July 26, 2016

Via E-Mail

Demesia Padilla
Chair, Executive Committee
Multistate Tax Commission
444 N. Capitol Street, NW
Suite 425
Washington, DC 20001

Re: COST Comments on the Uniformity Committee’s July 20, 2016 Report to the Executive Committee on Proposed Sections 1 and 17 Regulations

Dear Secretary Padilla:

On behalf of the Council On State Taxation (COST), I submit these written comments relating to the Uniformity Committee’s July 20, 2016 Report to the Executive Committee on “Issues Referred Concerning Public Comments on Draft Amendments to the General Allocation and Apportionment Regulations”. These comments supplement COST’s comments on the Hearing Officer’s Report on Proposed Sections 1 and 17 Regulations submitted to the Executive Committee on May 10, 2016.

About COST

COST is a nonprofit trade organization based in Washington, D.C. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of nearly 600 multistate and international businesses. COST’s objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

The Uniformity Committee’s Report on the Reasonable Approximation Rules

The Uniformity Committee voted to reject the Hearing Officer’s recommendation for the removal of burdensome requirements associated with making prospective changes in a sourcing methodology, including the reasonable approximation method. COST strongly supports the Hearing Officer’s recommendation on this issue and urges the Executive Committee to adopt the revisions to the proposed regulations made by the Hearing Officer. The Hearing Officer, after a thoughtful examination and consideration of the proposed regulations and the comments received from taxpayers, made only a handful of recommended changes to the proposed regulations. As such, from a taxpayer’s perspective, it would be very disappointing if one of the few
substantive changes (and likely the most important one) recommended by the Hearing Officer is rejected by the Executive Committee.

Specifically, COST supports all of the Hearing Officer’s suggested changes to Reg. IV.17.(a)(7)(D) that would allow a taxpayer to change its reasonable approximation method on a prospective basis without establishing the new method “improves the accuracy” of assigning the receipts and without the other additional notice and record retention requirements. As the hearing officer concluded:

“Nevertheless, I think it is reasonable to allow taxpayers to adjust their methodology without in effect having to justify the change so long as the new methodology meets the general requirements of section 17. What is essential is that the methodology used in any year is lawful, and I see no compelling reason to require taxpayers to in effect jump through another hoop because of a decision made in a prior year…. COST also proposes that language be stricken from this provision that requires taxpayers to retain and provide to the tax administrator documents that explain the nature and extent of any change, and the reason for the change. This suggestion also seems reasonable to me. If a taxpayer can defend its sourcing methodology in any year under the requirements of the statute and regulations, that ought to be sufficient.” (MTC Hearing Officer Report at 11-12).

The Hearing Officer’s proposed language would allow a taxpayer to make a prospective change to a previously selected reasonable approximation method without being subject to an unreasonable and unnecessary threshold (“more accurate”) or burdensome reporting requirements. State tax administrators are amply protected by the provisions in subsection 7(C) requiring that any method chosen be “reasonable” and applied in a consistent manner year to year, and that contemporaneous records be retained that explain the determination and application of the chosen method.

Alternatively, the Uniformity Committee recommended that if the Executive Committee disagrees with its position, at least the “notice” requirement relating to a prospective change should be included in the final proposed regulations. While the “notice” requirement is not as troubling as the “more accurate” requirement, COST still supports adopting all of the Hearing Officer’s recommended changes, including the deletion of the “notice” requirement. The problem with the “notice” requirement is that it would apply to all prospective changes in a “method of assignment”, not just a change in a “reasonable approximation” method. COST’s concern is that there could any number of very minor changes in methods of assignment under the numerous ordering rules included in Section 17 or based on slight variations in taxpayer data. It would be onerous and unworkable to require “notice” each time such a change in the method of assignment is made. If the Executive Committee decides to embrace the Uniformity Committee’s “fallback” position, we request that language be added that limits the “notice” requirement to situations where the new method of assignment leads to a “substantive” difference in outcome (e.g., a 50 percent or more change in receipts).
The Uniformity Committee’s Report on the Definition of “Receipts” in Relation to Financial Services Providers

The Uniformity Committee voted not to make any changes to the proposed regulations with regard to the definition of “receipts” in section 1(g), and not to delay approving the proposed regulations to address the exclusion of certain receipts earned in the regular course of business by financial services providers and similarly situated businesses. As indicated in comments previously submitted by COST and the FIST coalition, the current model statute and proposed regulations relating to Sections 1 and Section 17 are problematic because of the exclusion of receipts from lending, hedging, and securities transactions that constitute a significant source of income earned in the regular course of business by many financial services providers (e.g., banks, securities broker-dealers, asset management companies) and similarly situated businesses. While the Uniformity Committee recognizes this is an issue, it recommends it be resolved by the Section 18 working group as part of a special industry regulation, after the regulations relating to Sections 1 and 17 are finalized.

The gap in the definition of receipts earned by certain financial services providers in the regular course of business is an indirect result of the MTC basing its market sourcing regulations largely on the regulations developed previously by Massachusetts. While the MTC did make some adjustments for differences between the Massachusetts corporate income tax and those of many other states, such as addressing market sourcing rules in the context of both separate entity filing states and combined filing states, the MTC did not address other differences—namely that Massachusetts has special industry provisions for financial institutions. This omission creates problems in other states that have neither adopted the MTC special industry rules for financial institutions nor have special industry provisions of their own.

Instead of adjusting the MTC model statute and regulations to account for these differences, the Uniformity Committee has recommended that this issue be dealt with at a later date, and only in the context of a special regulation promulgated under Section 18, and not by expanding the definition of receipts in Section 1. The problem with this solution is that the significant number of states that do not have special industry regulations for financial institutions (or too narrowly define such entities) would not address this “receipts” gap if they adopt the Section 1 and Section 17 regulations as currently proposed. This will inhibit the MTC’s uniformity goal and have a distortive impact on many financial institutions by excluding significant revenue streams from receipts subject to apportionment. This provision is also inconsistent with the definition of receipts used for purposes of the MTC’s Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions.

While COST understands the desire of the Uniformity Committee to move the proposed regulations expeditiously to completion, we believe it is worthwhile to spend the extra time to “get it right” – particularly since the impacted industry is a large one and willing to work with the MTC to come up with a more inclusive “receipts” definition.

Finally, if the Executive Committee decides to move forward with the proposed market sourcing regulation without creating a broader definition of “receipts” inclusive of key financial industry revenue streams, we strongly encourage it to at least hold back the Section 1 proposed regulation
for additional work on the “receipts” factor. Alternatively, the Executive Committee could include language in the regulations (or prepare a separate resolution) that makes it abundantly clear the issue of receipts earned in the regular course of business by many financial services providers and similarly situated businesses still needs to be addressed. This public statement would put states adopting the MTC model statute and regulations on notice that this issue is not resolved and needs further clarification.

**Conclusion**

COST continues to strongly support the Hearing Officer’s suggested changes that would allow taxpayers to adjust their “reasonable approximation” methodology prospectively without burdensome procedural requirements. COST also believes that the issues relating to the definition of “receipts,” particularly as they impact the financial services industry, should be resolved before the Sections 1 and 17 regulations are finalized.

Sincerely,

Karl Frieden

Cc: COST Board of Directors
Douglas L. Lindholm, COST President & Executive Director