale of a partnership interest that was held as part of the taxpayer's regular trade or business, the gain is business income.

> *Example 1:*
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> Corporation F, which is located in California, holds a partnership interest in a real estate investment partnership that has business income from activity in Arizona. A review of the operations indicates that the taxpayer engages in the activity of acquiring, owning, managing, renting, leasing, mortgaging, or otherwise encumbering real properties as a regular course of business. Since the

transaction test has been met, the distributive share of the income would be considered business. Likewise, the resulting gain or loss from the disposal of the partnership interest which generated the business income would also be business.

Corporation F reports its distributive share of the partnership's Arizona business income on the corporation's Arizona corporate income tax return as business income. Corporation F later disposes of its partnership interest. The capital gain realized from the disposition of the partnership interest is business income of Corporation F within the meaning of A.R.S. § 43-1131.1 since the interest in the partnership was held as part of Corporation F's regular trade or business.

A.R.S. § 43-1131.4 provides that "nonbusiness income" means all income other than business income. A.A.C. R15-2-1131.A provides, in part, that for purposes of administration the income of the taxpayer is business income unless clearly classified as nonbusiness income.

A.A.C. R15-2-1131.B.1.b also provides rules for determining whether gains or losses from the sale, exchange, or other disposition of real or tangible or intangible personal property constitutes nonbusiness income. The administrative rule provides that the gain or loss will constitute nonbusiness income **if the property was utilized for the production of nonbusiness income or otherwise was removed from the property factor for a substantial period of time (five years or more) before the year of the sale, exchange, or other disposition**.

The gain realized from the sale of a partnership interest is nonbusiness income if the corporation's interest in the partnership produced nonbusiness income or if the corporation's distributive share of the partnership's real and tangible property was removed from the property factor of the corporation's apportionment formula for a substantial period of time before the year of the sale.

Example 2:

Corporation D, which is located in New Jersey, holds a partnership interest in a real estate investment partnership that has business income from activity in Arizona. A review of the operations indicates that the taxpayer engages in the activity of manufacturing and selling swimming pools as a regular course of business. Corporation D does not have an interest in any other investment partnership nor does it own any real estate for investment purposes. Since neither the transaction test nor the functional test has been met, the distributive share of the income would not be considered business. Likewise, the resulting gain or loss from the disposal of the partnership interest would also be nonbusiness.

Corporation D allocates its distributive share of the partnership's income or loss to

Arizona as nonbusiness income. Corporation D later disposes of its partnership interest. The capital gain realized from the disposition of the partnership interest is nonbusiness income of Corporation D since it was not part of Corporation D's regular trade or business. The gain would be allocated to New Jersey.

RULING:

If a corporation disposes of a partnership interest that is an integral part of its regular trade or business, the gain realized from the disposition of the partnership interest is business income. The gain realized from such a disposition is properly includable in the business income of the corporation subject to apportionment by use of the apportionment formula.

If a corporation disposes of a partnership interest which produced nonbusiness income for the corporation or if the corporation's distributive share of the partnership's real and/or tangible property was removed from the corporation's property factor for a substantial period of time prior to the year of sale, the capital gain realized from the sale of the partnership interest is nonbusiness income.

Harold Scott, Director
Signed April 14, 1994

Explanatory Notice
The purpose of a tax ruling is to provide interpretive guidance to the general public and to department personnel. A tax ruling is intended to encompass issues of law which are not adequately covered in statute, case law or administrative rules. A tax ruling is a position statement which provides interpretation, details or supplementary information concerning the application of the law. **Relevant statute, case law, or administrative rules, as well as a subsequent ruling, may modify or negate any or all of the provisions of any tax ruling**. See GTP 92-1 for more detailed information regarding documents issued by the Department of Revenue.