The Executive Committee has a threshold decision: should it try to refine the Act’s COP or should it adopt the Draft’s Art. IV.17 and proceed with model regulations. The Hearing Officer presumes that the Executive Committee will endorse the Draft, and proceed with drafting of model regulations. Speed is of the essence if the MTC is to exert influence in this area. It can only be hoped that the states that have already marched down the path of market-based sourcing will reverse their current practices if those turn out to be inconsistent with MTC model regulations.

E. The Receipts Factor

The Uniformity Committee recommends that:

Article IV.1(g) **SalesReceipts**” means all gross receipts of the taxpayer that are not allocated under Sections 4 through 8 of this Act—paragraphs of this article, and that are received from transactions and activity in the regular course of the taxpayer’s trade or business; except that receipts of a taxpayer other than a securities dealer from hedging transactions and from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities, shall be excluded.

1. Reasons for Change

This proposal elevates the heart of a 1973 MTC Regulation into the body of the proposed statute. MTC Reg. IV.15(a) provides that “for the purposes of the sales factor of the apportionment formula for each trade or business of the taxpayer, the term ‘sales’ means all gross receipts derived by the taxpayer from transactions and activity in the regular course of the trade or business.” Accordingly, the regulation
excludes from the sales factor gross receipts related to transactions satisfying the functional test, such as the sale of a machine, equipment, plant, or a business.

Closely related to this regulation is MTC Reg. IV.18(c), which provides that “substantial amounts of gross receipts from an incidental or occasional sale of a fixed asset used in the regular course of the taxpayer’s trade or business” are excluded from the sales factor. This regulation would seem to be unnecessary under MTC Reg. IV.15(a). More recent MTC Regulations exclude from the sales factor the so-called treasury function activities. MTC Regs. IV.2(a); IV.18(c)(4). All of these regulations seem inconsistent with Act Art. IV.1(g), which provides that “[s]ales’ means all gross receipts of the taxpayer not allocated under paragraphs of this Article,” and are best understood as sweeping propositions under alternative apportionment.

The Draft thus rejects the view that if an item of income is included in the preapportionment tax base, the related receipts should be included in the sales factor. The throwout rule proposed by Draft Art. IV.17 also rejects this view (as does any throwout rule).

The Report’s strongest argument for including the gross receipts from only the transactional definition is that it is “generally agreed that the purpose of the sales factor is to reflect the taxpayer’s market activity, not its production activity. If that is the case, then the type of receipts that are included in the sales factor should be those that reflect the contribution of the taxpayer’s market to the earning of income. It is unnecessary, and may be counter-productive, to include receipts from transactions involving the taxpayer’s production property—such as plant, machinery, and equipment—in the sales factor. Including
receipts from these types of assets would not reflect the market for the taxpayer’s product and could essentially double count the property factor.

“In a three-factor apportionment formula, the sales factor is intended to balance the property and payroll factors, and it should be defined to offset rather than amplify the contributions of the production states. If the Executive Committee were to adopt a single sales factor, then this analysis may be different. In that case, it may be reasonable to provide for some reflection of the contributions of production states, even if that is accomplished through the sales factor.” Report, p. 16.

2. Public Comment

Mr. Miller characterized the existing definition of receipts as “overly broad,” which has led to efforts to inflate the denominator, resulting in “nowhere” income. He would prefer to define sales more narrowly. He also challenged the view that receipts from business income have to in the sales factor.

Sutherland objected to the exclusion of receipts from hedging transactions, stating that hedging activity directly relates to some taxpayers’ ability to establish and maintain a marketplace, and excluding them does not reflect the taxpayer’s sales.

3. Comments and Recommendations by the Hearing Officer

The United States Supreme Court has never endorsed the Report’s view of the sales factor. The Report’s view is also inconsistent with the Act, which defines sales as including all gross receipts that are not allocated. (The defect in this definition is addressed below.) The MTC Regulations
cited above would be unnecessary if the Act had adopted the Report’s narrow view of the sales factor.

By including only receipts received from transactions under the transactional test but excluding all other receipts, the Draft might place more weight on that category than its definition may be able to bear. A taxpayer wishing to include (or exclude) the receipts from a transaction would have an incentive to characterize an activity as falling within (or without) the transactional test, creating the potential for litigation that the Draft’s broadened definition of business income was appropriately supposed to reduce.

A taxpayer seeking to include receipts in the sales factor would want to avoid the functional test and would have an incentive to characterize a transaction as a service rather than as property. Services are outside the functional test but could satisfy the transactional test. Conversely, a taxpayer seeking to exclude the receipts would have an incentive to characterize a transaction as property rather than a service and then argue the functional test rather than the transactional test was satisfied. Especially in a digital world, the line between property and services can be blurry (as well as the line between tangible and intangible property). The goal should be to reduce pressure on these categories but the Draft does the opposite.

The Draft’s incorporation of the Act’s definition of the transactional test with its reliance on the concept of “regular” is inconsistent with the Hearing Officer’s proposed draft of apportionable income. See Section III.C above. The Draft would resurrect the very problem that the Hearing Officer was trying to avoid in his draft—litigation over the word “regular.” The Hearing Officer fears that the definition of “regular,”
with all of its ambiguities, will become the focus of future litigation if the Draft’s definition of receipts is adopted.

These comments expose the interplay between the definition of apportionable income and the definition of receipts in the sales factor. That interplay is minimized in the Act because the sales factor includes all receipts from business income. The Draft, however, includes in the sales factor only a subset of receipts generated by apportionable (business) income.

Another significant interplay is between the throwout rule under the Draft’s proposed market-based sourcing and the receipts factor. Draft Art. IV.17(a)(4)(ii)(C) throws out certain receipts from the sale of intangibles. For example, receipts from the sale of stocks and bonds and other intangible financial assets would be excluded from the receipts factor under Draft Art. IV.17. See Section III.D(8) above. Receipts from hedging and from the treasury function (discussed below) are generated by the sale of intangibles. Accordingly, the adoption of Draft Art. IV.17 would eliminate the need to address these receipts in Draft Art. IV.1(g).

Whether the sales factor should be viewed as the Report suggests, rather than partly as a political compromise as described in Section III.A above, the apportionment formula must yield to the constitutional mandate that it be fair, reflect a reasonable sense of how income is generated, and be rationally related to values connected with the taxing state. That principle trumps a particular view of the sales factor.

To be sure, the constitutional mandate should not be woodenly followed any more than the proposition that the receipts factor should
be limited to transactions satisfying the transactional definition should be slavishly followed. But the Hearing Officer believes there should be strong and compelling reasons for excluding from the sales factor the receipts related to income that is included in the preapportionment tax base. And the Hearing Officer views the sales factor as more in the nature of a political compromise than the result of any grand economic theory or model.

Excluding receipts from the sales factor has the result of apportioning the gain (or loss) generating those receipts using the status quo ante apportionment formula. The Hearing Officer recognizes that situations exist for which excluding the receipts would be acceptable but others in which it would not. Much depends on the apportionment formula (e.g., three factor or one factor), the nature of the income generating the receipts at issue (e.g., the sale of a depreciable or amortizable asset), and the ability to assign the receipts in an acceptable manner to the numerator of a particular state’s sales factor. The difficulty of saying anything very useful in the abstract is that transactions come in so many sizes and shapes.

Consider, for example, a corporation that at the beginning of January sold a trivial amount of inventory and shortly thereafter sold the plant in State A that manufactured that inventory and ceased operations. Assume the gain on the sale reflected increases in the value of the real property in State A, and that the inventory was delivered outside of State A. If State A used a single-sales factor, and the receipts from the sale of the plant were excluded as the Draft proposes, none of the gain would be apportioned to State A, which has a strong claim to tax such gain. If all the destination states also used a single sales factor and
excluded the receipts from the sale of the plant, the gain would be apportioned based entirely on the receipts from the inventory. In this case, a very tiny tail would wag a very large dog, perhaps violating the external consistency doctrine or triggering Section 18 relief.

One could describe the above problem as being caused not by the exclusion of the receipts but rather by the adoption of a single sales factor. As a matter of logic, the problem is caused by *both* the exclusion of gross receipts and the adoption of the single sales factor. But one teaching of *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978) is that the Supreme Court is not likely to mandate particular types of apportionment formulas; accordingly, in litigation the formula will probably be accepted as the starting point. The framework of analysis is likely to be on whether as applied the formula is fair and reflects a reasonable sense of how income is generated if the gross receipts from the sale of the plant are excluded from the sales factor.

Obviously, the illustration above has been purposely skewed to mark one polar point on the continuum of possible situations, whose results under the Draft could vary dramatically. Excluding the receipts from the sale of goodwill by a manufacturer ceasing operations, for example, might be acceptable under a three-factor formula. (Draft Art. IV.17(a)(4)(ii)(C) would, however, throw out these receipts from the sales factor.)

Depreciable personal property raises a further complication because it involves assets whose gain on the sale might recapture in whole or in part the previously deducted depreciation. Under the Draft (and Act) there is a disconnect between the states bearing the cost of the depreciation deductions associated with the asset and the states that
tax the gain that recaptures that depreciation. (Loss assets are discussed separately below.)

In other words, the apportionment of taxable income can be viewed as the apportionment of gross income less the apportionment of expenses, one of which would be depreciation. Depreciable business property would have generated deductions, which would have reduced taxable income and thus income taxes in the states to which the taxable income was apportioned. Depreciation reduces the basis of an asset and gain on the sale recaptures in whole or in part those deductions.

To illustrate, consider an asset that cost $1000 and that was depreciated over a number of years to $100. If the asset were sold for $1000, it will generate a tax gain of $900. That gain represents a recapture of the entire $900 of depreciation previously taken. Cf. Int. Rev. Code of 1986, Section 1245. The Draft (and the Act) would tax the $900 of tax gain using the taxpayer’s apportionment formula in the year of sale. The Act includes the $1,000 receipts in the sales factor; the Draft would not.

An alternative approach, perhaps more defensible (albeit not very administrable) would be to apportion the gain to the states that bore the cost of the recaptured depreciation. For example, assume the corporation was taxable in two states: A and B. Assume State A’s apportionment percentage remains constant at 10% and State B’s apportionment percentage remains constant at 90%. Assume further that State A’s tax rate remains constant at 5% and State B’s tax rate remains constant at 10%. Using the asset described above, if $900 of depreciation were claimed over the life of the asset, $90 would have
been apportioned to State A, reducing taxes because of that deduction by $4.50. The corporation would have apportioned $810 of depreciation to State B, reducing taxes because of that deduction by $81.

Of the $900 gain on the sale of the asset, $90 would be apportioned to State A, increasing tax by $4.50, which offsets the cost of the depreciation previously apportioned to State A. Of the $900 gain on the sale of the asset, $810 would be apportioned to State B, increasing tax by $81, which offsets the cost of the depreciation previously apportioned to State B. The correct result is reached by excluding the gross receipts from the sale.

That result, however, would be achieved under a very specific—and unrealistic—set of conditions. The apportionment percentage would have to be the same in each of the states in which the corporation was taxable over the life of the asset, the tax rate would have to remain the same, and the corporation would have to be taxable in exactly the same states.

Obviously, apportionment percentages change, both quantitatively and qualitatively. Tax rates change. The states in which the corporation is taxable will change, not only because business operations might expand or contract, but also because of changes in the interpretation of nexus. In addition, the economic life of an asset is likely to be longer than the period over which depreciation is claimed, virtually ensuring that none of these conditions will be satisfied. It would be sheer serendipity if apportioning the gain in the year of sale without including the gross receipts would reach the correct answer.
The receipts factor alone cannot begin to deal with these considerations, nor can the property factor. One approach to this problem would be to segregate the sold asset for schedular treatment. Consider the $900 tax gain in the asset above. Under a scheduler approach, if the asset had been depreciated over five years, the amount of each year’s depreciation that is recaptured could be multiplied by each state’s apportionment percentage in each of those years, then multiplied by the appropriate tax rate in each year, and the results aggregated (putting aside credits and NOLs and the like). The aggregate amount would be that state’s share of the tax on the gain.

A further complication is that if the asset were sold for more than $1000, only $900 would represent a tax gain. The excess of the sales price over $1000 would be an economic gain. The economic gain might reflect changes in market conditions independent of actions by the taxpayer, making the normative treatment of the gain harder to determine.

If expenses were deducted that helped create the tax gain, such as drilling expenses that led to the discovery of oil, making the property worth many times its purchase price, then the same arguments for recapturing depreciation could apply to “recapture” those expenses.

Losses become trickier. A loss on the sale of an asset can be viewed as functionally equivalent to the amount of depreciation that should have been allowed in an ideal world with perfect information. Put differently, if the rules on depreciation reflected the actual decline in the value of an asset, there would generally be no loss on the sale of an asset because its adjusted basis would equal its fair market value.
To conform the treatment of loss assets with the above approach for gain assets, a taxpayer would apportion the loss in the year of sale based on an imputed annual amount of additional depreciation. That amount would be multiplied by each state’s apportionment factor in each of the years in which the asset was depreciated. That amount of apportioned imputed depreciation would then be multiplied by the appropriate state tax rate in each of the years the asset was depreciated, and the results then aggregated (again putting aside credits and NOLs and the like). The result would be each state’s share of the loss.

The reader should rest assured that the Hearing Officer is not seriously suggesting that the above approach be implemented; only showing how apportioning the gain (or loss) in the year of sale to the states in which the taxpayer is doing business in that year, which may be quite different from the states in which the asset was depreciated, using an apportionment percentage quite different from the percentages that applied in the years of depreciation, and tax rates that might have changed over time, does not begin to recapture the cost of previously claimed depreciation, regardless of whether the gross receipts on the sale are included or excluded from the sales factor.

So what to do? Intertemporal differences are typically ignored by most states (installment sales being the exception). Either including the gross receipts generated by income satisfying the functional test as the Act does, or excluding such receipts as the Draft does, can raise external consistency and Section 18 issues, and it is not clear that there is a systemic bias one way or the other. The Hearing Officer has seen situations that triggered Section 18 issues where the gross receipts
were included and ones where they were excluded. Generalizations are simply not very useful given the wide range of transactions that can occur.

Excluding the gross receipts from transactions satisfying the functional test, however, has one advantage not set forth in the Report. If a business is sold as a stock sale, the sale of a partnership or membership interest, Draft Art. IV.17(a)(4)(ii)(C) would throw out the receipts. If a business is sold as an asset sale, the receipts from tangible assets would be assigned under Art. IV.16 using the destination principle. By excluding such receipts from the sales factor, the Draft would conform stock sales, partnership sales, and membership interests in an LLC with asset sales.

i. Exclusion of Receipts from Hedging Transactions and from the Maturity, Redemption, Sale, Exchange, Loan or other Disposition of Cash or Securities

The Report defends its exclusion of receipts from hedging and from the so-called treasury function (which is a shorthand for the maturity, redemption, sale, exchange, loan or other disposition of cash or securities) as follows: “[b]asing the definition of ‘sales’ on the purpose of the sales factor has implications for whether to include receipts from the treasury function and other financial activities where there is no ‘customer’ (e.g., receipt of dividends or interest income). If the purpose of the sales factor is to reflect the taxpayer’s market for its product, then, unless the taxpayer is a securities dealer, receipts from its treasury function and other financial activities should be excluded. These exclusions are consistent with the MTC’s current model regulations. Some states exclude these receipts entirely. Some limit
inclusion to net rather than gross receipts. If the problem were only distortion, then a limitation to net may be fine. But if there is also a policy problem of inconsistency with the purpose of the sales factor, or a practical problem of how to source these treasury function receipts, then exclusion may be the better approach. The Committee chose exclusion.” Report, p. 16.

In the interests of disclosure, the Hearing Officer has participated in cases involving both the treasury function and hedging on the issue of whether the gross receipts involved were sales within the definition of Act Art. IV.1(g). In all of these cases, the persons in charge of these transactions were unaware of state tax considerations and operated under strict guidelines that constrained their discretion to buy and sell. And one crucial difference between the two situations is that certain taxpayers might not be in business without the ability to hedge their purchases of critical raw materials. For these taxpayers, hedging is part of an inventory control function, which goes to the heart of generating business income. Nonetheless, the Hearing Officer is aware of the theoretical and pragmatic arguments against including the receipts in the sales factor from both the treasury function and from hedging.

The Hearing Officer will not debate the merits of excluding the receipts from the hedging or the treasury function. In his opinion, the Draft needlessly creates a bad precedent of excluding a class of transactions from the sales factor. It is not difficult imagining that the tables might be turned on a state with a taxpayer (or industry) lobbying for the exclusion of a class of receipts that will be in its favor, citing for support the precedent of the state having previously excluded the receipts from hedging and the treasury function. The club today can become a snake
that bites tomorrow. Because Draft Art. IV.17(a)(4)(ii)(C) already throws out the receipts from hedging and the treasury function, see Section III.D(8) above, Draft Art. IV.1(g) need not address these transactions.

The Hearing Officer prefers a statute that sends the message that exclusion of gross receipts is the exception and should be limited to exceptional circumstances. The specific exclusion for hedging and the treasury function sends the wrong message. To be sure, the throwout rule in Draft Art. IV.17(a)(4)(ii)(C) could be viewed as sending that same message, but it is more muted. As a political matter, the Hearing Officer believes that the throwout rule for the sale of intangibles in Draft Art. IV.17(a)(4)(ii)(C) is less likely to be successfully seized upon by lobbyists seeking similar treatment for their clients than if the sales factor explicitly excluded hedging and the treasury function.

Some might argue that the treasury function and hedging are so significant that they merit a “belts and suspenders” approach, being both thrown out under Draft Art. IV.17(a)(4)(ii)(C) as well as in Draft Art. IV.1(g). But this “belts and suspenders” approach invites a court to reconcile the two provisions, which may result in the more specific—Draft Art. IV.1(g)—superseding the more general—Draft Art. IV.17(a)(4)(ii)(C).

If a court were to do so, a policy issue would then arise regarding the exception for securities dealers. The exception’s rationale is clear: for dealers the so-called treasury function represents transactions and activities that would be described under the transactional test. But so might the income of market makers and others that might not be described as a “securities dealer.” Indeed MTC Reg. IV.18(c)(4)(E)(Ex.(ii)) excludes traders as well as dealers from the
treasury function, but the Draft excludes only the latter. A similar question can be raised about those involved in hedging that might be the counterpart of a “securities dealer.” The risk of singling out securities dealers as an exception from the treasury function is that other persons exist that perform equivalent activities. This drafting problem is avoided under the throwout rule of Draft Art. IV.17(a)(4)(ii)(C).

Dealers will still have to assign the receipts from their treasury function activities to the numerator of a state’s sales factor. That assignment will presumably take place under the rules of Draft Art. IV.17(a)(4)(ii)(C), which will throw out the receipts. Accordingly, the carve out would seem to have no effect on where the receipts would be assigned under the Draft but will lend some support to a dealer’s Section 18 claim for equitable apportionment.

For the reasons above, the Hearing Officer concludes that the preferred course is to deal with hedging and the treasury function only under Draft Art. IV.17(a)(4)(ii)(C) and encourages the MTC to deal with the issue through a regulation and also address whether others, like traders, should also be covered.

On an administrative note, the Hearing Officer recommends that any time an exclusion from a factor is provided as the Draft does for receipts generated by business income satisfying the functional test, or as the Draft does with its throwout rule under Art. IV.17, the tax return should be designed so that the items at issue are identified. If a return is filed with the exclusion or throwout already being taken so that the item never appears in the first instance, an auditor is handicapped in determining whether the statute has been followed.
Finally, the Hearing Officer fully endorses the Draft’s change in the name from “sale” to “receipts.” Receipts better captures the range of items that can be included, such as dividends, interest, capital gains, rents, royalties, and services.

4. Proposed Draft by the Hearing Officer

The Hearing Officer presents two alternative drafts. Each assumes that Draft Art. IV.17(a)(4)(ii)(C) has been adopted by the Uniformity Committee and that receipts from the treasury function and from hedging do not have to be addressed by Draft Art. IV.1(g).

The alternatives clean up a problem with the Draft. The Draft retains the language of the Act referring to the “gross receipts of the taxpayer not allocated . . .” The problem is that receipts are not allocated, gain or loss is. The two alternatives below eliminate that reference.

i. Alternative One

“‘Receipts’ means gross receipts of the taxpayer that are received from, or associated with, transactions or activities generating apportionable business income defined in Art. IV.1.”

Alternative One is broader than the Draft and broader than Alternative Two. It implements the principle that if income is apportionable, the concomitant receipts should be included in the sales factor so that the apportionment formula is more likely to be fair and reflect a reasonable sense of how income is generated and prevail on a constitutional challenge.

The Hearing Officer prefers his proposed draft of business income in Art. IV.1(a) to that proposed by the Uniformity Committee, see Section
III.E, but the reference in Alternative One to Art. IV.1 will incorporate whatever the MTC decides.

Alternative One would cover receipts from transactions or activities that might not satisfy either the transactional or functional tests but would nonetheless satisfy the constitutional test. The Hearing Officer considers this an advantage but presumably the Uniformity Committee would not.

Compared with the Alternative Two, Alternative One will reach more situations that raise potential claims of alternative apportionment. Some might welcome that; others will not.

Less fundamentally, Alternative One replaces the conjunctive “and” with the disjunctive “or” and changes “activity” to “activities.” A disadvantage of Alternative One is that it does not treat asset sales of businesses the same as stock, partnership, or LLC sales.

ii. Alternative Two

“‘Receipts’ means gross receipts of the taxpayer that are received from, or associated with, transactions or activities generating apportionable business income defined in Art. IV.1, excluding substantial amounts of such gross receipts from an incidental or occasional sale of a fixed asset or other property that was, or is, related to, or part of, the operation of the taxpayer’s trade or business.”

This alternative adopts the hoary MTC Reg. IV.18(c) cited above, which excludes a subset of transactions satisfying the functional test. Alternative Two excludes some situations that might otherwise raise issues of alternative apportionment under Alternative One.
Alternative Two would presumably exclude the receipts from the typical sale of a business, thereby having the effect of equating the treatment of stock, partnership, or LLC sales whose receipts are excluded from the sales factor under Art. IV.17(a)(4)(ii)(C) with asset sales of a business. The terms “substantial,” “incidental,” and “occasional,” have apparently not spawned significant litigation. These terms can be dealt with through regulations. The absence of litigation can be ambiguous of course, and does not necessarily mean things are working well; sometimes it merely means that problems are not being discovered on audit or that the rule or regulation favors taxpayers. Nonetheless, the Hearing Officer prefers Alternative Two to the Draft.