



MULTISTATE TAX COMMISSION

MEMORANDUM

TO: MTC Uniformity Committees

FROM: Bruce Fort, Counsel, Multistate Tax Commission

DATE: 3/9/07

RE: **Proposal To Adopt Sourcing and Nexus Regulation for Intangible Holding Companies**

The states have had adopted many responses to the proliferation of Intangible Holding Companies (IHC's) which were so widely used in the early and mid-1990's. The state responses have included add-back statutes, currently in place in nineteen states, attempts to challenge the legitimacy of the deductions based on lack of economic substance, and use of representational or economic nexus theory. For states employing the last response, assertion of nexus, UDITPA's sourcing rules for the sales factor presents a second hurdle which must be overcome, which is attributing income from the licensing of trade marks to the state where the license is employed to generate income. (Sourcing rules for the property and payroll factors present less of a problem because a "typical" intangible holding company has almost no property or payroll, and a court should agree that these factors can be eliminated under Section 18 of UDITPA.) Although tax planning has grown ever more sophisticated, a fair number of traditional IHC's continue to operate to this day. A regulation addressed to such companies, while perhaps coming later than it should have, may still be appropriate, since the states' authority to adopt industry-wide regulations under Section 18 of UDITPA is widely accepted.

Section 17 of UDITPA provides that sales other than sales of tangible personal property are sourced to the state where income-producing activity occurs, or, where income-producing activity occurs in more than one state, to the single state with the greatest cost of performance. MTC Model Regulation IV.17.(2) provides that income-producing activity includes the sale, licensing or other use of intangible personal property, while the mere holding of such property is not itself an income-producing activity. The same regulation continues with rules for how to source income from the performance of services, and from the licensing of real property and tangible property. Gross receipts from licensing tangible personal property are assigned to the state wherein the property is located. Gross receipts from performance of a service are generally sourced to the state where the service was performed, with each time spent in each state considered a separate income-producing activity. Regulation IV.17.(3). The regulation mysteriously omits any

rule for sourcing income from the licensing of intangible personal property. Regulation IV.18.(C)(3), however, does address the issue, stating that gross receipts should be assigned to the state where income-producing activity occurs “with respect to income from intangible property.” The regulation provides that “usually”, the income producing activity with respect to sale, licensing or other use of intangible personal property can be readily identified.” *Id.* Reading the two regulations together, one can argue that the “income-producing activity” for an intangible is where it is “used” by a third party, not by the taxpayer. This conclusion can be reached because “use” of the intangible by the licensor would ordinarily not generate a receipt. The “use” must therefore refer to the location of someone else’s use of the property. The drafters of the regulations assume that this location can be readily identified, and so don’t identify that location further.

While it can be argued that UDITPA’s model regulations already provide adequate guidance to taxpayers, additional and specific guidance would certainly aid a court or hearing officer. Adoption of a special industry regulation would also aid courts in upholding both nexus and proper apportionment in the face of arguments that a taxpayer was deprived of adequate notice as to how its income would be sourced. Such a regulation may also the effect of increasing voluntary compliance by foreclosing arguments that a taxpayer was unsure of its filing requirements. In addition, as discussed in a separate paper, use of IHC’s has become so pervasive that some taxpayers have argued that it was incumbent upon tax departments to recognize IHC’s as a separate industry and promulgate regulations under administrative rule-making statutes and MTC Regulation IV.18(a), which provides that Section 18 may only be invoked in unusual factual circumstances.

In 1996, Arkansas adopted a special regulation for the sourcing of income from intangible holding companies. That regulation is set forth below in a modified form. The regulation provides that it is inapplicable where the operating company for the taxpayer has not claimed a deduction (or where the operating company has added-back royalties and interest). The regulation makes clear it is not intended to broaden nexus beyond the IHC situation. I propose that the states consider adoption of Arkansas’s regulation in modified form to preclude future disputes as to proper sourcing of income. The regulations seems to be clear and concise. I am not familiar with any challenges to the regulation.

MODIFIED ARKANSAS REGULATION:

Apportionment of Business Income Arising From Intragroup Intangible Licensing Transactions. —

Apportionment of Business Income Arising From Intragroup Intangible Licensing Transactions

3.1. Determination

3.1.a. In accordance with the terms of {Section 18 of UDITPA} , the Director

determines that the allocation and apportionment provisions of the Article IV do not fairly represent the extent of business activity in the State of Arkansas for taxpayers described in paragraph 3.

3.1.b. A corporation which owns, licenses or manages intangible property has nexus with [adopting state] for purposes of filing a corporate income tax return when the corporation seeks the benefit of economic contact with [adopting state] by directing its economic activity at this State through the licensing of these intangibles in an intragroup intangible licensing transaction.

Definitions

The following words and terms when used in this Regulation shall have the following meanings:

3.2.a. “Group” means two or more corporations which are owned or controlled, either directly or indirectly, by the same interests. Corporations which are eligible for inclusion in a consolidated group for the purposes of filing a consolidated return under the Internal Revenue Code are members of a group. However, corporations which are not eligible for inclusion in a federal consolidated return are still part of a group for the purposes of this regulation if there is common ownership, management or control of the corporations or other factors which demonstrate that one corporation has sufficient influence over the affairs of another to cause the corporations to enter into business transactions with each other.

3.2.b. “Passive intangible holding company” means a corporation which derives some or all of its income from the management and licensing of intangible assets. As used in this Regulation, the terms “passive intangible holding company” and “licensor” shall be recognized as meaning the same corporation.

3.2.c. “Intragroup intangible licensing transaction” means a license of intangible property rights between two or more members of a group, if one of the parties to the transaction is a passive intangible holding company. Intragroup intangible licensing transactions shall include, licensing of trademarks, trade names, patents, copyrights, and any other transaction authorizing the use of intangible property in this State.

3.2.d. “Intangible income” means income generated by an intragroup intangible licensing transaction.

3.2.e. “Licensee” means the group member which recognizes an expense for the use of the passive intangible holding company's intangible property.

3.2.f. “Measuring activity” means such action on the part of the licensee which, pursuant to the terms of a licensing agreement, serves as the basis for determining the extent of the licensee's liability for payment of intangible income.

Application

This Regulation shall apply only to taxpayers which have the following characteristics:

3.3.a.i. The taxpayer is a passive intangible holding company;

3.3.a.ii. The taxpayer receives business income from intragroup intangible licensing transactions with one or more other members of the same group doing business within the jurisdiction of this State; and

3.3.a.iii. At least one of the other members of the same group from which business income is received by the taxpayer is subject to the tax imposed by the [adopting state].

3.3.b. A passive intangible holding company shall not be subject to the provisions of this regulation for income derived from any intragroup intangible licensing transaction if the licensee does not claim a deduction on its [adopting state] income tax return for expenses associated with the intragroup intangible licensing transaction or if those expense have been added back into the licensee's taxable income pursuant to [add-back statute]. If the licensee elects to forego this deduction, the passive intangible holding company shall not be required to report the income from the intragroup intangible licensing transaction for [adopting state] income tax purposes.

3.4. Business Income

3.4.a. Where a taxpayer meeting the requirements of paragraph 3 has income from sources both within and without this State, the amount of business income from sources within this state shall be determined pursuant to [Article IV] except as modified by this regulation.

3.4.b. If a passive intangible holding company has income both from intragroup intangible licensing transactions and from other sources, the income derived from sources other than intragroup intangible licensing transactions shall not be subject to [adopting state] income tax unless the income would have been taxable in [adopting state] regardless of the intragroup intangible licensing transactions. The purpose of this regulation is to require passive intangible holding companies to apportion income derived from intragroup intangible licensing transactions and pay [adopting state] income tax on that apportioned income. This regulation is not intended to require the apportionment of other income which would not have otherwise been subject to [adopting state] income tax.

3.5. Sales Factor-Intragroup Intangible Licensing Transactions

For purposes of computing the sales factor of a passive intangible holding company, sales or receipts arising from an intragroup intangible licensing transaction are in this State and shall be included in the numerator of the sales factor as follows:

3.5.a. If the licensing agreement states a method of measuring the activity between the licensor and licensee which accurately reflects the licensor's business activity attributable to this State, then the sales or receipts shall be included in the numerator of the sales factor as provided in the licensing agreement.

3.5.b. If the licensing agreement does not state a method of measuring the activity between the licensor and licensee, then the measuring activity shall be based on one of the following methods that accurately reflects the licensor's business activity attributable to this State:

3.1. If licensee is engaged in an activity which generates sales or receipts, the numerator of the sales factor shall include licensee's percentage of sales in this State compared to the licensee's total sales; or

3.2. If licensee is engaged in an activity which does not generate sales or receipts, the numerator of the sales factor shall include licensee's percentage of units produced, or cost of units produced, in this State compared to the licensee's total units produced, or total cost of units produced; or

3.3. If neither of the above methods accurately represent the licensor's business activity in this state, the licensor may petition for or the [Director] may require any other method which will accurately represent the licensor's business activity attributable to this State.

If the licensing agreement states a method of measuring the activity between the licensor and licensee in addition to a specifically stated dollar amount, the sales or receipts attributable to this State shall be based on the stated measuring activity plus the specifically stated dollar amount computed based on one of the methods stated in 5(b) which accurately reflects the licensor's business activity attributable to this State.

Examples

The following examples are provided as guidance for purposes of determining whether an intangible income measuring activity is deemed to be readily identifiable to a specific activity occurring within a unique geographic location.

a. A licensing agreement provides that royalty income is to be based upon a percentage of licensee's total sales. Such a measuring activity accurately reflects the licensor's business activity occurring within [adopting state] due to the fact a

licensor may determine the specific geographic location of the sales which generated the licensor's entitlement to income as outlined in paragraph 5(a).

b. A licensing agreement provides that royalty income is to be based upon the number of stores displaying a licensed trademark. Such a measuring activity accurately reflects the licensor's business activity occurring within [adopting state] due to the fact a licensor may determine the specific geographic location of the stores which generated the licensor's entitlement to income as outlined in paragraph 5(a).

c. A licensing agreement provides that royalty income is to be based upon a fixed quarterly amount. Such a measuring activity is *not* readily identifiable to a specific activity occurring within a unique geographic location due to the fact the royalty income is not based upon an identifiable activity. If the licensee's business activity generates sales or receipts, the numerator of the licensor's sales factor shall be calculated as outlined in paragraph 5(b)(1) of this regulation. If the licensee's business activity does not produce sales or receipts, then the numerator of the licensor's sales factor shall be calculated as outlined in paragraph 5(b)(2) of this regulation.

Effective Date

This Regulation shall be effective for tax years beginning on or after _____.

Penalty

No penalty shall be assessed against any taxpayer for failure to make estimated tax payments for the first year a tax return is due as a result of this regulation.