



MEMORANDUM

To: Multistate Tax Commission Uniformity Committee
From: Helen Hecht, General Counsel
Regarding: Draft Amendments to Sections 1 & 17 of the
General Allocation and Apportionment Regulations
Referral of Issues from the Executive Committee
Date: June 1, 2016

The Commission's Executive Committee has requested the Uniformity Committee consider certain comments on the draft amendments to the model General Allocation and Apportionment Regulations and report back the Executive Committee at its meeting in July 2016.

BACKGROUND

The following events are important:

- July 2014 – the Commission adopted significant changes to Compact Article IV (UDITPA) Sections 1 and 17.
- July 2014 – at the urging of the hearing officer, Professor Richard Pomp, the Executive Committee asked the Uniformity Committee to act quickly to draft regulations to implement those changes.
- September 2014 – the Uniformity Committee formed Section 1 and 17 work groups.
- December 2015 – the work groups submitted a set of draft amendments.
- December 2015 – the Uniformity Committee approved the draft amendments.¹
- January 2016 - the Executive Committee approved the draft amendments for hearing.
- March 2016 – a public hearing was held before Brian Hamer.
- May 12, 2016 – the Executive Committee heard recommendations of the hearing officer as well as public comments on those recommendations.

¹ The Uniformity Committee adopted one minor change to Reg. IV.(2).(a)(5)(G) which read: "Nothing in this definition shall be construed to modify, impair or supersede any provision of Section IV.18." The change would add the phrase, "or regulations promulgated thereunder." That change was mistakenly omitted from the draft of the amendments that was published for the public hearing.



Additional public comments were raised at the May 12 meeting. They primarily concern changes adopted by the Commission to Article IV which, in part, exclude from the receipts factor receipts from hedging, certain receipts from securities transactions, and the loan of cash and also do not provide for sourcing of those receipts. Those submitting these additional comments urged the Commission to delay approval of the draft amendments related to Section 1 and 17 generally (that is, all the amendments including those which would implement market-based sourcing).

The Executive Committee has asked the Uniformity Committee to consider and respond to all comments. This memo provides a briefing for the Uniformity Committee on the comments broken down as follows:

- Recommendations of the hearing officer,
- Comments on hearing officer recommendations,
- Additional public comments and requests to delay amendments, and
- Information and staff analysis of the additional public comments.

RECOMMENDATIONS OF THE HEARING OFFICER

The Commission’s hearing officer, Brian Hamer, made certain recommendations based on the public hearing—summarized below. The hearing officer’s full report is available – here: [http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Public-Hearing-3-2016/Hearing-Officer-Report-General-Allocation-and-Appportionment-Regs-\(revised\).pdf.aspx](http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Public-Hearing-3-2016/Hearing-Officer-Report-General-Allocation-and-Appportionment-Regs-(revised).pdf.aspx). The report contains the public comments, the hearing officer’s analysis, copies of the draft regulatory amendments, and the Commission’s changes to Article IV (UDITPA), to which those amendments relate. (Note that the hearing officer rejected some requests made during the public hearing.)

Change Reg. IV.17.(a)(7)(C) [page 67] as follows:

- (C) [Tax Administrator] Authority to Adjust a Taxpayer’s Return. **The provisions contained in this Reg. IV.17.(a)(7)(C) are subject to Reg. IV. 17.(a)(7)(B).** The [tax administrator’s] ability to review and adjust a taxpayer’s assignment of receipts on a return to more accurately assign receipts consistently with the rules or standards of Reg. IV.17, includes, but is not limited to, each of the following potential actions.

Change Reg. IV.17.(a)(7)(D) [page68] as follows:

- (D)** Taxpayer Authority to Change a Method of Assignment on a Prospective Basis. In filing its original return for a tax year, a taxpayer may change its method of assigning its receipts under Reg. IV.17, including changing its method of approximation, from that used on previous returns. **However, the taxpayer may only make this change for purposes of improving the**

accuracy of assigning its receipts consistent with the rules set forth in Reg. IV.17, including, for example, to address the circumstance where there is a change in the information that is available to the taxpayer as relevant for purposes of complying with these rules. Further, a taxpayer that seeks to change its method of assigning its receipts must disclose, in the original return filed for the year of the change, the fact that it has made the change, and must retain and provide to the [tax administrator] upon request documents that explain the nature and extent of the change, and the reason for the change. If a taxpayer fails to adequately disclose the change or retain and provide the required records upon request, the [tax administrator] may disregard the taxpayer's change and substitute an assignment method that the [tax administrator] determines is appropriate.

Change Reg. IV.17 (d)(e)(3) [page 95] as follows:

(3) License of a Production Intangible.

If a license is granted for the right to use intangible property other than in connection with the sale, lease, license, or other marketing of goods, services, or other items, and the license is to be used in a production capacity (a “production intangible”), the licensing fees paid by the licensee for that right are assigned to [state] to the extent that the use for which the fees are paid takes place in [state]. Examples of a license of a production intangible include, without limitation, the license of a patent, a copyright, or trade secrets to be used in a manufacturing process, where the value of the intangible lies predominately in its use in that process. If the [tax administrator] can reasonably establish that the actual use of intangible property pursuant to a license of a production intangible takes place in part in [state], it is presumed that the entire use is in this state except to the extent that the taxpayer can demonstrate that the actual location of a portion of the use takes place outside [state]. In the case of a license of a production intangible to a related party, the taxpayer must assign the receipts to where the intangible property is actually used. In the case of a license of a production intangible to a party other than a related party where the location of actual use is unknown, it is presumed that the use of the intangible property takes place in the state of the licensee's commercial domicile (where the licensee is a business) or the licensee's state of primary residence (where the licensee is an individual). If the [tax administrator] can reasonably establish that the actual use of intangible property pursuant to a license of a production intangible takes place in part in [state], it is presumed that the entire use is in this state except to the extent that the taxpayer can demonstrate that the actual location of a portion of the use takes place outside [state]. In the case of a license of a production intangible to a related party, the taxpayer must assign the receipts to where the intangible property is actually used.

Change Reg. IV.17.(d)(3)(B)(1)(c) Example (i) [page 73] as follows:

Example (i). Direct Mail Corp, a corporation based outside [state], provides direct mail services to its customer, Business Corp. Business Corp transacts contracts with Direct Mail Corp to deliver printed fliers to a list of customers that is

provided to it by Business Corp. Some of Business Corp’s customers are in [state] and some of those customers are in other states. Direct Mail Corp will use the postal service to deliver the printed fliers to Business Corp’s customers. . . .

Change Reg. IV.17.(d)(3)(B)(3)(d) [page 84] as follows:

Example (vi). Wholesale Corp, a corporation that is based outside [state], develops an Internet-based information database outside [state] and enters into a contract with Retail Corp whereby Retail Corp will market and sell access to this database to end users. Depending on the facts, the provision of database access may be either the sale of a service or the license of intangible property or may have elements of both, but for purposes of analysis it does not matter. See Reg. IV.17.(e).(5). . . . See Reg. IV.17.(d).(3)(B)3.c.ii. Reg. IV.17.(d).(3)(B)3.bReg. IV.17.(d).(3)(B)3.bReg. IV.17.(d).(3)(B)3.bReg. IV.17.(d).(3)(B)3.b. Note that it does not matter for purposes of the analysis whether Wholesale Corp’s sale of database access constitutes a service or a license of intangible property, or some combination of both. See Reg. IV.17.(e).(5). In any case in which Wholesale Corp’s receipts would be assigned to a state in which Wholesale Corp is not taxable, the receipts must be excluded from the denominator of Wholesale Corp’s receipts factor. See Article IV.17.(c) and Reg. IV.17.(a).(6)(D).

COMMENTS ON HEARING OFFICER RECOMMENDATIONS

Two groups submitted comments on the hearing officer’s recommendations – the American Bar Association Tax Section (ABA) and the Council on State Taxation.

ABA COMMENTS ON THE HEARING OFFICER RECOMMENDATIONS

Ms. Shirley Sicilian, representing the ABA, provided oral comments on the ABA’s proposal to a provision allowing the Commission to provide nonbinding mediation to states and taxpayers where the method of sourcing of receipts (or sales) results in signification duplicative sourcing for a particular taxpayer. (The hearing officer did not recommend including such a provision.)

Ms. Sicilian stated that, given the differences between states, there will be multiple taxation issues for particular taxpayers and urged the Commission to provide a means to address this problem for affected taxpayers. Distortion relief authority (Article IV, Section 18) would be the basis for the mediation process and the MTC already has an informal ADR program which it recommends to taxpayers when issues of multiple taxation arise. The ABA agrees that its proposal would be limited to sales factor sourcing issues and the states would only commit to non-binding mediation. It asks the Executive Committee to reconsider this proposal. (While the hearing officer found such a proposal is unnecessary, Staff sees no particular problems with it.) The ABA also provided the summary on the following page of the different receipts sourcing methods currently used by states.

Sales Factor Sourcing for Services

Market-Based Sourcing	Market-Based Sourcing	Service Performed	Income Producing Activity/ Cost of Performance
<ul style="list-style-type: none"> • Benefit Received <ul style="list-style-type: none"> ▪ Arizona (election)* ▪ California* ▪ Iowa* ▪ Michigan* ▪ Missouri (if ultimate beneficiary in MO) ▪ Ohio (CAT) ▪ Rhode Island* ▪ Utah ▪ Washington (B&O) ▪ Wisconsin* • Service Received <ul style="list-style-type: none"> ▪ Illinois* ▪ Maine* ▪ Minnesota* 	<ul style="list-style-type: none"> • Service Delivered <ul style="list-style-type: none"> ▪ Alabama ▪ District of Columbia* ▪ Massachusetts ▪ Pennsylvania* ▪ Tennessee • Customer Located <ul style="list-style-type: none"> ▪ Georgia* ▪ Maryland ▪ Nebraska* ▪ New York* ▪ Oklahoma 	<ul style="list-style-type: none"> • Colorado* • Connecticut* • Delaware • Louisiana • New Jersey* • Texas (Franchise tax) based on fair value* 	<ul style="list-style-type: none"> • Alaska • Arkansas • Florida • Hawaii • Idaho • Indiana* (benefit)** • Kansas • Kentucky^ (delivered) • Mississippi^ (benefit) • Montana • New Hampshire • New Mexico^ (delivered) • North Carolina • North Dakota • Oregon* • South Carolina • Vermont • Virginia • West Virginia

^ Legislation to change sourcing in 2015 failed

**Indiana's interpretation of "income producing activity" essentially results in market-based sourcing

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COST COMMENTS ON THE HEARING OFFICER RECOMMENDATIONS



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May 10, 2016

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Re: COST Comments on Hearing Officer's Report on Proposed Sections 1 and 17 Regulations

Dear Secretary Padilla:

On behalf of the Council On State Taxation (COST), I submit these written comments to express our support and concerns regarding Hearing Officer Brian Hamer's Recommendations on Proposed Draft Amendments to the Commission's Model General Allocation and Apportionment Regulations, set forth in the Hearing Officer Report dated May 1, 2016. Please share our comments and suggested language changes with the other members of the Executive Committee.

COST appreciates the Hearing Officer's consideration of the comments we submitted on March 7, 2016 (attached). We strongly support the Hearing Officer's suggested changes allowing taxpayers to adjust their "reasonable approximation" methodology prospectively without burdensome procedural requirements. We would, however, like to reiterate the importance of several additional changes to the proposed regulations that we recommended but were not supported by the Hearing Officer. Finally, we would like to comment on an additional issue relating to unintended consequences that may result from changes to the definition of "receipts," particularly for the financial services industry.

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.



Council On State Taxation (COST)
Comments on Secs. 1 and 17 Hearing Officer Report

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The Hearing Officer Report

COST appreciates the Hearing Officer’s thoughtful examination and consideration of the comments we submitted relating to the proposed amendments to Commission’s model general allocation and apportionment regulations. Several of the Hearing Officer’s suggested changes should be adopted 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 that the new method “improves the accuracy” of assigning the receipts and without the other additional record retention requirements in the subsection. 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).

In addition, COST supports the Hearing Officer’s recommendation to add a new first sentence to proposed Reg. IV.17.(a)(7)(C) to avoid confusion regarding tax agencies’ authority to modify a taxpayer’s reasonable approximation method by clarifying that subsection is subject to the general rules applicable to original returns as set forth in proposed Reg. IV.17.(a)(7)(B).

While COST supports the Hearing Officer’s recommended changes listed above, we would also reiterate our support for several other changes in the proposed regulations that were detailed in our letter of March 7, 2016 but not endorsed by the Hearing Officer. These include allowing taxpayers to change their reasonable approximation method on an amended return; the elimination or raising of the percentage threshold for utilizing the customer billing address safe harbor; and the elimination of the presumption relating to production intangible sourcing. (see attached letter).

Additional Concerns with “Receipts” Definition

The proposed draft amendments to Reg. IV.2.(a)(6)(F) reflect provisions within the revised Compact Article IV, Section 1 that “receipts of a taxpayer from hedging transactions and from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities, shall be excluded.” While the proposed draft amendments’ adoption of this language is faithful to the recent Article IV changes, the amendments fail to recognize the distortive impact this may have on many financial institutions by excluding significant income 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.



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COST recognizes the MTC Section 18 work group is currently examining model regulatory language to address instances in which the exclusion of certain receipts from the receipts factor would lead to distortion in the apportionment of a taxpayer’s income. This effort, however, will be insufficient to the extent: 1) it is completed after the Section 1 rule amendments are finalized or 2) a state adopts the Section 1 rule changes along with the Section 17 changes, but not the Section 18 changes currently being developed. States lacking special financial services apportionment rules (such as those included within the model MTC statute) that adopt the proposed draft amendments to Reg. IV.2.(a)(6)(F) will distort the apportionment factors of financial institutions (or similarly situated companies) by excluding major income streams from receipts subject to apportionment. The proposed draft amendments therefore should recognize that receipts generated as part of a taxpayer’s primary business (*e.g.*, broker-dealers, banks) should be excepted from the operation of this exclusion.

Further, Reg. IV.(a)(6)(F) provides: “The taxpayer’s treatment of the receipts as hedging receipts for accounting or federal tax purposes may serve as indicia of the taxpayer’s primary purpose [of engaging in the activity giving rise to the receipts], but shall not be determinative.” In providing the taxpayer’s accounting or federal tax treatment constitute “indicia” but are not “determinative,” the proposed draft amendments create uncertainty, provide undue latitude to the taxing authority to make audit adjustments, and certainly will produce controversy. As such, we recommend this provision be removed.

Conclusion

As highlighted above, the Hearing Officer’s Report on the proposed Sections 1 and 17 Model Market-Based Sourcing Regulations addresses several provisions that we believe should be adopted as modified before the regulations are approved, and COST makes further recommendations beyond the findings of the report. COST respectfully requests that the Executive Committee make the above changes to the proposed regulations to ensure that taxpayers and tax agencies are treated in an even-handed manner and that the regulations provide flexibility for taxpayers consistent with the goals of the fair and efficient tax administration.

Sincerely,

Karl Frieden

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

As to the comments on the hearing officer’s recommendations, staff believes the hearing officer’s report and the comments above provide sufficient information for the Uniformity Committee’s consideration, but will provide analysis if requested.

ADDITIONAL PUBLIC COMMENTS & REQUESTS TO DELAY AMENDMENTS

In addition to comments on the hearing officer’s recommendations, additional public comments were also raised for the first time before the Executive Committee concerning the treatment of hedging and certain receipts from securities. These additional comments are provided below.

COST’S ADDITIONAL PUBLIC COMMENTS

A portion of COST’s letter of May 10 includes additional comments (see excerpts):

The proposed draft amendments to Reg. IV.2.(a)(6)(F) reflect provisions within the revised Compact Article IV, Section 1 that “receipts of a taxpayer from hedging transactions and from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities, shall be excluded.” While the proposed draft amendments’ adoption of this language is faithful to the recent Article IV changes, the amendments fail to recognize the distortive impact this may have on many financial institutions by excluding significant income 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.

COST recognizes the MTC Section 18 work group is currently examining model regulatory language to address instances in which the exclusion of certain receipts from the receipts factor would lead to distortion in the apportionment of a taxpayer’s income. This effort, however, will be insufficient to the extent: 1) it is completed after the Section 1 rule amendments are finalized or 2) a state adopts the Section 1 rule changes along with the Section 17 changes, but not the Section 18 changes currently being developed. States lacking special financial services apportionment rules (such as those included within the model MTC statute) that adopt the proposed draft amendments to Reg. IV.2.(a)(6)(F) will distort the apportionment factors of financial institutions (or similarly situated companies) by excluding major income streams from receipts subject to apportionment. The proposed draft amendments therefore should recognize that receipts generated as part of a taxpayer’s primary business (e.g., broker-dealers, banks) should be excepted from the operation of this exclusion.

Further, Reg. IV.(a)(6)(F) provides: “The taxpayer’s treatment of the receipts as hedging receipts for accounting or federal tax purposes may serve as indicia of the taxpayer’s primary purpose [of engaging in the activity giving rise to the receipts], but shall not be determinative.” In providing the taxpayer’s accounting or federal tax treatment constitute “indicia” but are not “determinative,” the proposed draft amendments create uncertainty, provide undue latitude to the taxing authority to make audit adjustments, and certainly will produce controversy. As such, we recommend this provision be removed.



FIST COALITION'S ADDITIONAL PUBLIC COMMENTS

Financial Institutions State Tax Coalition

May 11, 2016

Demesia Padilla
Executive Committee Chair
Multistate Tax Commission
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Re: Proposed Draft Amendments to the Commission's Model General Allocation and Apportionment Regulations

On behalf of the Financial Institutions State Tax ("FIST") Coalition, I am submitting these written comments regarding the proposed draft amendments to the Commission's model general allocation and apportionment regulations. The FIST Coalition respectfully requests that the draft amended Regulations IV.1 and IV.17 ("Sections 1 and 17 Regulations") be sent back to the uniformity committee to address the issues outlined below and to give taxpayers/practitioners adequate (non-tax season) time to review and provide comments.

1. It appears that the current draft amendments to the Model General Allocation and Apportionment Regulations do not reflect the intent of the revised UDITPA provisions that the Commission voted on.

When reviewing recent draft language of the Section 18 work group, we became curious as to why interest income on lending activities and interest and dividends on investment activities were not addressed in the general apportionment sourcing rules (i.e., Section 17 Regulations), rather than now being addressed as exceptions under Section 18.

From the May 3, 2012 MTC staff document provided to the Executive Committee, it is clear that receipts that were not considered to be receipts from the treasury function or receipts where there is no customer were intended to be included in the receipts factor and thus should be addressed in the Model General Allocation and Apportionment Regulations. According to examples in the May 3, 2012 document:

4. Taxpayer routinely sells and replaces a certain type of equipment used in the production of its product (e.g., fleet vehicles). Taxpayer's income from these sales meets the transactional test and is treated as business income. The gross receipts are "sales" for sales factor purposes.
5. Taxpayer makes an installment sale and receives interest income on the installment payments.

The interest on installment payments is included as gross receipts for sales factor purposes.

In addition, the FIST Coalition believes that the revised receipts factor definition does NOT exclude interest from lending, and interest and dividends on investments. The revised definition is:

(g) “Receipts” means all gross receipts of the taxpayer that are not allocated under 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 from hedging transactions and from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities, shall be excluded.** (Emphasis added)

This definition excludes receipts “from the maturity, redemption, sale, exchange, loan or other disposition” of cash or securities, but does NOT exclude receipts from holding securities or loans as long as they are from transactions and activity in the regular course of the taxpayer’s business.

Also, a review of Mr. Pomp’s Hearing Officer’s report on the UDITPA rewrite indicates that the Hearing Officer interpreted the latter part of the revised receipts factor definition to exclude from the factor certain treasury function receipts and not fees and interest from lending transactions. See for example, page 107 of the Hearing Officers Report where Mr. Pomp notes:

“[t]he 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) . . .”

Additionally, draft Regulation IV.2.(a)(6)(A) provides:

In the case of a taxpayer engaged in manufacturing and selling or purchasing and reselling goods or products, “receipts” includes all gross receipts from the sales of such goods or products (or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the tax period) held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. Gross receipts for this purpose means gross sales less returns and allowances, and includes all interest income, service charges, carrying charges, or time-price differential charges incidental to such sales. Federal and state excise taxes (including sales taxes) shall be included as part of such receipts if the taxes are passed on to the buyer or included as part of the selling price of the product. (Emphasis added)

Moreover, in order to ensure a level playing field, taxpayers who lend to customers (whether or not the taxpayer falls within the financial institution definition) should be required to source fees and interest from their lending activity in the same manner as required of financial institutions.

The FIST Coalition acknowledges that the reason that interest on lending and interest and dividends on investments may have been inadvertently excluded from the draft amendments to the Section 17 receipts sourcing regulation is because the work group started with the Massachusetts market-sourcing regulations and the Massachusetts law specifically excludes interest and dividends from the sales factor.

Accordingly, the FIST Coalition believes that the Commission’s model general allocation and apportionment regulations should be sent back to the uniformity committee to include sourcing for fees and interest on lending and receipts on investments that are part of the taxpayer’s regular trade or business.

2. **The FIST Coalition agrees with Mr. Hamer’s Hearing Officer’s Report that “given the complexities of the modern economy, it seems likely that some parts of the section 17 rules will be found wanting.”**

The Coalition has already identified several of those wanting parts above, and believes there likely are other inadequate areas in these complex regulations that would be identified if the regulations were not finalized until the Section 18 Regulations were completed. In addition, issuing draft regulations and requesting comments during the busy annual financial statement/tax season will always result in limited taxpayer/practitioner review and input. Accordingly, the Coalition believes that during the period that the Uniformity Committee works on adding the interest and investment sourcing provisions, the entire proposed draft amendments to the Commission’s model general allocation and apportionment should remain open for additional comments that taxpayers and practitioners may identify during a non-tax season review.

3. **Adoption of the draft amendments to Section 1 and Section 17 Regulations before the Section 18 Regulations are written will cause turmoil for taxpayers whose regular trade or business is dealing in hedging and securities.**

It is clear from the documents supporting the UDITPA rewrite, including Mr. Pomp’s Hearing Officer’s Report, that the exclusion of the hedging and securities transactions from the receipts factor was not intended to apply to securities dealers. Mr. Pomp’s Hearing Officer’s report notes that the exclusion should also apply to other taxpayers such as market makers and similar taxpayers who deal in securities and hedging. In reaction to Mr. Pomp’s comment, in an effort to move the UDITPA rewrite forward, the exclusion for securities dealers was removed from the receipts definition, and instead was to be addressed in special industry apportionment provisions under Section 18.

It is also clear from MTC staff documents regarding the UDITPA rewrite that the hedging exclusion was meant to deal with the issue presented in *General Mills v. Franchise Tax Board* [No. A131477 (Cal. Ct. App 2012)] and was not meant to apply to securities dealers.

For securities dealers, market makers and similar taxpayers, receipts from securities and hedging transactions reflect the contribution of the taxpayer’s market to the earning of income and should be included in their receipts factor.

Adoption of the draft amendments to the Section 1 and Section 17 Regulations before the Section 18 Regulations are written will cause turmoil for taxpayers whose regular trade or business is dealing in hedging and securities. It would have both tax compliance and financial statement implications – how would such taxpayers determine their current and deferred state



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effective tax rates and prepare tax returns if there is no apportionment guidance and adoption of the narrow receipts factor results in over 50% of their receipts from transactions with customers being excluded from the receipts factor?

It also would raise constitutional issues to exclude such large components of the taxpayers' receipts from the receipts factor.

Accordingly, the FIST Coalition believes that the draft amended Regulations IV.1 and IV.17 should not be adopted until the Section 18 Regulations are completed to ensure that other issues that are more fitting under the Section 17 Regulations are identified and taxpayers whose trade or business include hedging and dealing in securities are not left in limbo as to how to compute their financial statement effective tax rates and how to complete their tax returns.

Conclusion

The FIST Coalition requests that the draft amended Section IV.1 and IV.17 Regulations be sent back to the uniformity committee to address the above issues and to give taxpayers/practitioners adequate (non-tax season) time to review and provide comments.

Otherwise, if the draft regulations are adopted, they should first be amended to provide that until industry regulations are adopted, taxpayers that deal in securities and hedging will continue to apportion their income in the same fashion as the state laws and regulations provided as of 12/31/2015 and will not be bound by the provisions in the amended regulations.

Please contact me if you have any questions regarding the above comments.

Sincerely,

Karen Boucher

Karen Boucher
Financial Institution State Tax Coalition LLC
Managing Member

E&Y'S ADDITIONAL PUBLIC COMMENTS

The following comments were provided by Mr. Joe Huddleston of E&Y via Email to the Hearing Officer on May 9 and were read to the Executive Committee on May 12:

Brian and Helen,

We wanted to make you aware of certain points that I plan to raise at the hearing scheduled for May 12th. Specifically, we have concerns with the proposed definition of "Receipts" and a specific exception from such definition being proposed to Regulation IV.2.(a)(6)(F) in Section 1 of the Multistate Tax Commission's ("MTC") Model General Allocation and Apportionment Regulations. As proposed and reported in the Hearing Officer report issued on May 1, 2016, the Model General Allocation and Apportionment Regulations proposes to exclude receipts from hedging and lending (of cash or securities) transactions from the definition of "Receipts." While we respect the extensive work conducted over the past two years to develop the recommended changes we find that the changes as proposed may cause issues for taxpayers that should be further analyzed and considered before becoming finalized.

The derivatives and hedging market plays a vital role in today's economy. Also businesses engage in various types of lending transactions, including security lending and/or overall lending. Today's businesses actively engage in such products in the regular course of business to manage risk and increase profit. We understand the complexities surrounding hedging transactions and cause for concern, however we do not agree with the proposal to simply remove such transactions from the definition of receipts altogether. The proposed regulation excluding hedging transactions from the sales factor, yet treating as "apportionable income," runs contrary to its own principals and those established by the U.S. Constitution by failing to create a fair or reasonable approximation of how income is generated for the reasons noted above. As such, we recommend that the MTC reexamine the proposed amendment to exclude hedging and lending transactions from the definition of "receipts." We would be pleased to discuss these comments with you or your staff and work with you in drafting clarifying language.

Overall, we recommend that the MTC reexamine the proposed amendment to MTC's Model General Allocation and Apportionment Regulations which excludes hedging and lending transactions from the definition of "receipts" for the following reasons:

1. The exclusion of hedging transactions and lending from the definition of "receipts" deviates from the purpose UDITPA because it distorts the taxpayer's business income in determining its sales factor.
2. The exclusion of hedging and lending transactions from "receipts" for state purposes is inconsistent with the federal treatment of hedging transactions.
3. The recommended definition of hedging transactions will cause confusion because it is inconsistent with already existing state definitions, which properly identify only specific types of hedging transactions to be excluded.

4. The exclusion of all hedging and lending transactions from the definition of a corporation's receipts is inconsistent with the treatment of hedging and lending transactions for the receipts of financial institutions. Such inconsistent treatment should be further considered so that similarly situated taxpayers would not be subject to differing apportionment standards.

It is important that the MTC revise the proposed regulation to more accurately reflect the business income in the sales factor of corporations engaged in non-distortive hedging and lending transactions. We would be pleased to discuss the Comments with you or your staff if that would be helpful.

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On June 1, 2016, Mr. Huddleston provided additional comments as follows:

The inclusion of gross income from securities (including hedges) and interest income from lending of securities is appropriate and necessary to accurately reflect income for all taxpayers for whom such activity and income is from the ordinary course of the taxpayer's trade or business. To exclude such income will not accurately reflect a taxpayer's business conducted within the state. A number of states have already addressed the inclusion of such income in the definition of receipts as well as determined the appropriate methodology to source such income.

Income from securities, including hedging and derivative activity, are a significant driver of net income and receipts for a number of industries including securities broker-dealers, security dealers, mortgage originators, proprietary traders, asset managers, commodity dealers and holding companies. By excluding receipts from securities and interest income from lending of securities from the sales factor, it could significantly reduce the relevance of the receipts factor or result in a manner completely inconsistent with the true business of these industries.

The inclusion of receipts from this business activity has been addressed in the development of the MTC financial organization apportionment model act as well as within a number of specific state statutes. In developing these provisions standards have been established that should not be ignored as the MTC has proposed in Section 17. A complete exclusion of such receipts from the factor would result in numerous taxpayers and states to consider adopting alternative apportionment methodologies for a significant

number of taxpayers. This would seem to be contrary to the purpose of the Model Act and the development of a more standard formulary apportionment model.

It is important to note that a significant number of states have considered the complexity of inclusion of such income in the receipts factor and have addressed a number of the issues that the Committee has considered. As such there are numerous examples of a frame work that can and should be considered before any proposal is submitted. None of these states have removed income from securities completely from the receipts factor. Instead they have adopted rules that address the industries and businesses that have significant income from such activity.

The following are a few examples of where states have addressed hedging transactions with respect to the receipts factor. All of the states listed have tried to distinguish between certain types of securities transactions. By not issuing a blanket exclusion of all hedging transactions, each state acknowledges that there are certain types of industries reliant on securities transactions as the core of their business and as such should be taken into account for the receipts factor. As you will notice, the states that have addressed this issue tend to be those states in which the financial services industries significantly contribute to the economy of those states or are near financial services centers and we respectfully request the MTC take these into consideration.

New York: As part of their recent tax reform, New York includes receipts and net gains from securities transactions in the sales factor under N.Y. Tax Law §210-A.² It includes those receipts, net income, net gains, and other items that are included in the computation of the taxpayer's business income for the taxable year, and provides taxpayer's with a couple of options for sourcing receipts and net gains from securities transactions depending on the type of transaction. For sales of securities that essentially constitute inventory (those marked-to-market federal tax purposes under IRC 475 and 1256) of the taxpayer, such receipts and net gains are sourced either based on a customer sourcing method or fixed percentage method at the election of the taxpayer. Otherwise, securities transactions are required to be sourced under the relative customer sourcing method prescribed by the state. New York provided specific sourcing rules for a number of securities transactions including: loans; federal, state, and municipal debt;

² N.Y. Tax Law §210-A.1 states, "Business income and capital shall be apportioned to the state by the apportionment factor determined pursuant to this section. The apportionment factor is a fraction, determined by including only those receipts, net income, net gains, and other items described in this section that are included in the computation of the taxpayer's business income (determined without regard to the modification provided in subparagraph nineteen of paragraph (a) of subdivision nine of section two hundred eight of this article) for the taxable year. The numerator of the apportionment fraction shall be equal to the sum of all the amounts required to be included in the numerator pursuant to the provisions of this section and the denominator of the apportionment fraction shall be equal to the sum of all the amounts required to be included in the denominator pursuant to the provisions of this section."

asset backed securities and other government agency debt; corporate bonds; reverse repurchase agreements and securities borrowing agreements; federal funds; physical commodities; and any other financial instrument. In addition, New York provides specific sourcing provisions for other receipts from broker or dealer activities and receipts from investment companies.

California: California defines “gross receipts” as the gross amounts realized (the sum of money and the fair market value of other property or services received) on the sale or exchange of property, the performance of services, or the use of property or capital (including rents, royalties, interest, and dividends) in a transaction that produces business income, in which the income, gain, or loss is recognized under the Internal Revenue Code, as applicable for purposes of this part.³ California then specifically enumerates certain receipts that are not included in the definition of “gross receipts.” Amounts specifically excluded from gross receipts include amounts received from transactions in intangible assets held in connection with a treasury function of the taxpayer's unitary business and the gross receipts and overall net gains from the maturity, redemption, sale, exchange, or other disposition of those intangible assets, as well as amounts received from hedging transactions involving intangible assets.⁴ However, taxpayers principally engaged in these types of transactions are not subject to this exclusion. Under Cal. Rev. & Tax Code §25120(f)(2)(K), a taxpayer principally engaged in the trade or business of purchasing and selling intangible assets of the type typically held in a taxpayer's treasury function, such as a registered broker-dealer, is not performing a treasury function with respect to income so produced.

Furthermore, California adopts a narrower definition of a hedging transaction to include only those transactions related to the taxpayer's trading function involving futures and options transactions for the purpose of hedging price risk of the products or commodities consumed, produced, or sold by the taxpayer.⁵ Under the proposed MTC definition, any type of receipt arising from a business activity will be considered from a hedging transaction if the primary purpose of engaging in the business activity is to reduce the exposure to risk caused by other business activities. The proposed MTC definition further provides that receipts from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities are *excluded* regardless of whether or not the events or transactions are engaged in for the purpose of hedging.

To the extent the transaction is not otherwise excluded, for California corporate income tax purposes receipts from the sale of intangible property are sourced to the state to the extent the property is used in the state. In the case of marketable securities, sales are in

³ Cal. Rev. & Tax Code §25120(f)(2)

⁴ Cal. Rev. & Tax Code §25120(f)(2)(K),(L)

⁵ Cal. Rev. & Tax Code §25120(f)(2)(L)

this state if the customer is in this state.⁶ Where the sale of intangible property is the sale of shares of stock in a corporation or the sale of an ownership interest in a pass-through entity, other than sales of marketable securities, California provides specific sourcing rules that look to the underlying assets of the corporation or partnership in which the stock or interest is being sold.⁷

Connecticut: Connecticut provides special industry sourcing rules for “securities brokerage services.” Corporations that provide “securities brokerage services” must apportion their net income derived from rendering such services using a single-factor formula measured by brokerage commissions and margin interest paid on brokerage accounts.⁸ [Please note that the recently enacted legislation revising the sourcing of receipts under SB 502 does not impact the sourcing rules for securities brokerage services.] “Security brokerage services” means services and activities including all aspects of the purchasing and selling of securities rendered by a broker, as defined in 15 USC 78c(a)(4) and registered under the provisions of 15 USC 78a to 78kk, inclusive, as from time to time amended, to effectuate transactions in securities for the account of others, and a dealer, as defined in 15 USC 78c(a)(5) and registered under the provisions of 15 USC 78a to 78kk, inclusive, as from time to time amended, to buy and sell securities, through a broker or otherwise.⁹ Security brokerage services shall not include services rendered by any person buying or selling securities for such person's own account, either individually or in some fiduciary capacity, but not as part of a regular business carried on by such person.¹⁰ “Brokerage commission” means all compensation received for effecting purchases and sales for the account or on order of others, whether in a principal or agency transaction, and whether charged explicitly or implicitly as a fee, commission, spread, mark-up or otherwise.¹¹

New Jersey: For New Jersey corporate income tax purposes, the sales factor includes the receipts of the taxpayer, computed on the cash or accrual basis according to the method of accounting used in the computation of its net income for federal tax purposes, arising during such period from the following:

- sales of its tangible personal property located within this State at the time of the receipt of or appropriation to the orders where shipments are made to points within this State;

⁶ Cal. Rev. & Tax Code §25136(a)(2)

⁷ Cal. Code Reg. tit. 18, §25136-2(d)(1)(A)(1)

⁸ Conn. Gen. Stat. §12-218(g)(1).

⁹ Conn. Gen. Stat. §12-218(g)(3)(A)

¹⁰ Id.

¹¹ Conn. Gen. Stat. §12-218(g)(3)(C)

- sales of tangible personal property located without the State at the time of the receipt of or appropriation to the orders where shipment is made to points within the State;
- services performed within the State;
- rentals from property situated, and royalties from the use of patents or copyrights, within the State; and
- all other business receipts (excluding dividends excluded from entire net income by paragraph (1) of subsection (k) of section 4 of P.L.1945, c.162 (C.54:10A-4) earned within the State.¹²

New Jersey adopts special sourcing rules for certain industries including securities or commodities broker-dealers and asset management companies. Under N. J. Admin. Code §18:7-8.10(f), receipts from the services of a registered securities or commodities broker or dealer shall be sourced to New Jersey if the customer is located within the State. “Securities” and “commodities” have the same meaning as under IRC §475. Similarly, a New Jersey tax court found that securities bought and sold by a New Jersey market-maker in the over-the-counter securities market were integrated with the company's business carried on in other states and, therefore, receipts generated by the securities transactions were earned at the location of the company's customers.¹³

As it relates to asset management companies, New Jersey provides that the sales factor shall include receipts from asset management services and shall be sourced to the domicile of the customer.¹⁴ “Asset management services” means the rendering of investment advice, making determinations as to when sales and purchases are to be made, or the selling or purchasing of assets and related activities.¹⁵

Illinois: Illinois has also addressed taxpayers that primarily deal in securities transactions and has provided that the interest, net gains (but not less than zero) and other items of income from intangible personal property, shall be included in the numerator of the sales factor if the taxpayer is a dealer in the item of intangible personal property within the meaning of Section 475 of the Internal Revenue Code, and the income or gain is received from a customer in Illinois.¹⁶ Otherwise, such receipts are to be sourced based on where the income-producing activity is performed.¹⁷ We note that with the exception of this last provision, Illinois has adopted market-based sourcing rules.

¹² N.J. Rev. Stat. § 54:10A-6(B)

¹³ See *Mayer & Schweitzer, Inc. v. Director, Div. of Taxation*, 20 N.J. Tax 217, 226 (Tax 2002)

¹⁴ N.J. Admin. Code §18:7-8.10(e)

¹⁵ N.J. Admin. Code §18:7-8.10(e)(4)(i)

¹⁶ 35 Ill. Comp. Stat. 5/304(a)(3)(C-5)(iii)

¹⁷ *Id.*

In addition, Illinois has recently adopted regulations addressing hedging transactions. Under 86 Ill. Admin. Code 100.3380(c)(6)(B), Illinois now excludes any income, gain or loss from a transaction properly identified as a hedge under 26 USC 1221(b)(2)(A), 475(c)(3) or 1256(e)(2). A “hedging transaction,” as a transaction entered into by a taxpayer in the normal course of business primarily to manage interest rate risk or the risk of price or currency fluctuations (See 26 USC 475(c)(3), 1221(b)(2)(A) and 1256(e)(2)).¹⁸

In its reasoning, the Illinois Department of Revenue provides in 86 Ill. Admin. Code 100.3380(c)(6)(A), that gains and losses on hedging transactions entered into to manage the risks associated with the acquisition of resources by a taxpayer (for example, price fluctuations in commodities consumed in the taxpayer's business) do not reflect the market for the taxpayer's goods and services and, therefore, should be excluded from the sales factor. However, gains and losses on hedging transactions entered into to manage risks associated with the gross income the taxpayer expects from its sales of goods and services (for example, the effect of foreign currency fluctuations on the dollar amount of gross income the taxpayer will receive from sales to a particular foreign country) are best accounted for in the sales factor as adjustments to the gross receipts from the transactions whose risks are being hedged. Gains and losses on hedging transactions that manage risks associated with both acquisitions and sales of the taxpayer (for example, electricity futures bought or sold by a taxpayer engaged in the business of buying and selling electrical power), or that otherwise cannot be associated with a particular transaction or class of transactions in the computation of the sales factor, should also be excluded from the sales factor. Taxpayers must refer to the federal income tax law for a framework for identifying gains and losses from hedging transactions to the transactions or class of transactions being hedged and for keeping records necessary to support the identifications.

Illinois provides instances in which hedging transactions are includible in gross receipts:

1. If the taxpayer's books and record clearly identify a hedging transaction as managing risk relating to a particular item or items of gross receipts, including anticipated items of gross receipts, that must be included in the sales factor;
2. If, for federal income tax purposes, the hedging transaction is integrated with the hedged item;
3. A transaction entered into by one member of a federal consolidated group identified as a hedge against a risk of another member if the two members are not members of the same unitary business group because

¹⁸ 86 Ill. Admin. Code 100.3380(c)(6)(A)

the transaction is not hedging against a risk face by the taxpayer entering into the transaction; and

4. A transaction entered into by one member of a unitary business group with another member because the risk remains within the group.

Rhode Island: For purposes of computing the sales factor under the Rhode Island Corporate Income Tax, "gross receipts from sales" specifically includes net income from the sale or other disposition of securities or financial obligations.¹⁹ Rhode Island also adopts special industry apportionment and sourcing rules for taxpayers which provide "securities brokerage services," under which, at the election of the taxpayer, all net income derived directly or indirectly from the sale of securities brokerage services by a taxpayer shall be apportioned to Rhode Island only to the extent that securities brokerage customers of the taxpayer are domiciled in Rhode Island. The portion of net income apportioned to Rhode Island shall be determined by multiplying the total net income from the sale of the services by a fraction: the numerator is the brokerage commissions and total margin interest paid in respect of brokerage accounts owned by customers domiciled in Rhode Island for the taxpayer's taxable year; and the denominator is the brokerage commissions and total margin interest paid in respect of brokerage accounts owned by all of the taxpayer's customers for the same taxable year.²⁰

Florida: The Florida Department of Revenue has held in Technical Assistance Advisement No. 12C1-007 that gross receipts from three hedging transactions: (1) hedges on materials related to its inputs; (2) hedges related to the commodity it sells; and (3) hedges unrelated to items it purchases or sells; were never included in the sales factor, and net receipts from hedges on input materials used by the taxpayer and commodities unrelated to the taxpayer's business are also excluded. However, net receipts from hedging on commodities the taxpayer sells in its business are considered "sales" and included in the sales factor because the taxpayer is engaged in the sale of the underlying commodity.²¹

¹⁹ R.I. Gen. Laws §44-11-14(a)(2); R.I. Code R. 15-04.5

²⁰ R.I. Gen. Laws §44.11.14.2(b); R.I. Code R. 15-04.11(d)(2); R.I. Code R. 15-04.10(g)(2);

²¹ Fl. Dept. of Rev., TAA, No. 12C1-007 May 25, 2011.

INFORMATION AND STAFF ANALYSIS OF ADDITIONAL PUBLIC COMMENTS

The following information is provided in response to the additional public comments (raised after conclusion of the public hearing process) to assist the Uniformity Committee in evaluating those comments. This section is broken down into background information, summary of staff analysis, and information in response to the additional comments of COST, the FIST Coalition, and E&Y – point-by-point.

BACKGROUND INFORMATION

All of the additional public comments concern the treatment of receipts from hedging and certain securities transactions and the loan of cash which are, in turn, related to specific changes to Article IV (UDITPA), Sections 1 and 17, adopted by the Commission in 2014:

- So-called “functional” receipts are now excluded from the definition of “receipts,” and therefore the receipts factor;²²
- Receipts from “hedging” are explicitly excluded from the definition of “receipts;”²³
- Receipts from “the maturity, redemption, sale, exchange, loan or other disposition of cash or securities” are also explicitly excluded from the definition of “receipts;”²⁴ and
- Receipts from the license and from certain sales of intangible property are sourced to the market, but all other receipts from intangible property sales are “throw out” of the receipts factor.²⁵

Some of the additional comments appear to misunderstand how the Commission decided to address securities dealers. The original draft of the changes to the definition of “receipts” included an exception for securities dealers. That exception would have allowed a securities dealer to include in its receipts factor transactional receipts even if explicitly excluded. The Commission’s hearing officer, Professor

²²See the changes to Section 1(g): “Receipts” means ~~all~~ gross receipts of the taxpayer that are not allocated under 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 from hedging transactions and from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities, shall be excluded.

²³Id.

²⁴ Id.

²⁵ See the changes to Section 17(a): “Sales . . . are in this State if the taxpayer’s market for the sales is in this state. The taxpayer’s market for sales is in this state: . . . (4) in the case of intangible property, (i) that is rented, leased, or licensed . . . ; and (ii) that is sold . . . provided that [rules for sourcing certain sales of intangible property not applicable]; and (C) all other receipts from a sale of intangible property shall be excluded from the numerator and denominator of the sales factor.

Richard Pomp, pointed out that inclusion of such receipts for securities dealers would be inconsistent with the changes to Section 17.²⁶ Changes in subsection 17.(a)(4) do not provide for sourcing of receipts from hedging or receipts from securities (or the loan of cash). Furthermore, the changes would require certain receipts to be thrown out from the receipts factor. For this as well as other reasons, the Uniformity Committee recommended that the exception for securities dealers be removed from the changes to the definition of “receipts.” That decision was approved by the Executive Committee and by the Commission. (See further discussion below.)

The Uniformity Committee has recognized that under the changes to Article IV, Sections 1 and 17 adopted by the Commission, the receipts factor may not fairly reflect the market for sales for some taxpayers, including securities dealers. Cases where the receipts factor does not reflect the market would need to be addressed under Section 18, either with special regulations or on an ad hoc basis. The Committee therefore proceeded to first draft amendments to generally implement Sections 1 and 17. It is now considering separate regulations under Section 18 through a work group formed for that purpose. (This is also consistent with the long-standing practice of the Commission in adopting special industry regulations under Article IV, Section 18 as separate models from the General Allocation and Apportionment Regulations.²⁷)

²⁶ See Report of the Hearing Officer, Multistate Tax Compact Article IV (UDITPA), Proposed Amendments, Sec. III.E.3 which states in part: “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 also Sec. III.E.3.i. where the hearing officer responds to the Uniformity Committee’s report on the Draft defending the exclusion of hedging and other securities related receipts as proposed in the amendments, saying: “Because Draft Art. IV.17(a)(4)(ii)(C) already throws out the receipts from hedging and the treasury function . . . Draft Art. IV.1(g) need not address these transactions.” And, further as to the apparent inconsistency in the exception for securities dealers and how a court might view that inconsistency: “. . . 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. . . . The risk of singling out securities dealers as an exception from the treasury function is that other persons exist that perform equivalent activities.” The hearing officer therefore recommended against including the exclusion for hedging or securities related receipts along with the exception for securities brokers and relying on Section 17 entirely. The Uniformity Committee would, instead, recommend the elimination of the exception for securities dealers. This was approved by the Executive Committee and the Commission.

²⁷ One reason why special industry regulations have taken the form of models that are separate from the model General Allocation and Apportionment Regulations (which may contain some basic Section 18 regulations) is that some states may have a policy of adopting such special industry regulations by statute rather than as agency rules.

SUMMARY OF STAFF ANALYSIS OF THE ADDITIONAL PUBLIC COMMENTS

The general thrust of many of the additional comments appears to be to that the Commission should delay adoption of the draft amendments to general regulations for Sections 1 and 17 until all issues under Section 18 can be addressed. As an alternative, some comments appear to suggest that if the Commission adopts the draft amendments to the general regulations, it should also commit to a position on how states should address securities brokers and others who may have substantial receipts from certain securities related transactions.

It would not serve the purpose of the Commission in promoting uniformity among the states who are adopting market sourcing to delay issuance of general regulations, which address a multitude of different activities and industries, in order to address narrower circumstances that may or may not require special rules necessitating further study. (And it is not clear how that delay would help the securities brokers, or others who may have significant receipts from securities related transactions.) Nor would it allow the Commission to respond appropriately to an observation of the hearing officer (for the Article IV changes) that: “The MTC anticipates that key terms [with respect to market sourcing] will be resolved by subsequent model regulations. The substance of those regulations and the speed with which they will be issued will be the key to the MTC’s success in achieving uniformity.”²⁸ In short, it appears that delay in issuing general regulations would be an example of “allowing the perfect to be the enemy of the good.”

As for the Commission’s ability to commit to some particular position on the question of how receipts of securities brokers (and others who may have substantial receipts from certain securities related transactions) should be treated, this would be inconsistent with the Commission’s practice of having the Uniformity Committee study these types of issues before taking a position.

INFORMATION AND ANALYSIS – ADDITIONAL COMMENTS OF COST

1. Contrary to COST’s suggestion, there is no conflict between Sections 1 and 17, and Section 18 special industry regulations.

The COST letter suggests that draft amendments to Sections 1 and 17 regulations conflict with the Formula for the Apportionment and Allocation of Net Income of Financial Institutions (referred to here as model financial institution regulations) recently adopted by the Commission pursuant to Art. IV, Section 18. This is incorrect.

²⁸ Report of the Hearing Officer, Professor Richard Pomp, Multistate Tax Compact Article IV [UDITPA] Proposed Amendments, p. 57.

Proposed amended regulation IV.17.(a).(7)(A) provides: “To the extent that regulations adopted pursuant to Section 18 conflict with provisions of these regulations adopted pursuant to Section 17, the regulations adopted pursuant to Section 18 control.”

Also, at its December 12, 2015 meeting, the Uniformity Committee adopted a change to Reg. IV.(2).(a)(5)(G) which read: “Nothing in this definition shall be construed to modify, impair or supersede any provision of Section IV.18.” The change would add the phrase, “or regulations promulgated thereunder.” (NOTE – this change was inadvertently omitted from the version of the regulations published with the Hearing Officer’s Report, but has been included in the version referred back from the Executive Committee to the Uniformity Committee.)

2. COST’s alternative to delaying the amendments to regulations, which would be to simply exempt certain taxpayers from the operation of changes adopted by the Commission, would simply create different problems.

The COST letter claims that any effort to address special circumstances or industries under Section 18 “will be insufficient” if that effort is completed after the amendments to regulations for Sections 1 and 17. COST proposes that the regulations provide an explicit exception to the exclusion of hedging and certain securities related receipts (etc.) for certain taxpayers. But this does not resolve how those receipts would be sourced under Section 17. Under the Section 17 changes adopted by the Commission in 2014, those receipts could not be sourced (since they are not from the license or from certain sales of intangibles). COST also comments that some states may not adopt the Commission’s model financial institution regulations. But any state that includes receipts in the receipts factor must presumably provide some way to source those receipts—whether by Commission regulations or otherwise.

3. The indicia for when receipts are from “hedging” were considered by the Section 1 work group and the impact of the definition of “hedging” is narrower than COST implies.

COST also takes issue with Reg. IV.(a)(6)(F), which provides: “The taxpayer’s treatment of the receipts as hedging receipts for accounting or federal tax purposes may serve as indicia of the taxpayer’s primary purpose [of engaging in the activity giving rise to the receipts], but shall not be determinative.” COST claims that: “In providing the taxpayer’s accounting or federal tax treatment constitute ‘indicia’ but are not ‘determinative,’ the proposed draft amendments create uncertainty, provide undue latitude to the taxing authority to make audit adjustments, and certainly will produce controversy. As such, we recommend this provision be removed.”

The likelihood of controversy around the definition of hedging is greatly reduced, however, because receipts from securities are either separately excluded or are thrown out under Section 17(a)(4).²⁹ The separate exclusion of receipts from hedging, and therefore the exact definition of “hedging,” will have a much narrower impact since any receipts of hedging done by way of securities trading will already be excluded or thrown out. If, under Section 18, it is deemed necessary to include certain receipts involving securities in the receipts factor in certain situations or for certain taxpayers, then the definition of hedging may take on greater importance. But again, this issue would then be best addressed in that context, under Section 18.

INFORMATION AND ANALYSIS – ADDITIONAL COMMENTS OF THE FIST COALITION

1. Contrary to the Coalition’s assertion, the proposed amendments to Sections 1 and 17 regulations are consistent with the Commission’s changes to Article IV, as well as the Commission’s clear intent.

The FIST Coalition claims:

“It appears that the current draft amendments to the Model General Allocation and Apportionment Regulations do not reflect the intent of the revised UDITPA provisions that the Commission voted on.”

The language the Commission voted on in 2014 is as follows:

g) “Receipts” means all gross receipts of the taxpayer that are not allocated under 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 from hedging transactions and from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities, shall be excluded.

This language is unambiguous. Nor has it been suggested by the Commission or the Executive Committee that it would be appropriate for the Uniformity Committee, through its Section 1 and 17 work groups, to interpret this clear exclusion differently.

2. The May 3, 2012 memo to the Executive Committee, relied upon by the Coalition, does not support its claims.

The FIST letter cites a May 3, 2012 Commission staff document for support. However, the cited parts of that document have nothing to do with receipts from hedging or

²⁹ While there is lingering misunderstanding of these exclusions (see the background section above), no one seems to doubt that the exclusion was intended for “treasury function” receipts and that if receipts from securities transactions are not “hedging” then they are likely to be from treasury function activities.

from securities or the loan of cash. The letter cites the following example from the document:

“4. Taxpayer routinely sells and replaces a certain type of equipment used in the production of its product (e.g. fleet vehicles). Taxpayer’s income from these sales meets that transactional test and as treated as business income. The gross receipts are “sales” factor purposes.”

This has nothing whatsoever to do with the exclusion of receipts from hedging or from securities transactions or the loan of cash. The letter also cites this example:

“5. Taxpayer makes an installment sale and receives interest income on the installment payments. The interest on installment payments is included as gross receipts for sales factor purposes.”

Again, this appears to have nothing to do with the explicit exclusion of “receipts from hedging, from securities, or from the loan of cash.”

3. The Coalition’s assertion that interest and dividends are not excluded cannot be squared with the Commission’s changes to Article IV, Section 1(g) (definition of “receipts”) or Article IV, Section 17(a)(4)(ii)(C).

The FIST Coalition argues that the definition of receipts does not exclude interest from lending or interest and dividends on investments. As to interest from lending, the definition excludes receipts of a taxpayer from . . . loan . . . of cash. If receipts from the loan of cash do not include interest, it is not clear what they do include. As for interest and dividends from investments, those are not explicitly excluded from the receipts factor under the definition of “receipts.” But they are also not explicitly sourced under Section 17 and may be thrown out of the receipts factor under Sec. 17(a)(4)(ii)(C).³⁰ The Uniformity Committee and its work groups have therefore concluded that regulations for sourcing interest and dividends are not appropriate under Section 17 and are to be addressed, instead, under Section 18.

4. The Coalition misreads the importance of the hearing officer’s comments on the changes to Article IV, Section 1(g).

The FIST letter cites the Report of the Hearing Officer – Professor Pomp, where he refers to the exclusion from the definition of receipts as the exclusion of receipts from the “treasury function.” The Coalition claims this supports the view that the Commission did not intend to exclude all receipts from hedging and from securities

³⁰ This was recognized by the Hearing Officer, Professor Richard Pomp. See Section III.E. of that report where he recognizes that the throw-out rule of Sec. 17(a)(4)(iii)(C) applies generally to receipts from securities.

transactions and from the loan of cash. However, the original changes to the definition of receipts as proposed for hearing (and so part of the Hearing Officer’s report) included an exception to the exclusion for securities dealers. That exception for securities dealers could have been (and apparently was) read by the hearing officer as effectively excluding only treasury function receipts.

But, as noted in the summary above, after the public hearing and in response to the hearing officer’s report, the Uniformity Committee recommended changes to the language of Section 1 to remove the apparent conflict between the securities dealer exception and Section 17(a)(4)(ii)(C), which would not source but would throw out receipts from securities transactions.³¹ The Executive Committee, on May 8, 2014, adopted the recommendation to remove the exception for securities dealers (by striking “other than a securities dealer”), so that the language eventually approved by the Commission in July 2014 now excludes all hedging and securities transaction receipts.

Moreover, even if there was any remaining ambiguity about how the final language approved by the Commission should be interpreted, the fact that the one exception for securities dealers was removed from the definition conclusively reflects the intent of the Commission to exclude all receipts from securities.

It should also be noted that the decision to amend the original draft language and exclude the phrase “other than a securities dealer,” was made after much discussion over the course of six months from December 2013 to May 2014, in public calls of the Uniformity Committee. Prior to the May 8, 2014 meeting of the Executive Committee, the staff of the commission published information summarizing the issues, including the issue of the definition of receipts. That issue was also discussed at the Executive Committee’s meeting on May 8, 2014 prior to the vote to strike the language “other than a securities dealer.”³²

³¹ See the Report of the Hearing Officer, Section III.E.3.i: “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. Note that the Uniformity Committee concluded that the opposite approach – changing the definition of receipts rather than Art. IV.17.(a)(4)(ii)(C) was the best approach to resolving the conflict.

³² See, in particular, the Minutes of the Executive Committee’s May 8, 2014 meeting available at: http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Committees/Executive_Committee/

5. The inclusion and sourcing of incidental interest along with receipts from the sale of goods is not an indication that the Commission intended to include in the receipts factor all interest or that the rules for sourcing interest for financial institutions should apply to installment sale-interest instead.

The FIST Coalition claims that Regulation IV.2(a)(6)(A), which provides that gross receipts of a taxpayer engaged in manufacturing and selling goods or products includes “all interest income, service charges, carrying charges or time-price differential charges incidental to such sales,” shows the Commission did not intend to exclude receipts from loaning cash. This does not follow. The inclusion (or exclusion) of incidental receipts, including interest, would presumably not materially alter the proportion of income attributed to the market for the underlying sale (since the receipts are, by definition, incidental). The FIST Coalition also states that “taxpayers who lend to customers . . . should be required to source fees and interest from their lending activity in the same manner as required of financial institutions.” Even if the Uniformity Committee agrees with this assertion, the expansion of the regulations for financial institutions would have to be adopted as part of Section 18.

6. Tabling the issuance of necessary amendments to the General Allocation and Apportionment Rules until all special industry situations can be addressed would delay the issuance of those amendments indefinitely.

The FIST Coalition claims that “adoption of the draft amendments to the Section 1 and Section 17 Regulations before the Section 18 Regulations are written will cause turmoil for taxpayers whose regular trade or business is dealing in hedging and securities.” However, the letter does not explain how adoption of regulations which do not and cannot address receipts of hedging and securities transactions will have such an effect. Nor does it explain how delaying amendments to the general regulations would make any difference to those dealing in securities.

It should also be noted that Section 17 amended regulations do provide for the sourcing of commissions and fees received from the customers of securities dealers. Whether the general approach to using only commissions and fees in the receipts

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which state as follows: The hearing officer had noted a conflict between Art. IV(1)(g) and the proposed Art. IV.17(a)(4)(ii)(C). Under Art. IV.1(g), gross receipts of a securities dealer are included in the receipts factor. But those receipts would be thrown out under Art. IV.17(a)(4)(ii)(C). The Uniformity Committee provided two proposed ways to deal with the discrepancy: strike the phrase “other than a securities dealer” in Art. IV.1(g), or add a new subsection to Art. IV.17 essentially inserting the securities dealer carve-out. The Uniformity Committee recommended the first solution. Upon a motion duly made by Mr. Johnson to recommend consideration of the Uniformity Committee’s recommendation to strike the phrase by the Commission, the motion passed by voice vote.

factor, while excluding other receipts from securities held or sold on the dealer's own account, would actually create distortion is not clear. Rather, this is the kind of special industry question best addressed separately under Section 18.

7. It is not clear how an exception can be made for hedging activities that would not "swallow the rule."

In addition to excluding receipts from securities transactions, hedging receipts are explicitly excluded. So, hedging receipts (at least those involving securities) will generally be subject to a "double exclusion." That is, any receipts that are not "hedging" would likely still be excluded. Moreover, hedging receipts would not generally be sourced and would therefore be thrown out under Section 17(a)(4)(ii)(C). This treatment of hedging was extensively vetted in the public hearing with respect to the amendments to Article IV. For example, the Report of the Hearing Officer makes the following points:

- Draft Art. IV.17(a)(4)(ii)(C) would throw out the receipts from the treasury function (receipts from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities) and from hedging.
- 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).
- . . . 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.
- 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 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.
- 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).

(See these and similar comments in Sec. III.E.3 of the Report of the Hearing Officer, Professor Richard Pomp.)

It is not clear, therefore, that some exception for receipts from hedging can be made except in circumstances in which it is not otherwise possible to fairly represent the income of the taxpayer.

8. The FISC Coalition asks the Executive Committee to do the following:

- Change the draft amendments to the Section 1 and 17 regulations to include receipts from hedging, securities and the loan of cash;
- Table the draft amendments pending adoption of regulations under Section 18, and also direct the Uniformity Committee to continue to take input on any and all issues under Sections 1 and 17 for some extended period of time; or
- Include in the draft amendments a statement that until Section 18 regulations are adopted addressing the inclusion and sourcing of receipts from hedging, securities transactions and the loan of cash, states must apply existing rules as of 12/31/2105.

It is not possible to grant the first request without ignoring the changes adopted by the Commission to Sections 1 and 17. The language excluding receipts from hedging, from securities transactions and from the loan of cash, as well as the provision under Section 17.(a)(4)(ii)(C) throwing out receipts not sourced under Section 17.(a)(4), is simply unambiguous. The issues raised by the Coalition therefore can only be addressed under Section 18.

As to the second alternative request, there is no precedent for indefinitely delaying the issuance of general regulations until some special industry issue can be fully addressed. Taxpayers in a wide variety of industries, and tax administrators in a number of states, need the general rules provided by these amendments to the general regulations to help create a consistent system of market sourcing. (Had the Commission taken the approach of not finalizing general regulations until all special industry rules could be worked out, there would never have been any general regulations.) It would be far more disruptive to the tax system as a whole to leave these general rules in “limbo” indefinitely.

Finally, as for the FIST Coalition’s alternative request—that the amended regulations include an explicit provision stating that, until the Commission adopts specific rules for hedging receipts and receipts of securities dealers, states must continue to use the state specific rules in effect at 12/31/2015—such a provision appears to be unnecessary. Rather, this is a state law issue, to be resolved by the particular states under their own existing authority.

INFORMATION AND ANALYSIS – ADDITIONAL COMMENTS OF E&Y

1. Contrary to the claim that the exclusion of hedging transactions and lending from the definition of “receipts” deviates from the purpose UDITPA because it is distortive, it has been shown that inclusion of such receipts can cause distortion.

Courts have found that inclusion of receipts of securities related transactions, including hedging, is likely to cause distortion because the profit margin on such transactions (and hedging transactions in particular) is likely to be very small while the volume of receipts is likely to be very large in comparison to the taxpayer’s profits on and receipts from sales of products to customers.³³

2. It is not clear in what way exclusion of hedging and lending transactions from “receipts” for state purposes “is inconsistent with the federal treatment of hedging transactions,” as E&Y claims.

To the extent the taxpayer is a financial institution, receipts from lending transactions are included under model rules for such taxpayers adopted by the Commission (revised as of 2015). The federal treatment of hedging centers around the determination of whether gains and losses are ordinary or capital. See Reg. § 1.1221-2. Therefore, it is not clear that the federal rules are relevant to determining whether hedging receipts should be included in the apportionment formula for state tax purposes.

3. The recommended definition of hedging transactions will cause confusion because it is inconsistent with already existing state definitions, which properly identify only specific types of hedging transactions to be excluded.

As noted above, in addition to explicitly excluding hedging receipts, the changes to Art. IV, Sec. 1(g) separately exclude receipts from certain securities transactions. This means that under these changes, hedging done by way of securities transactions will be excluded regardless of the definition of hedging. Also, unlike the argument that there may be some taxpayers for whom receipts from securities related transactions should be included to avoid distortion, it is not clear how an exception can be made for hedging that does not “swallow the rule.”

4. While E&Y claims that the exclusion of all hedging and lending transactions from the definition of a corporation’s receipts is inconsistent with the treatment of hedging and lending transactions for the receipts of financial institutions, such “inconsistent treatment” has long been the rule.

³³ See *General Mills, Inc. v. Franchise Tax Bd.*, 208 Cal.App.4th 1290 (2012)



Financial institutions were originally excluded from UDITPA, both as adopted by the Uniform Law Commission and as incorporated into the Multistate Tax Compact. (See Art. IV, Sec. 2.) This may be because states have long imposed separate taxes on financial institutions or because the drafters recognized that financial institutions have unique activities and unique challenges when it comes to apportionment of income. The first model apportionment regulations for financial institutions were adopted by the Commission in 1994. According to the hearing officer, Alan Friedman, the Commission had been looking at the issue since the 1970s, although a formal effort was not launched until the mid-1980's (and then lost steam after urging from industry to study the matter further). Most recently, amendments to the original regulations were adopted by the Commission in 2015.

The Commission's special industry rules for financial institutions recommend but do not prescribe a definition for states that adopt those rules and therefore the issue of how broadly the rules apply is a state-specific issue. As noted above, the draft amendments under Section 17 make clear that where the financial institutions rules apply, they control.