



MEMORANDUM

TO: Wood Miller, Chair
Uniformity Committee
Multistate Tax Commission

FROM: Bruce Fort
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DATE: July 24, 2015

SUBJECT: **Report of the Article IV, Section 17 Model Regulations Work Group**

1. Executive Summary.

Last year the Income and Franchise Tax Uniformity Subcommittee appointed a “Section 17 working group” to develop model regulations for application of “market-based” sourcing of receipts from the sale of services and the utilization of intangible property. The working group has been using the 2014 Massachusetts regulations implementing that state’s market-based sourcing statute as a basis for its efforts. Those efforts are now largely complete, although some issues remain undecided; some of the issues will be presented on July 28, 2015 for the full Uniformity Committee’s consideration and direction and are summarized in Section 5, below.

The most recent draft of the regulations (dated July 20, 2015) is available on the MTC’s “Section 17 Webpage, linked here: http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Section-17-Model-Market-Sourcing-Regulations/SECTION17_WORKING-MODEL-REG-DRAFT-V17-hh.pdf.aspx.

2. Statutory Background for the “Section 17 Model Regulations” Effort.

In July of 2014 the Multistate Tax Commission gave its approval to a model statute which amends five different areas of the Multistate Tax Compact’s Article IV, which incorporates the Uniform Division of Income for Tax Purposes Act (“UDITPA”). Those amendments to Article IV are: (1) clarifying the definition of apportionable (formerly “business”) income in Section 1; (2) narrowing the scope of the “receipts” factor (formerly the “sales” factor) used to apportion

income, now in Sections 1 and 17; (3) eliminating the use of an equally-weighted three-factor formula in Section 9 as a default rule, acknowledging that most states have chosen to give additional weight to the sales factor; (4) extensively modifying the methodology of apportioning receipts from activities other than sales of tangible personal property (“TPP”) in Section 17, from an “income-producing activity” location standard to a “market-based” standard of where the service or property is delivered or used; and (5) explicitly authorizing the use of special industry regulations as an alternative to standard apportionment rules in Section 18, while imposing other conditions on the application of equitable apportionment (still under consideration).

The need to change how receipts from services and non-TPP sales are sourced was and is widely viewed as the driving force behind the Commission’s and the states’ efforts to modernize and reform UDITPA. The growth of interstate economic activity in recent decades exposed serious flaws in UDITPA’s non-TPP receipts sourcing rules, especially the “all of nothing” approach to sourcing services income to the single state with the plurality of income-producing activity “as measured by cost of performance.” Additionally, the inability to predict where “income-producing activity” occurs for services (as well as intangible property utilization) became significantly more problematic as states moved to a single sales factor sourcing formula. While some of the other reforms to UDITPA could be accomplished by judicial interpretation or simple statutory changes without imperiling needed uniformity, sourcing receipts from services and intangible property to the “marketplace” presented a more difficult challenge for a variety of reasons. Additionally, states were steadily moving to “market-based” sourcing systems, but doing so in a non-uniform manner.

3. The Course of Efforts to Draft Model Section 17 Sourcing Regulations.

The “Section 17 workgroup” began its deliberations on a comprehensive set of regulations for sourcing receipts in the fall of 2014. The drafting effort was preceded by a substantial amount of information-gathering by the Commission’s legal staff that focused on: (1) the scope of multi-state services in the current economy;¹ and (2) detailed descriptions of current state “cost of performance” and “market-based” sourcing rules.²

The workgroup that formed in the fall of 2014 was chaired by Michael Fatale of the Massachusetts Department of Revenue and included substantial and continuing contributions from Phil Skinner of Idaho, Chris Coffman of Washington, Jeff Henderson of Oregon, Holly Coons of Alabama, and Aishah Hashmi and Nirmail Dhaliwal of the District of Columbia. Public participants have included Ben Miller, Karen Boucher, and Alysse McLoughlin of McDermott, Will & Emery’s Boston office.

Several weekly meetings were held in the fall of 2014 in which the workgroup started to consider rules for in-person services, which the group considered to be the easiest and most straightforward application of the “market sourcing” concept. The discussions served to

¹The summary of federal SIC industry codes as they relate to the service economy and the economy as a whole is available here: <http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Section-17-Model-Market-Sourcing-Regulations/Copy-of-Service-Industries-Sec-17-Information.pdf.aspx>.

² The summary of state sourcing rules is available here: <http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Section-17-Model-Market-Sourcing-Regulations/Copy-of-Copy-of-Sec-17-Master-List-1-1-2014.pdf.aspx>.

emphasize how many options and variations might be utilized in determining where “delivery” occurred in a manner that reflected the marketplace for services, for instance, in services pertaining to real property.

At the MTC’s Income and Franchise Tax Uniformity Committee meeting in December of 2014, a breakthrough of sorts occurred when the subcommittee approved a motion to adopt Massachusetts’ recently promulgated market-based sourcing regulations as the model for the Commission’s regulations. The Massachusetts regulations were chosen because of the similarity of that state’s sourcing statutes to the MTC model statute and because the regulations were well-developed (having been subject to extensive public comment and revision) and were more comprehensive than regulations existing in other market-based sourcing states. It should be noted that California also has extensive market-based sourcing regulations, although the state’s market-based sourcing statute differs from the MTC statute in some respects. Alabama and Washington have also developed extensive regulations. Language from each of these state’s regulations have been considered and, in some cases, incorporated into the MTC draft regulations now before the group.

4. Description of the MTC’s Current Draft Model Section 17 Regulations.

a. General Rules of Application.

The model regulations begin with a nine-part “General Rules” section which outlines the basic approach to market-based sourcing, describes the section headings which follow, gives definitions, instructs taxpayers on general principles of application, including the need to apply rules for sourcing on a hierarchical basis, rules for reasonably approximating the location of delivery to the marketplace, exclusion of certain receipts, the ability of taxpayers and tax authorities to make adjustments to returns, including the interaction of Section 17’s rules with equitable apportionment rules. *The working group studied these rules extensively and found they were appropriate and administrable, suggesting mainly minor changes to the Massachusetts’ model.*

b. Sourcing for Sales, Leasing, Renting or Licensing Real Property.

Often overlooked in discussions of UDITPA’s sourcing rules, both the original and the new version of the model statute address receipts from sales, leases and licenses of real property and leases and licenses of tangible personal property in Section 17. The new model regulations follow the language of the new Section 17 statute as well as the Commission’s previous model regulations in assigning those receipts to the location of the real property by specifying that the “market” for that property is co-extensive with its location. *The working group is satisfied with the model regulation.*

c. Sourcing of Sales from the License, Rental or Lease of Tangible Property.

The model regulation draft follows the new Section 17 statute and former Commission model regulations in assigning those receipts to the location(s) of the property; in the case of mobile property, the assignment is accomplished by prorating the time spent in each jurisdiction. Note:

although not stated in the regulation, under IV.17.c, where a taxpayer is not “taxable” in a jurisdiction in which it leases, licenses or rents such property, or where it cannot reasonably approximate the location of such property, those receipts will be thrown out of the denominator. *The working group expressed no concerns with the model regulation.*

d. Sourcing of Receipts from Services.

The draft begins with a general statement that services are sourced based on the taxpayer’s market, not its location, and identifies three categories of services with different rules of assignment for each.

1. In-Person Services.

The regulation assigns such services to the place of delivery. Application of the rules should be easy to predict and administer in most instances. *The working group has considered proposals “tinkering with” with these rules but so far has not given final approval to any final language.*

The working group has recommended removing sections on “delivery” and “transportation” services since these industries are subject to special industry regulation in most states. (Massachusetts’ regulations, in the case of multistate activity, assign such services to the state of delivery.)

2. Services Not Delivered In Person to a Customer.

This section of the model regulations has proven to be the most intellectually challenging and has been the focus of much of the working group’s consideration. It contains several sub-rules for determining the location where a service is delivered and the taxpayer’s “marketplace” for a service, depending on the nature of the service, the nature of the customer, the means of delivery, and whether professional services are involved. The rule covers both physical deliveries of a service, e.g., advertising materials, and electronic deliveries. A detailed “decision tree” chart is currently posted on the MTC’s Section 17 webpage.³ The following is intended only as a general description of the applicable provisions:

- a. Physical Delivery: receipts are assigned where services are delivered to a customer, or on behalf of a customer through physical means, such as distribution of flyers, and includes custom software installed at a business.
- b. Electronic Delivery to a Customer: if the customer is an individual, receipts are sourced to place where the customer receives the delivery with provision for reasonable approximations, using billing addresses as a default in many instances. Where the customer is a business, the service is delivered to where the business’s employees or designates actually use the service, to the extent known, with several additional rules for approximating that location.

³ <http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Section-17-Model-Market-Sourcing-Regulations/Sourcing-Decision-Tree-v5.pdf.aspx>.

- c. Electronic Delivery Through or on Behalf of a Customer: this category includes advertising and sources the receipts to the ultimate recipient of the service, e.g., the location where consumers would view an advertisement. The rule also covers non-advertising services “looking through” to the ultimate consumer of those services. Determining the marketplace for services will often necessitate efforts to reasonably approximate to location of the delivery to end users. A major concern of the working group has been to identify the marketplace for Internet services which in theory can be accessed on a world-wide basis, where the realistic marketplace may be limited to the United States.

3. Professional Services.

A third category of service transactions are “professional services” that are treated slightly differently from other “In-Person” and remotely delivered services. In the case of professional services delivered to a business, the receipts are assigned to the place where the contract is managed, and if that is not determinable, to the place where the order was placed, and if that is not determinable, to the customer’s billing address. Architectural and engineering services associated with particular real estate are assigned to the location of that real estate. Note that the rule may have an impact on financial service entities to the extent the entity or receipt is not subject to a separate financial institutions regulation. The workgroup has proposed removing a rule of assignment for services performed for a mutual fund. Despite the fact that most states follow the Massachusetts’s example of employing a “look-through” to the mutual fund’s customer to determine the “market” for such services, the group determined this treatment should be addressed in special industry regulations. *The working group is also considering whether a special rule for related party transactions is appropriate which would assign such receipts to the “location where the related party does business” and not to where the contract is managed.*

Finally, it should be noted that the workgroup is considering a change to the list of “professional services” to include credit card processing activities; under an in-person approach, those services would usually be sourced to the location where the employees perform their services; under a “professional services” approach those receipts would be sourced to the location where the contract is managed.

- e. Sourcing of Receipts from Leases and Licenses of Intangible Property.

The draft regulations begin with a general section that equates the location of use of intangible property with the “marketplace” for that property. The regulation establishes rules for how a mixed transaction involving both tangible and intangible property rights will be treated (as a sale of tangible property). The regulation then divides intangible property into two broad categories: “marketing” intangibles and “production” intangibles.

1. Marketing Intangibles.

Marketing intangibles are defined as the right to use intangible property in connection with the sale of goods or services to customers, and are assigned to the place where that ultimate sale

occurs. Trademarks and trade names are examples of marketing intangibles. Because a licensor may not have direct information on where its licenses are used, resort to reasonable approximation methods based on state population will be frequently employed. *Significantly, the working group has proposed language specifying that the denominator for such sales is limited to the United States unless the licensor can demonstrate the extent to which the intangibles are used in foreign markets.* Additionally, the size of the denominator will be limited to the extent that sales otherwise assigned to states or foreign countries that do not have jurisdiction to subject the taxpayer to a tax may be thrown out of the numerator and denominator.

2. Production Intangibles.

Production intangibles are defined as property primarily valuable for its use in a production capacity, as compared to licensing intangibles. Examples of production intangibles include copyrights, patents and trade secrets. If a licensor knows the location where its production intangible is used, the receipt is assigned to that location. If some of the use occurs within the taxing state, e.g., a customer's factory located in the state, a presumption arises that all use occurs within the state. If the licensor does not know where the actual use occurs, the production intangible receipts are assigned to the licensee's commercial domicile (or state of residence if an individual). The working group has proposed a special rule for related-party transactions eliminating the presumption that use occurs at the licensee's commercial domicile.

3. Mixed Marketing/Production Intangibles.

If the license for a mixed intangible specifies different payment amounts for different uses, the receipts will be divided and sourced accordingly. If the contract does not specify different payment amounts, the receipts will be treated as licensing receipts and sourced accordingly.

4. Overlapping License/Sale of Good or Service Delivered Electronically.

If a license also involves the delivery of an electronic good or service, e.g., access to on-line databases, the receipts will be treated as electronically-delivered goods and services.

f. Sales of Intangible Property.

Only receipts of certain types of intangible property sales are assigned to a particular state; other intangibles property receipts are eliminated from the numerator and denominator of the factor. Thus, in the case of a sale of (1) a contract right or (b) a government license authorizing business to be conducted in a specific geographic area, the receipts are assigned to the state(s) in which such rights are or may be exercised. Other "sales" of intangible property that are contingent on the productivity of use of the property will be treated as a license to use such property and sourced accordingly. All other sales receipts are excluded from the factor, as are sales receipts that would be sourced to locations where there is no jurisdiction to subject the taxpayer to tax.

g. Special Rules: Software and Sales of Digital Goods and Services

Because these types of transactions are usually interstate in nature and compose a significant portion of the economy, the draft regulations separately state rules for how these receipts should be sourced.

1. Software.

The transfer of a license to use or the sale of pre-written software is treated as the sale of tangible personal property when delivered on a tangible medium. In other cases, it is treated as the sale of goods and services delivered to, through or on behalf of a customer via electronic means under IV.4.c and IV.5 (see Section 4.d.2, above). This will often result in a “look-through” to the customer’s customer to determine the place of delivery and use.

2. Digital Goods and Services

Receipts from the sales of digital goods and services are treated as the sale of a service delivered electronically, with different sourcing rules depending on whether the customer is a business or individual. Sales of digital goods and services through a telecommunications company, to the extent not otherwise sourced via special industry regulation, are also treated as the sale of a service via electronic means.

h. Examples.

The draft regulations currently contain 59 examples illustrating application of the model regulations’ rules. The examples have been studied and vetted to ensure they are accurate and also that they do not exceed the scope of or otherwise conflict with the rules which they exemplify. The working group believes these examples will be very helpful to states and practitioners alike, although the regulatory language is sufficient without the examples to explain the operation of the sourcing rules. It should be noted that some states discourage the use of examples in regulations.

5. Issues Presented for Uniformity Committee Discussion:

The working group has identified the following issues which it believes should be brought to the Uniformity Committee’s attention at this time for discussion, although most of the issues do not need to be definitely resolved for the working group to continue its efforts.

A. Should Examples be Included in the Draft Regulations? (See Section h, above):

In the current draft, all of the examples have been moved to the end of the document with links to pertinent sections. Not all states allow or encourage examples in regulations. There are at least four options for how to treat the 59 examples: (a) leave examples where they are; (b) move examples back into body of draft under each section heading; (c) place examples in a separate document, *e.g.*, “Proposed Model Examples for IV.17 Regulations”; (d) eliminate examples entirely.

- B. Should “credit card processing services” be included in the definition of professional services?

This change was proposed by a practitioner.⁴ The effect of the change would be to clarify that such receipts would be sourced to the customer’s commercial domicile as the place of delivery, when those receipts might otherwise be sourced to where those services are delivered as in-person services (generally, the place of performance).

- C. Should the Section 17 Regulations include an incidental receipts (“*de minimis*”) rule allowing taxpayers to exclude certain categories of receipts as an administrative and compliance convenience?

This proposal was also submitted by a practitioner who was involved in the MTC’s prior efforts to update the financial institutions special industry sourcing regulations.⁵ The purpose of the proposed amendment would be to eliminate excessive accounting and compliance costs where elimination of certain receipts would not materially affect the taxpayer’s apportionment percentages. A somewhat analogous rule allowing taxpayers to ignore or include certain receipts from “incidental sales” is found in the equitable apportionment section of the current Model Apportionment Regulations.⁶ Although many members of the working group expressed sympathy with the proposal generally, other members expressed strong concerns with it. In particular, concerns were raised that the “incidental receipts” exception could be used to avoid state economic presence nexus standards. One question which arose was whether it would be appropriate to establish a different rule for Section 16 receipts (sales of TPP) and Section 17 receipts.

- D. Should the Uniformity Committee consider changes to the current model apportionment regulations defining “Subject to Tax” in light of possible concerns with the receipts factor denominator?

MTC’s current model allocation and apportionment regulations define a foreign country as being a “state” for purposes of determining whether a taxpayer is subject to tax in that country, necessary for apportionment and sales-throw-back determinations. And most states have now adopted a broad economic nexus standard for taxability. As an international tax matter, however, almost all countries use a “permanent establishment” (substantial physical presence) standard to determine jurisdiction to tax. This raises the question of whether taxpayers engaged in certain forms of advertising and other electronic commerce may be able to avoid “throw-out”

⁴ See: <http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Section-17-Model-Market-Sourcing-Regulations/Mcdermott-Revised-Public-Comment.pdf.aspx>.

⁵ <http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Section-17-Model-Market-Sourcing-Regulations/Public-Comment-UPDATED.pdf.aspx>.

⁶ IV.18(c)(2): Insubstantial amounts of gross receipts arising from incidental or occasional transactions or activities may be excluded from the sales factor unless their exclusion would materially affect the amount of income apportioned to this state. For example, the taxpayer ordinarily may include in or exclude from the sales factor gross receipts from transactions such as the sale of office furniture, business automobiles, etc.

of receipts for potential “deliveries” into foreign country marketplaces despite not being subject to tax in those countries under international tax standards.

One question presented by these different nexus standards is whether a new “subject to tax” rule is necessary for sourcing Section 17 receipts, and if so, whether the standard should be developed by the current working group. It should be noted that the Uniformity Committee chose not to pursue a proposed effort to modernize the “subject to tax” provisions in the context of sales-throwback four years ago.

E. How should the interaction of Section 17 and Section 18 (Equitable Apportionment) be handled?

The current draft model (page 7 under “General Rules”) provides that nothing in Section 17’s sourcing rules affects the use of Section 18 and further provides that in the event of a conflict between Section 17 and model regulations promulgated under Section 18, the latter controls. The working group has questioned whether the reference to Section 18 should include specific examples of where sourcing under Section 17 would lead to inappropriate results. The working group has also expressed concern that insufficient guidance exists for how current special industry regulations might interact with Section 17, and the application of Section 17 rules when a state has not adopted a model special industry rule. *Note: the General Rules limit the ability of taxpayers and tax administrators to select a “better” apportionment position where the position claimed on an original return is reasonable and supported by law. (General Rules, pp. 7-9.)*

F. Should the model rules address the possibility that related party transactions could be used as a means of inappropriately apportioning income, or save that issue for “equitable apportionment” regulations?

The current model regulations have been modified in a few instances to establish a different rule or presumption for sourcing receipts and approximating the marketplace when related party transactions are involved. (*Draft*, pp. 21, 23.) Some other recommendations have been opposed. (*Draft*, p.19.) The working group seeks the recommendations of the Uniformity Committee as to whether further modifications of the section 17 sourcing rules are appropriate.