



MULTISTATE TAX COMMISSION

*Working Together Since 1967 to Preserve Federalism and Tax Fairness*

**To: Robynn Wilson, Chair**  
**Members of MTC Income & Franchise Tax Uniformity Subcommittee**  
**From: Shirley Sicilian, General Counsel**  
**Date: October 8, 2010**  
**Subject: Model Compact Art. IV.17 Amendments**

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## **I. Background**

At its July, 2009 meeting, the Executive Committee directed that “revisions to Article IV of the Compact - specifically, the five areas suggested as focal points for ULC’s revision project - be referred to the Uniformity Committee and that [the Uniformity Committee] come back to the Executive Committee if the Uniformity Committee recommends the scope of issues be changed.” The five areas are:

Primary concern -

1. Sales factor numerator sourcing for transactions other than sales of tangible personal property – Art.IV.17

Other important concerns -

2. Definition of Sales – Art.IV.1(g)
3. Definition of Business Income – Art.IV.1(a)
4. Factor Weighting – Art. IV.9
5. Distortion Relief Provision - Art.IV.18

The Uniformity Subcommittee started with revisions for item 1, sales factor sourcing, and has answered an original and a follow-up list of policy questions over discussions that covered three in-person meetings and five teleconferences.<sup>1</sup> Based on this policy direction, the drafting group has produced the next draft for the Subcommittee’s consideration at our October 19, 2010 teleconference (Attachment A).<sup>2</sup> We’ve also produced a list of three follow-up questions for section 17 (Attachment B). Because the third follow-up question overlaps with some of the decisions that must be made in revising Art. IV.1(g), the definition of “sales,” we’ve attached a policy question

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<sup>1</sup> The in-person meetings were held December 1-2, 2009, March 2-3, 2010, and July 25-26, 2010. The five teleconferences were held January 22, 2010; February 3, 2010; February 17, 2010; May 13, 2010, and June 22, 2010. At its December, 2009 meeting, the subcommittee heard educational presentations from Professor Richard Pomp, Alva P. Loisel Professor of Law, University of Connecticut School of Law; Mr. Prentiss Wilson, former Ernst & Young National Director of State and Local Tax Practice and Procedure; Professor Michael McIntyre, Professor of Law, Wayne State University Law School; and Professor Charles McClure, Herbert Hoover Business School, Stanford University.

<sup>2</sup> The Drafting Committee includes Joe Garrett, AL; Ben Miller and Melissa Potter, CA-FTB; Ted Spangler, previously with ID and now retired; Michael Fatale, MA; Eric Smith, Gary Humphrey, Debra Buchanan, OR; and MTC Staff – Bruce Fort and Shirley Sicilian.

list for that provision as well (Attachment C). We've also attached a list of tax policy factors to consider in answering these follow-up questions (Attachment D).

## II. Summary of Current Draft Proposal (See Attachment A)

- **Market Sourcing.** Art. IV.17 sources a receipt to the location of the “income-producing activity” that produced it. If that activity occurs in more than one state, then the receipt is sourced to the state with the “greater proportion of income-producing activity ... based on costs of performance.” The Subcommittee found this rule tends to source to the location of production, thereby duplicating the purpose of property and payroll factors and missing the purpose of the sales factor, which is to recognize market states. The Subcommittee directed that the draft explicitly source to the market state.

- **Specified Location for Four Transaction Types.** Art. IV.17 sources receipts from all transactions other than sales of tangible personal property according to a single, “income-producing activity” rule. The Subcommittee found that the vagueness of this rule, perhaps necessitated by its enormously broad application to all but one type of transaction, makes it hard to apply, as a practical matter, to the various different categories of transactions. The Subcommittee directed that the draft more specifically define a reasonable location of “market” for each of four broad categories of transactions:

- Sale of services – to the location of delivery; and if that location cannot be determined, it shall be reasonably approximated. This rule is similar to UDITPA sales factor sourcing for sales of tangible personal property.
- Sale or lease of intangibles – to the location of use. This rule is similar to UDITPA allocation rule for non-apportionable income from intangibles.
- Lease of tangible personal property – to the location of the property. This rule is consistent with the current MTC model regulations, which hold that the income producing activity associated with a lease of tangible property takes place at the location of the property.
- Sale or lease of real property – to the location of the property. This rule is consistent with the current MTC model regulations, which hold that the income producing activity associated with the sale or lease of real property takes place at the location of the property.

- **Proportional, rather than “All or Nothing.”** Art. IV.17 sources an entire receipt to the single state with the “greater proportion of income producing activity.” The Subcommittee found the current rule can result in unnecessarily volatile and possibly arbitrary sourcing where activity, based on cost of performance, is spread nearly uniformly over several states. The Subcommittee directed that the amendment allow a single receipt to be sourced among multiple states, and the “to the extent that” language is intended to accomplish that direction.

- **Throwout.** Art. IV.16 contains a throwback rule to address the potential for “nowhere income.” But Art. IV.17 does not. The Subcommittee recognized that throwback is a difficult concept to apply in the case of services, and that the potential for “nowhere income” may be low under the current rule; which, by sourcing to the location of performance, tends to source to the location of property or payroll and thus to a state where nexus would likely exist. However, the proposed rule, like Art. IV.16, would source receipts to the market state. And although the existence of a market may generally

allow for the exercise of nexus with respect to intangibles and service transactions unimpeded by P.L.86-272, the Subcommittee directed the inclusion of a throwout provision for whatever non-nexus situations may arise, and for situations where the specified sourcing rule is not determinable.

**III. Next Step –Address Remaining Policy Questions, Conceptual Regulatory Direction, Circulate to Taxpayers (See Attachments B, C, D)**

The next step is for the Subcommittee to address the three remaining questions for revising Art.IV.17 (Attachment B). We hope that during the October 19, 2010 teleconference we can get Subcommittee direction on the first two of the remaining three section 17 related questions, and begin discussing the third question which involves the definition of “sales” as well as section 17 sourcing (See Attachment C). The Subcommittee has indicated it would like to complete recommended amendments for the definition of “sales” before finalizing amendments to section 17.

We have another teleconference scheduled for November 16, 2010 at 3:30 Eastern, when we hope to continue our discussion of the third question. And then we have set aside the entire morning of December 7, 2010 to discuss, and possibly finalize, this stage of the drafting at our in-person meeting in Atlanta, Georgia. After this drafting stage is complete, the Subcommittee has indicated it would like to give some conceptual regulatory direction, and then circulate the draft for taxpayer input prior to a final Uniformity Committee vote.

The Subcommittee may wish to establish work objectives and timelines for completing section 17 amendments and for reviewing each of the other four Compact provisions.



MULTISTATE TAX COMMISSION

*Working Together Since 1967 to Preserve Federalism and Tax Fairness*

**Model Compact Art. IV.17 Amendments**  
**Income & Franchise Tax Uniformity Subcommittee Working Draft**  
*Section 17 - As of July, 2010*

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- 17(a) Sales, other than sales described in Section 16, are in this State if the taxpayer's market for the sale is in this state. The taxpayer's market for a sale is in this state:
- (1) In the case of sale, rental, lease or license of real property, if and to the extent the property is located in this state;
  - (2) In the case of rental, lease or license of tangible personal property, if and to the extent the property is located in this state;
  - (3) In the case of sale of a service, if and to the extent the service is delivered to a location in this state; provided, that if such location cannot be determined, it shall be reasonably approximated;
  - (4) In the case of sale, lease or license of intangible property, if and to the extent the intangible property is used by the payor in this state; provided, that if the location of such use cannot be determined, it shall be reasonably approximated.
- (b) If the taxpayer is not taxable in a state to which a sale is assigned, or if the state of assignment can not be determined under subsection (a), such sale shall be excluded from the denominator of the sales factor.



MULTISTATE TAX COMMISSION

*Working Together Since 1967 to Preserve Federalism and Tax Fairness*

**Model Compact Art. IV.17 Amendments  
Income & Franchise Tax Uniformity Subcommittee**

**Remaining Policy Questions  
For Discussion Purposes Only  
October 8, 2010**

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1. **Explicit Regulatory Authority.** Should an explicit reference to regulatory authority be added to Section 17? For example:

17(c) The tax administrator may proscribe regulations as necessary or appropriate to carry out the purposes of this section.”

2. **“Reasonable Approximation”.** With the removal of the “cascade” language, is it necessary that the statute explicitly authorize “reasonable approximation” directly in the sourcing provision (a)?

- A. Would “reasonable approximations” be better as part of the “contingency” provisions under 17(b)? For example:

17(a) Sales, other than sales described in Section 16, are in this State if the taxpayer’s market for the sale is in this state. The taxpayer’s market for a sale is in this state...

(3) In the case of sale of a service, if and to the extent the service is delivered to a location in this state; ~~provided, that if such location cannot be determined, it shall be reasonably approximated;~~

(4) In the case of sale, lease or license of intangible property, if and to the extent the intangible property is used by the payor in this state; ~~provided, that if the location of such use cannot be determined, it shall be reasonably approximated.~~

(b) If the taxpayer is not taxable in a state to which a sale is assigned, or if the state of assignment ~~under subsection (a)~~ under subsection (a) can not be determined ~~under subsection (a) or reasonably approximated~~, such sale shall be excluded from the denominator of the sales factor.

- B. Or, could “reasonable approximations” be allowed, and better addressed, through regulation?

**3. Sale or License of Intangible Property.** When the taxpayer sells or licenses intangible products, how should we source the receipts from that sale or license? In **section 3.A**, we consider sourcing for receipts from intangibles that are sold or licensed by the taxpayer as a product which the taxpayer provides to its customers. In **section 3.B**, we consider receipts from non-inventory, business assets – such as good will, working capital, or treasury function related investment assets – that are or were used in Taxpayer’s own unitary business.

**A. Receipts from intangible property that was held as inventory for sale or license to taxpayer’s customers.** These would include receipts from intangibles transactions occurring in the course of the taxpayer’s regular trade or business, including receipts from intangibles that had been held as inventory for sale or license to customers – such as, logo’s, cartoon characters, or patents/copyrights that are held for sale/license in the ordinary course of business to taxpayer’s customers.

**i. Sourcing options.** Where is the “market” for the sale or licensing of intangible property?

- a. Where delivered? (Same rule as used for tangible property in current model and for services in draft model.)
- b. Taxpayer’s commercial domicile?
- c. Customer’s commercial domicile?
- d. Customer’s billing address?
- e. Customer’s office from which product was ordered?
- f. As provided by contract?
- g. Customer’s activities?
  - (1) Customer’s use of the intangible in state? (E.g., customer’s production of a patented product in the state. Or customer’s use at the time of purchase? And, if used in more than one state, a ratio of the customer’s location of use at the time of purchase in this state compared to the customer’s location of use at the time of purchase everywhere?)
  - (2) Customer’s sales to customer’s customers in state? (Or customer’s sale of a product to customer’s customers that results in fees for the taxpayer.)
- h. Population (relative to other states in the area where the taxpayer’s customer is permitted to use the intangible)?

**ii. Use multiple sourcing options?**

- a. **Differentiate between different types of transactions?** *See, e.g., CA draft in appendix*
  - (1) **Complete transfer** (Sale)
  - (2) **Anything less than a complete transfer** (Licensing, leasing, rental or other permission to use of intangible property, including franchises, patents, copyrights, licenses, plans, specifications, blueprints, processes, techniques, formulas, designs, layouts, patterns, drawings,

manuals, technical know-how, and contracts pursuant to a licensing, leasing, rental, or similar agreement, etc.)

- b. **Differentiate between different types of intangibles?** *See, e.g.,* MA rule (partially superseded) in appendix.
  - (1) **Commercial and Trade intangibles** (e.g., commercial intangibles may include patents, know-how, designs and models used in production of goods or provision of services, and computer software; and trade intangibles may include research and development activities. OECD)
  - (2) **Marketing intangibles** (e.g., marketing intangibles include trademarks and trade names used to commercially exploit a product or service, customer lists, distribution channels, and unique names, symbols, or pictures with important promotional value. OECD)
  - (3) **“Mixed” intangibles.**
  
- c. **Differentiate between different types of customers?**
  - (1) **Individual persons, main street business vs. multistate businesses?** Customers that are individual persons or “main street businesses” are likely to be more easily located in a single state because all relevant activities are more likely to be in that single state. But when the customer is a multistate business with activities in more than one state, then do we need to more specifically identify which activity(s) will determine the state to which we’ll source?
  - (2) **Related entity customers vs. unrelated entity customers?** If the general rule is conceptually good for most situations, but might allow for manipulation, should we consider a special rule for situations where taxpayer and customer are related entities?
  
- d. **“Cascades?”** Should alternative rules be provided in the statute for those situations where information needed to source based on the primary rule(s) is not “readily determinable?” Or should “reasonable approximations” of the primary rule be allowed in statute and/or identified in regulations? *See, e.g.,* CA draft rule, MA rule (partially superseded), both in appendix.

**B. Receipts from sale or license of intangible property that is or was used as a business asset in TP’s unitary business.** These would include receipts from non-inventory, business assets that are or were used in Taxpayer’s unitary business – such as good will, working capital, treasury function related investment assets, or patents/copyrights that had previously been used by the taxpayer to manufacture its own product for sale to its customers.

- i. **Included in gross receipts?** *See* policy checklist for definition of “sales.” Should the sales factor include gross receipts from transactions involving taxpayer’s intangible property that is not inventory, but is (or was) instead used in the unitary business? Should the answer to this question be the same as for gross receipts from transactions involving taxpayer’s other (real and TPP), business assets?

- ii. Sourcing options** (if included in gross receipts):
  - a.** The same as receipts from intangible products sold or leased (marketed) to “customers” are sourced?
  - b.** The same as receipts from sale of real or tangible assets used in the business would be sourced?
  - c.** Buyer’s commercial domicile?
  - d.** Taxpayer’s commercial domicile? *See, e.g.,* UDITPA or MA rule (partially superseded), both in appendix.

–Appendix to Remaining Section 17 questions –

**1. UDITPA**

6. (c) Capital gains and losses from sales of intangible personal property are allocable to this State if the taxpayer's commercial domicile is in this State.
7. Interest and dividends are allocable to this State if the taxpayer's commercial domicile is in this State.
8. (a) Patent and copyright royalties are allocable to this State: (1) if and to the extent that the patent or copyright is utilized by the payer in this State, or (2) if and to the extent that the patent or copyright is utilized by the payer in a State in which the taxpayer is not taxable and the taxpayer's commercial domicile is in this State.  
(b) A patent is utilized in a State to the extent that it is employed in production, fabrication, manufacturing, or other processing in the State or to the extent that a patented product is produced in the State. If the basis of receipts from patent royalties does not permit allocation to States or if the accounting procedures do not reflect States of utilization, the patent is utilized in the State in which the taxpayer's commercial domicile is located.  
(c) A copyright is utilized in a State to the extent that printing or other publication originates in the State. If the basis of receipts from copyright royalties does not permit allocation to States or if the accounting procedures do not reflect States of utilization, the copyright is utilized in the State in which the taxpayer's commercial domicile is located....

**2. CA draft regulation:**

- (d) Sales from intangible property are assigned to this state to the extent the property is used in this state.
  - (1) In the case of the complete transfer of all property rights in intangible property for a jurisdiction or jurisdictions, not including the use, licensing, lease, rental or other use of intangible property, including patents, copyrights, licenses, plans, specifications, blueprints, processes, techniques, formulas, designs, layouts, patterns, drawings, manuals, technical know-how, and contracts, the sales are properly assigned to this state when:
    - (A) The intangible property is used by the purchaser at the time of purchase exclusively in this state;
    - (B) The intangible property is used by the purchaser at the time of purchase in this state and another state to the extent of the purchaser's location in this state as compared to the customer's locations everywhere the property is used;
    - (C) If the extent of the use of the intangible property in this state cannot be determined pursuant to subsections (A) or (B), it shall be reasonably approximated by reference to the activities of the customer;
    - (D) If the extent of the use of the intangible property cannot be determined pursuant to paragraphs (A), (B), or (C), then the gross receipt shall be assigned to the billing address of the customer.
  - (2) In the case of the licensing, leasing, rental or other use of intangible property, including patents, copyrights, licenses, plans, specifications, blueprints, processes, techniques, formulas, designs, layouts, patterns, drawings, manuals, technical know-how, and contracts pursuant to a licensing, leasing, rental, or similar agreement, not including sales of intangible property provided for in subsection (1), sales are properly assigned to this state:
    - (A) To the extent the intangible property is used in this state by the taxpayer's customer as is provided for by the contract between the taxpayer and the taxpayer's customer;

- (B) If the intangible property is used by the taxpayer's customer in this state and another state and the extent it is used in this state is not determinable pursuant to subsection (A), the extent of the use shall be measured by the volume of the tangible personal property which is sold by the taxpayer's customers to the customer's customers at or from locations in this state and which gives rise to payments to the taxpayer as compared with total sales of the taxpayer's customers;
- (C) If the extent of the use of the intangible property in this state cannot be determined under subsections (A) or (B), it may be reasonably approximated by reference to the activities of the customer; or
- (D) If the extent of the use of the intangible property in this state cannot be determined pursuant to subsections (A), (B), or (C), then the gross receipts shall be assigned to the commercial domicile of the taxpayer's customer.

### 3. MA Regulation (partially superseded)

d. In the case of the sale of a taxpayer's good will, or of the sale of other intangible property in a transaction not treated as a license ... the income producing activity is deemed to take place at the location of the taxpayer's commercial domicile.

c. In the case of the licensing of intangible property, the income-producing activity is deemed to be performed in the commonwealth to the extent that the intangible property is used by the licensee in the commonwealth. Intangible property generally includes copyrights, patents, trademarks, trade names, trade secrets, contract rights including broadcast rights, and similar intangibles where the use of the property may be transferred separately from ownership, provided that intangible property licensed as part of the sale of tangible property is treated as the sale of tangible property, and sales of good will and other intangible property are governed by 830 CMR 63.38.1(9)(d)3.d. A sale of intangible property that resembles a license, such as a contingent payment sale (a sale in which the receipts from the sale of the intangible property are contingent upon the use, productivity or disposition of property by the purchaser), will be treated as a license under this 830 CMR 63.38.1(9)(d)3.c.

i. Sourcing of separately identifiable items of income. For purposes of the provisions of 830 CMR 63.38.1(9)(d)3.c., each use of intangible property by a licensee that results in a separately identifiable item of income for the taxpayer is considered a separate use of the intangible property. For example, in the case of licenses or similar arrangements compensated by a percentage of the licensee's sales, each sale by the licensee that results in a payment to the licensor whether separate from or combined with other payments is a separate use. Except as otherwise stated herein, use of intangible property by a sublicensee does not constitute use for purposes of 830 CMR 63.38.1(9)(d)3.c., provided however that the Commissioner may take into account use by and activities of sublicensees in the case of licensing, sublicensing, or similar relationships among affiliated taxpayers.

ii. Attributing sales to place of use.

(A) License of marketing intangibles. Where a license is granted for the right to use intangible property in connection with the sale, lease, license, or other marketing of goods, services, or other items (i.e., a marketing intangible), the royalties or other licensing fees paid by the licensee for such right are attributable to the commonwealth to the extent that the fees are attributable to the sale or other provision of goods, services, or other items purchased or otherwise acquired by Massachusetts customers. In the absence of actual evidence of the licensee's receipts derived from Massachusetts customers, the

licensing fee will be attributed to the commonwealth based upon the percentage of the Massachusetts population in the geographic area in which the licensee is permitted to use the intangible property to market its goods, services or other items. Examples of a license of a marketing intangible include the license of a service mark, trademark, or trade name. Where the license of a marketing intangible is for the right to use the intangible property in connection with sales or other transfers at wholesale rather than directly to retail customers, the licensing fee will be attributed to the commonwealth based upon the percentage of the Massachusetts population in the U.S. geographic area in which the licensee's goods, services, or other items are ultimately marketed using the intangible property.

- (B) License of non-marketing intangibles. Where 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 (i.e., a non-marketing intangible), the licensing fees paid by the licensee for such right are attributable to the commonwealth to the extent that the use for which the fees are paid takes place in Massachusetts. In such cases, it shall be presumed that the use takes place in the state of the licensee's commercial domicile unless the taxpayer or the Commissioner can reasonably establish the location(s) of actual use. Where the Commissioner can reasonably establish that the actual use of intangible property pursuant to a license of a non-marketing intangible takes place in part in Massachusetts, it shall be presumed that the entire use is in Massachusetts except to the extent that the taxpayer can demonstrate that the actual location of some or all of the use takes place outside Massachusetts. Examples of a license of a non-marketing intangible include 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 such process.
- (C) License of mixed intangibles. Where a license of intangible property includes both a license of a marketing intangible and a license of a non-marketing intangible and the fees to be paid in each instance are separately stated in the licensing contract, the Commissioner will accept such separate statement for purposes of this section if it is reasonable. Where a license of intangible property includes both a license of a marketing intangible and a license of a non-marketing intangible and the fees to be paid in each instance are not separately stated in the contract, it shall be presumed that the licensing fees are paid entirely for the license of the marketing intangible except to the extent that the taxpayer or the Commissioner can reasonably establish otherwise.



MULTISTATE TAX COMMISSION

*Working Together Since 1967 to Preserve Federalism and Tax Fairness*

**Income & Franchise Tax Uniformity Subcommittee  
Model Compact Art. IV.1(g) Amendments – Definition of “Sales”**

**Policy Question List  
October 8, 2010**

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- I. Should “sales” continue to be broadly defined as “all gross receipts,” or more narrowly defined to reflect the taxpayer’s market by including only receipts from taxpayer’s sales of its product to its customers? Is it appropriate to include a receipt from the sale of a production asset in the sales factor when the value of that asset is already included in the property factor? Is it necessary to include such a receipt when the income from the sale reflects value that accrued and depreciation expense which was taken against income generally over a long period of time? Should the sales factor include all items of business income?
- A. Rationale for Narrow approach: The role of the sales factor in the apportionment formula is to reflect the contribution of the market, or the demand side, to the earning of income. The property and payroll factors represent, respectively, the contribution of capital and labor or, collectively, the supply side. The factors themselves are not what is being taxed, they only reflect activities that give rise to income. As such, the items included in any factor should only reflect the activities it is designed to represent. It is therefore unnecessary, and in fact may be counter-productive, to include an item in the factor if it does not reflect that activity. In the case of the sales factor, only those items that represent the market, sales to customers, should be included. Because the sales factor is intended to balance the property and payroll factors it should be defined to offset rather than amplify the effects of the property and payroll factors. But including receipts from the sale of assets used in the business Because the purpose of the sales factor is to balance the other two factors, the use of those two elements to assign sales, costs of production, should be avoided. (*See*, Appendix – example of statute using narrow approach)
- B. Rationale for Broad approach: Reflects current model. Responsive to claim that: If a net receipt is included in the pool of income to be apportioned, the corresponding gross receipt should be included in the sales factor used to apportion it. Also, omitting receipts from a large asset sale could result in distortion to the extent the state does not include a property factor in its apportionment formula. For example, if taxpayer made a large gain on the sale of production assets located in a single sales factor state where it had made relatively few sales, and if that gain made up a significant part of the taxpayer’s apportionable income, then the State’s single sales factor apportionment formula may

produce a mismatch between where the apportionable income arose and where it's being apportioned. Including these types of receipts in the sales factor, and sourcing them to the location of the asset that produced the receipt, could alleviate this mismatch. Even states that do have a property factor could experience distortion if the sale took place early in the year (so that the property that produced the gain is not fully included in the property factor). If these situations occur and create distortion on a regular basis, then *ad hoc* relief under section 18 may not be the most efficient remedy. (See, Appendix – example of statute using broad approach)

II. If sales continue to be broadly defined, should the statute be amended to exclude certain receipts that generally create distortion, or do current model regulations adequately excluded these types of receipts?

- A. repayment, maturity, or redemption of the principal of a loan, bond, or mutual fund or certificate of deposit or similar marketable instrument;
- B. the principal amount received under a repurchase agreement or other transaction properly characterized as a loan;
- C. proceeds from issuance of the taxpayer's own stock or from sale of treasury stock;
- D. damages and other amounts received as the result of litigation;
- E. property acquired by an agent on behalf of another;
- F. tax refunds and other tax benefit recoveries;
- G. pension reversions;
- H. contributions to capital (except for sales of securities by securities dealers);
- I. income from forgiveness of indebtedness;
- J. amounts realized from exchanges of inventory that are not recognized by the Internal Revenue Code
- K. receipts related to transactions involving liquid assets held in connection with one or more treasury functions of the taxpayer;
- L. receipts from hedging transactions involving intangible assets, including options contracts to hedge foreign currency.

III. Implication for Section 17 statutes and regulations

- A. If we choose a narrow approach, there is no need for numerator sourcing of receipts from sale of intangible assets used in the unitary business.
- B. If we choose a broad approach, we need to consider numerator sourcing for receipts from sale of intangible assets used in the unitary business. E.g.:
  - 1. Location of the related tangible asset?
  - 2. Taxpayer's commercial domicile?
  - 3. Customer's commercial domicile?
  - 4. Different rules for some or all types of intangible asset sales? (e.g., receipts from sale of goodwill sourced to location of business's tangible assets; receipts from treasury function transactions sourced to location where function performed; etc.?)

IV. Should the statute specify that sales are eliminated in the context of combined reporting, or is this something that, if it should be done, should be done either in the combined reporting statutes or by regulation?

– Appendix –  
**Definition of Sales – Examples Illustrating Narrow and Broad Approaches**  
*Illustrations For Discussion Purposes Only*

• **Narrow Approach - Example**

- 1(g) “Sales” means total amounts received from a customer for:
- (A) goods, products or other property which would properly be included in the inventory of the taxpayer if on hand at the close of the tax period,
  - (B) provision of services, or
  - (C) rental, lease or licensing of property.

Accompanying regulation, or continuation of statute:

For purposes of this definition, “total amounts received” means the sum of money and fair market value of other property or services received by the taxpayer from transactions and activity in the regular course of its trade or business, net of returns and allowances, and includes interest, service charges, carrying charges, time-price differentials, and excise taxes if such taxes are passed on to the customer or included as part of the selling price.

[OPTIONAL] For purposes of this definition, “customer” does not include an entity whose unitary income is included with the taxpayer’s unitary income in the calculation of the total unitary income subject to apportionment.

• **Broad Approach - Example**

- 1(g) “Sales” means the total amount of receipts arising from transactions or activities that produce unitary income, but does not include:
- 1) repayment, maturity, or redemption of the principal of a loan, bond, or mutual fund or certificate of deposit or similar marketable instrument;
  - 2) the principal amount received under a repurchase agreement or other transaction properly characterized as a loan;
  - 3) proceeds from issuance of the taxpayer’s own stock or sale of treasury stock;
  - 4) damages and other amounts received as the result of litigation;
  - 5) property acquired by an agent on behalf of another;
  - 6) tax refunds and other tax benefit recoveries;
  - 7) pension reversions;
  - 8) contributions to capital (except for sales of securities by securities dealers);
  - 9) income from forgiveness of indebtedness;
  - 10) amounts realized from exchanges of inventory that are not recognized by the Internal Revenue Code
  - 11) receipts related to transactions involving liquid assets held in connection with one or more treasury functions of the taxpayer; and
  - 12) receipts from hedging transactions involving intangible assets, including options contracts to hedge foreign currency.



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**Model Compact Art. IV Amendments**  
**Income & Franchise Tax Uniformity Subcommittee**

**Criteria for Comparing Alternative Section 17 Sales Factor Numerator Sourcing Options**

*October 8, 2010*

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1. Conceptual foundation: Would the proposal reasonably reflect the taxpayer's market for the transactions giving rise to the receipts?
2. Ease of Administration
  - a. Can the elements of the factor be located geographically?
  - b. Does the proposal avoid the need to make difficult differentiations? (e.g., between types of products such as services, tangibles, and intangibles; between types of intangibles; etc?)
  - c. Will the proposal minimize cost of administration for both taxpayers and the state?
  - d. Is the information required readily available to the taxpayer? To the state?
3. Transparency and Compliance: Is the proposal simple and workable such that taxpayers can comply? Does the proposal minimize the opportunity for manipulation of the apportionment result?
4. Constitutionality
  - a. Nexus: Will the proposal tend to source to states where the taxpayer is doing business and thus has nexus? Is the apportionment result likely to reflect the level of taxpayer's business activity – specifically its market activity - conducted, in part, in the taxing state?
  - b. Non-Discrimination: Is the proposal non-discriminatory with respect to both interstate and purely in-state competitors?
  - c. Fair Apportionment
    - i. Internal Consistency: If applied by every jurisdiction, will the proposal result in no more than 100% of the unitary business income being subject

to tax? Does the proposal help assure that income is taxed once and only once - avoiding “nowhere income” and duplicative taxation *See, e.g., Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, 169 (1983).

ii. External Consistency: Will the proposal tend to reasonably reflect the manner in which income is earned? *See, Container, id.*

d. Fair Reflection of the Benefits: Will the proposal tend to reasonably reflect the relative extent of the taxpayer’s presence or activity in the state so that the taxpayer shoulders only its fair share of supporting the State’s provision of government services? *See Commonwealth Edison v. Montana*, 453 U.S. 609, 610 (1981).

#### 5. Equity and Reasonableness

a. Will the proposal promote horizontal equity by treating taxpayers in the same situation similarly?

b. Will the proposal promote vertical equity by distinguishing among taxpayers in a relevant way?

c. Is the proposal reasonably economically neutral? Will it minimize economic distortions that could arise from, e.g., creating incentives for taxpayers to use one type of production process over another?

d. Would transition to the proposal appear to have an acceptable fiscal impact to the states and taxpayers?