

ADDITIONAL INFORMATION – PROVIDED TO THE UNIFORMITY COMMITTEE

CONCERNING AMENDMENTS TO SEC. 1 AND 17 REGULATIONS – RECEIPTS FROM HEDGING, INTEREST, AND DIVIDENDS

BY MTC STAFF JULY 12, 2016

On last week's call, questions were raised as to whether amendments to Art. IV, Sec. 1 were understood to effectively exclude all receipts from hedging and from certain securities transactions, and whether it was understood they would also exclude dividends and interest. Also, there was discussion about whether receipts would be excluded from the receipts factor even if they were related to business income.

As a reminder, Sec. 1, as amended, reads in relevant part:

“(g) ‘Receipts’ means all gross receipts … 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.” So, the amendments exclude receipts that meet the functional test or (even if they meet the transactional test) are from hedging, certain securities transactions or the loan of cash.

Staff has previously provided information on the decision to remove an exception for securities dealers from the amendment to Sec. 1 as originally proposed. (See staff memo available here, and in particular Footnote 31 at p. 28): <http://www.mtc.gov/getattachment/Uniformity/ProjecTeams/Section-17-Model-Market-Sourcing-Regulations/Memo-to-the-Uniformity-Committee-June-1-2016.pdf.aspx>). But this memo did not analyze how the remaining language of the amendment ought to be read.

That subject was, instead, addressed by an earlier staff report to the Executive Committee (made prior to hearing on the Art. IV amendments) available here:

[http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Events/2013-14_Committee_Meetings/Exhibit%2020Memo%20from%20Shirley%20Sicilian%20to%20Cory%20Fon%20Art%20IV%2020\(05-03-2012\).pdf](http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Events/2013-14_Committee_Meetings/Exhibit%2020Memo%20from%20Shirley%20Sicilian%20to%20Cory%20Fon%20Art%20IV%2020(05-03-2012).pdf) – starting at page 14. That earlier memo concludes that hedging receipts, receipts from securities transactions, and receipts from dividends and interest would generally be excluded.

The memo first analyzes the commissions existing regulations. It notes that for taxpayers other than securities dealers, “receipts from dividends, or receipts associated with capital gain on the sale of a business,” would typically be functional test receipts and that the Commission’s model regulations, in place since 1973, generally exclude functional test receipts. The memo also notes that later adopted regulations excluded treasury function receipts – “such as repayment of a loan, short-term investments of working capital, or other financial activity – even though income associated with the activity could be included in business income by virtue of the transactional test.”

Then, the memo describes the proposed amendment to Sec. 1:

"This proposal would place the transactional test limitation, which has been in the Commission's model regulations since 1973, into the statute. Some would argue that if an item of income is included in the pool to be apportioned, then the related receipt should be included in the sales factor. But the purpose of the apportionment formula is to use some of the taxpayers' activities that can be geographically located as a means of attributing the source of taxpayers' income which is not, by itself, so easily located. Not all activities from which income arises are included in the apportionment formula, only three: property, payroll, and sales. And not all property, payroll or sales are included.

It's generally agreed that the purpose of the sales factor is to reflect the taxpayer's market activity, not its production activity. Also, basing 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 Commission'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."

That memo also sets out a number of examples of how the amendment would work, including the following:

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.
6. Taxpayer is not a securities dealer, but earns interest income from short-term investment of working capital. This income meets the transactional test and is treated as business income.
 - The gross receipts are not "sales" for sales factor purposes.
7. Taxpayer is not a securities dealer, but earns income from hedging transactions which were entered into mainly to control for variation in input prices. The income from these transactions meets the transactional test and is treated as business income.
 - The gross receipts are not "sales" for sales factor purposes.

As always, if you have questions or you have trouble accessing the documents linked in this message, please let me know.