



To: Wood Miller, Chair, Uniformity Committee

From: Holly Coon, Chair, Section 18 Model Regulations Working Group
Bruce Fort, Counsel, Multistate Tax Commission

Date: 12/9/16

Re: Report on Activities of Section 18 Model Regulation Working Group

The Uniformity Committee’s “Section 18” working group has been meeting regularly by telephone conference on a weekly basis to develop drafts of proposed model regulations addressing the use of alternative apportionment under Compact Article IV, Section 1(g) and 17, pertaining to the new definition of gross receipts and market-based sourcing, respectively.¹ The working group has concentrated its efforts on developing a proposed model regulation for apportioning the income of special purpose entities that may lack receipts derived from the sale of good and services in the ordinary course of business. That drafting effort is covered in a different document on the Uniformity Committee’s Agenda page. <http://www.mtc.gov/getattachment/Uniformity/Uniformity-Committee/2016/Uniformity-Committee-Meeting-12-2016/section18-status-memofordecember2016final.pdf.aspx>. The Commission’s webpage for the working group, which contains agendas, minutes of meetings and working drafts, can be found here: <http://www.mtc.gov/Uniformity/Project-Teams/Section-18-Regulatory-Project>.

The subcommittee has not yet addressed other possible industries or topics which may benefit from Section 18 model regulations.²

1. Financial Advisors:

One industry sector that might benefit from a special industry regulation are financial advisors, since they often provide services to mutual funds and other investment entities where a possible “look-through” to the fund or entity’s customers may be appropriate. California has struggled to come up

¹ The working group is chaired by Holly Coon, Alabama, and is staffed by counsel for the Multistate Tax Commission. The Commission wishes to thank the following state participants in particular for their advice and suggestions: Michael Fatale, Massachusetts; Phil Skinner and Nate Neilson, Idaho; Scott Fryer, Arkansas, Dee Wald and Matt Peyerl, North Dakota; Jason Larimer and Don Jones, Oregon; Jennifer Hays, Kentucky, Richard Botwright, Pennsylvania; and James Savage, Virginia.

² This memorandum is intended to be educational and explanatory in nature and does not represent the Commission’s legal interpretation of Article IV of the Compact, proposed or existing model regulations, or committee discussions and deliberations. Additionally, this memorandum is intended to offer suggestions for the Uniformity Committee’s consideration and does not constitute a recommendation by the Commission or its staff as to the advisability of any suggestion, idea or proposal.

with appropriate regulations for this industry. Its most recent “final” version of its market-based sourcing regulation, Regulation 25136-2, dropped two proposed examples of how the “look-through” might operate, apparently in response to comments received from industry representatives. See https://www.ftb.ca.gov/law/regs/25136-2/Final_Text.pdf.

2. Securities Dealers.

Receipts from the sales of securities are explicitly excluded from the definition of gross receipts under Compact article IV, Section 1(g). By contrast, California’s definition of receipts excludes securities except for sales of marketable securities by securities dealers. California’s recently finalized market-based sourcing regulations include a section on dealers in marketable securities. The regulations call for sourcing receipts from such sales to the customer’s billing address if an individual and to the customer’s commercial domicile for sales undertaken on behalf of corporations and other business entities. https://www.ftb.ca.gov/law/regs/25136-2/Final_Text.pdf. (pages 16-17.)

It has been suggested that the Commission’s proposed model regulations for sourcing receipts from the sale of professional services already provides adequate guidance to securities dealers, since their commissions on such sales would be considered apportionable “receipts.” See Reg. IV.17(d)(4). The regulation contains two examples of how a “Broker Co.” would assign its commissions from sales to individual customers and business customers. (Receipts from sales to business customers would be sourced to where the customer managed the contracts, not to commercial domicile as in California.) [http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Section-17-Model-Market-Sourcing-Regulations/Sec-1-17-Draft-Regulations-as-of-7-28-16-with-8-10-16-and-10-4-16-modifications-\(1\).pdf.aspx](http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Section-17-Model-Market-Sourcing-Regulations/Sec-1-17-Draft-Regulations-as-of-7-28-16-with-8-10-16-and-10-4-16-modifications-(1).pdf.aspx) (pages 54-55.)

3. Partnership Income:

The working group believes that the states are already in general conformity as to how to source partnership income when received by corporate entities: to the extent the partnership income is considered part of the unitary tax base, generally it is not separately apportioned but the apportionment factors of the partnership are included in the taxpayer’s apportionment formula. Taxation of partnership income for individuals is less uniform although most states impose a source-based tax on individual partners with nexus in the state (enforced through withholding regimes) with a residency based tax for partners with a credit for taxes paid on the same income. The Uniformity Committee may want to consider whether further guidance is needed for apportioning partnership distributions deriving from investment activities and other transactions that would not constitute “receipts” in the hands of a taxpayer under Compact Article IV, Section 1(g).

California has had a detailed regulation in place for apportioning partnership income since the mid-1970’s, spanning some 24 pages. Cal Reg. 25137-1. Modifications to that regulation have been proposed following California adoption of single-sales factor apportionment, market-based sourcing and other California tax developments. The rules were given a final hearing in 2014 but have not been finalized. https://www.ftb.ca.gov/law/regs/25137/07082014_Proposed_Language.pdf.

Although liquidating distributions generating capital gains would ordinarily be excluded from the definition of receipts, the working group has proposed a sourcing rule for such receipts where the taxpayer lacks income from transactions in the regular course of business. That rule would source the

receipts to where the partnership's factors (or possibly, assets) were located in the year preceding the disposition.

4. Amendment of Existing Special Industry Model Regulations:

The subcommittee has not undertaken a review of existing model regulations to ascertain whether the receipts factor sourcing rules in those regulations require amendment in light of the changes to Article IV. These regulations currently utilize market-based sourcing principles but do not always include the level of detail contained in the Commission's proposed model general allocation and apportionment regulations. (Those regulations provide that in the event of a conflict between general allocation and apportionment rules and industry-specific regulations, the latter regulations will control.) While the special industry rules follow market-based sourcing principles, most of the regulations will need updating to incorporate newly-adopted terms, such as "receipts" instead of "sales." The following is a summary of the "receipts" factor sourcing for each special industry:

- a. Airlines:
 - Weighted departures from each state versus departures everywhere.
- b. Construction Contractors:
 - Value (expected revenues) of construction projects located in state versus value of projects everywhere.
- c. Publishing:
 - TTP sales: based on Compact Article IV, Section 16;
 - Advertising Revenue: circulation factor with throw-back to place of distribution if not taxable in destination state;
 - Regional and local advertising: separate accounting for revenue from regional and local ads.
- d. Railroads:
 - Revenue miles for passenger travel in state versus everywhere, with intrastate travel separately allocated to state;
 - Revenue miles for freight and mail in state versus everywhere, with intrastate travel separately allocated to state;
 - All other "business" income apportioned under Compact Article IV, Sections 15-17 and regulations (need to amend references to prior regulation numbers).
- e. Television and Broadcasting:
 - Sales of content and associated advertising revenue to local radio and TV stations assigned to location of stations;
 - Sales of content and associated advertising revenue to networks based on in-state viewers versus everywhere viewers for network;
 - Sales of "film programming" to cable services based on in-state subscribers versus everywhere cable subscribers. No mention of advertising revenue.
 - No mention of satellite TV revenues but "broadcasting" includes satellite transmissions.
 - No mention of internet streaming revenues, e.g., Netflix, Amazon, Hulu.
 - Sales of content in tangible form sourced according to Section 16 TTP rules.

- Sales of intangible content sourced according to Section 17 regulations?
- f. Trucking Services:
- In-state travel revenues separately allocated;
 - All other sales apportioned according to revenue miles in state versus everywhere.
 - Miscellaneous service income sourced under Section 17. May be considered “in-person” services under Commission regulations.
- g. Telecommunications Services:
- Market based sourcing, with throw-out for sales into non-nexus states.
 - Fairly modern regulation (2007).
- h. Financial Institutions:
- Market-based sourcing for interest on loans and related fees and charges;
 - Retains original sourcing location when loans modified or sold;
 - Non-branch investment income sourced to where investment is managed.

5. Other Topics and Possible Special Industry Regulations:

A. Procedural Issues Surrounding Section 18:

The changes to the Multistate Tax Compact’s Article IV approved by the Commission in 2014 and 2015 included not just changes to the definition of receipts, business (now “apportionable”) income and sourcing for sales of services and transactions involving intangible property income. In addition, the Commission approved several changes to Section 18 including: (a) explicit recognition that states had the authority to adopt industry-wide rules; (b) a limitation on penalties where taxing authorities “retroactively” impose alternative apportionment formulas on taxpayers; (c) a prohibition on “retroactive” termination of written equitable apportionment agreements; and (d) rules imposing the burden of proof on the party seeking to invoke equitable apportionment (with a limited exception where the taxpayer has previously used such a methodology). <http://www.mtc.gov/getattachment/Uniformity/Article-IV/Model-Compact-Article-IV-UDITPA-2015.pdf.aspx>.

The working group has not made a detailed evaluation of whether these changes to Section 18 may call for new regulations. Preliminarily, it appears that the additional statutory language is so comprehensive that new regulatory guidance is not currently needed. Additionally, any regulation in this area runs the risk of conflicting with established state tax administrative procedures.

B. Other Possible Special Industry Regulations:

The working group has not received requests to study other potential areas for regulations implementing market-based sourcing and other changes to Compact Article IV. We seek suggestions from the Uniformity Committee, state revenue agencies and interested members of the public.