



MULTISTATE TAX COMMISSION

REPORT

**Meeting of the
Multistate Tax Commission
Doubletree by Hilton Hotel
181 Church Street**

Charleston, South Carolina 29401

Dial-In Number to Participate by Phone: 1 (800) 689-9374 – passcode 371632#

December 10, 2015

8:30 a.m. – 4:30 p.m. Eastern

This report is also available on the MTC website at mtc.gov. Follow the links to the meeting event.

To: Wood Miller, Chairman,
Multistate Tax Commission Uniformity Committee

From: Section 17 Workgroup - Bruce Fort, Counsel, Multistate Tax Commission

Subject: Report on Status of Draft Model Section 17 Regulations Implementing
Market-Based Sourcing of Receipts

Date: December 4, 2015

Introduction

The Section 17 workgroup has been meeting telephonically on a regular basis since last July in public meetings. The workgroup's last meeting was November 17, 2015. The workgroup is chaired by Michael Fatale, Deputy Counsel, Massachusetts Department of Revenue. Participants include Phil Skinner, Idaho (informal reporter), Holly Coon, Alabama, Jeff Henderson, Oregon, Chris Coffman, Washington, Aaishah Hashmi and Nirmail Dhaliwal, District of Columbia, and John Seibert, North Carolina. Other state participants include Scott Fryer, Arkansas, Steve Wynne, Idaho and Jennifer Hays, Kentucky (Legislature). The Commission wishes to express its sincere thanks to these members and our public participants for guiding this effort to its current status, discussed below.

*If you would like additional information about this meeting, contact Helen Hecht, General Counsel,
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Background and Status

The Section 17 model regulation workgroup was established in August of 2014 following the Commission's approval of changes to Multistate Tax Compact Article IV (UDITPA). In November of 2014, the Uniformity Committee voted to use Massachusetts' market-based sourcing regulations as a template for the Commission's Section 17 model regulation. In July of 2015, at the Commission's annual meeting, the Uniformity Committee gave its approval to the drafting group's efforts to that date and provided additional direction to the group on six particular topics, described below.

At this point, the workgroup believes that the draft of the proposed model regulation, which has also been incorporated with the Section 1 workgroup's proposed amendments to the Commission's General Model Allocation and Apportionment Regulation, is ready for the Uniformity Committee's consideration.

The workgroup has also identified issues that need to be addressed with respect to equitable apportionment and special industry regulations under Section 18. The workgroup recommends that the Uniformity Committee approve the market-based sourcing draft before the Section 18 issues are addressed.

Summary of the Issues for Discussion by the Uniformity Committee

At its July 2015 in-person meeting, the workgroup asked the Uniformity Committee to give its input and direction on several issues. The following is a summary of the questions, the direction given by the committee and the way in which the workgroup addressed the issue:

- (a) **Handling of examples.** The draft currently contains 56 examples exemplifying the substantive sourcing rules. Some states discourage the use of examples in regulations. The Uniformity Committee asked that the examples remain in the body of the regulation under their appropriate topics. The current draft includes the examples within the body of the text.
- (b) **“Credit Card Processing Services” included with examples of “Professional Services.”** The workgroup recommended this amendment to the Massachusetts rules and it was approved by the Uniformity Committee in July 2015. This will result in the receipts for such services being sourced to the location where the contract is principally managed by the customer in most instances. See Section IV.17(d)(4)(A) (page 22 of current Section 17 draft).
- (c) **Inclusion of *de minimis* exception for sourcing of certain categories of service receipts:** The exception was suggested by a practitioner as particularly helpful to the financial services industry to reduce compliance costs. The Uniformity Committee declined to approve the particular *de*

minimis exception presented in July 2015 for certain categories of receipts but also instructed the workgroup to continue to look into the concept.

It should be noted that the current integrated draft dated December 3, 2015 (page 22) does include a provision giving a taxpayer the election to include or exclude “insubstantial” amounts of gross receipts if such inclusion or exclusion would not affect the amount of income apportioned to the state. Regulation IV.(2).(a).(6)(E).

The latest draft does not include any additional *de minimis* exception for sales of services or specific types of services but such an exception could be incorporated into “alternative apportionment” rules under Section 18 applicable to some or all types of receipts.¹ It is assumed that states and taxpayers will come to practical resolution of such issues on audit.

(d) Proposed Modification of “Doing Business/Subject to Tax” Standards:

Under Article IV, Section 17, sales to a state or country in which the taxpayer is not taxable are eliminated from the sales factor denominator and numerator. Article IV, Section 3 provides that a taxpayer will be considered “taxable in another state” if “(1) in that State he is subject to . . . tax . . . or (2) that State has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the State does or does not do so.” Current regulations apply the same standard used in determining if a state has jurisdiction to impose tax when the question is whether a foreign country has jurisdiction to impose tax (e.g. “economic nexus”), even though international jurisdictional standards are usually more stringent (“conduct of an active trade or business”).

The workgroup had considered whether some sellers might effectively dilute their domestic receipts factor by including receipts assigned to foreign countries where they would not be subject to that country’s tax. Several provisions of the draft will limit the ability of taxpayers to artificially dilute domestic sales numerators by over-stating the sales denominator. First, a taxpayer must take steps to determine the market or reasonably approximate sales into a marketplace. Second, where population data is used as a secondary method to reasonably approximate receipts from sales (sales delivered electronically or on behalf of a business customer, and licenses of marketing intangibles) the model regulations requires a showing that the service or intangible are “materially” delivered or used outside the U.S. (integrated draft,

¹ IV.18(c)(2) of the prior model apportionment regulations provides: “Insubstantial amounts of gross receipts arising from incidental or occasional transactions or activities may be excluded from the sales factor unless their exclusion would materially affect the amount of income apportioned to this state. For example, the taxpayer ordinarily may include in or exclude from the sales factor gross receipts from transactions such as the sale of office furniture, business automobiles, etc.”

pp. 55, 67.) Finally, the equitable apportionment principles of Article IV, Section 18 could be used to avoid distortive results on an *ad hoc* basis.

The Uniformity Committee asked the Section 17 workgroup to review the issue and to recommend changes. The workgroup has elected to hold off on recommending any proposed changes to regulations under Section 3 for now to allow further study of the necessity for a different standard. The workgroup felt it was not appropriate to delay adoption of the regulation while the issue continued to be studied, in the absence of any evidence that this is a current problem for states with market-based sourcing rules.

(e) Integration of Section 17 with Section 18’s “Equitable Apportionment”

Rules: The workgroup asked the Uniformity Committee about integration of Section 17’s sourcing rules with existing model regulations promulgated pursuant to the “Equitable Apportionment” provisions of Section 18. The Committee approved language providing that: (1) Section 18 remained fully applicable to receipts sourced under Section 17, and (2) Section 18 regulations would take precedence over more general Section 17 regulations. The Committee asked the workgroup to proceed to integrate, as necessary, but suggested that including examples of equitable apportionment situations in the draft, without also adopting substantive rules, would be inappropriate.² The workgroup believes Section 18 issues should be addressed by a separate workgroup and that the adoption of Section 17 regulations should not be delayed.

The Section 1 workgroup has eliminated a number of Section 18 regulations for sourcing sales of non-tangible personal property in the existing model allocation and apportionment regulations, because those regulations assumed the use of a cost-of-performance standard under Section 17 (under Article IV prior to the 2014 amendments).

(f) Special Rules for Transactions with Related Parties: The workgroup informed the Uniformity Committee that a number of states wished to include special rules on related party transactions. The Committee instructed the workgroup to draft those rules with input from a special subcommittee formed for that purpose. The workgroup made the following changes:

1. Added a definition of “related party” (page 39 of December 3 integrated draft);
2. Adopted a general rule specifying that information of a related party intermediary should be imputed to the taxpayer (page 41 of integrated draft);

² The draft addresses what might be thought of as industry-specific issues including software transactions, digital goods and services, and telecommunications. See IV.17.(g).

3. Adopted an exception for professional services provided to a related party, sourcing such receipts to where the related party has operations, based on property and payroll (pages 61 of integrated draft); and
4. Required a taxpayer to assigns receipts from the license of production intangibles to related parties to the location of actual use, eliminating approximation as a means of sourcing (page 67 of integrated draft).

In addition to these issues from the Uniformity Committee’s July meeting, the workgroup discussed and considered a number of other issues. The project page on the MTC website provides an archive of the issues. For example, the workgroup discussed:

(a) Use of U.S. Census Bureau Data for Population Estimates, and Elimination of Special Rule for Determining Percentage of Internet Users.

The workgroup spent some time discussing and researching the best sources for determining both domestic and worldwide population statistics for use in approximating the marketplace for certain sales, and eventually determined that use of U.S. census Bureau population (as of the close of the taxable year) was the most reliable long-term source for that information. The workgroup also voted to eliminate a special provision appearing in earlier drafts that would have required reference to internet use by state and country in some circumstances—in order to simplify the regulations.

(b) Special Rule for Sourcing Attorney Services in Litigation Context.

The treatment of legal services took up a significant amount of time and interest. Under the standard sourcing rules for professional services, those receipts are generally sourced to the client’s principle residence if an individual and to the place where contracts are managed if a business. Several examples (pages 63-64 of integrated December 3 draft) address these rules. The workgroup felt those rules were adequate and declined to make specific rules for litigation-related activities.

(c) Limiting Inclusion of Foreign-Market Sales.

Traditionally, U.S. corporations have made sales overseas through foreign subsidiaries. With the rise of electronic commerce, those sales patterns may change. The model regulation requires that where sourcing is based on rules of reasonable approximation using population data, a taxpayer must demonstrate that it “materially” sold services or marketed a product in an overseas country or that its intangible property was materially used in a foreign country before that country’s population can be added to the sales factor denominator. The workgroup debated adding additional restrictions to such inclusions, including defining “materially” and changing the “subject to tax” provisions, but has declined to so.