MULTISTATE TAX COMMISSION

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

To: Wood Miller, Chair
Members of MTC Income & Franchise Tax Uniformity Subcommittee
From: Shirley Sicilian, General Counsel
Date: January 12, 2010
Subject: Compact Amendments – Article IV.17

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## I. Background.

At its July, 2009 meeting, the Executive Committee approved a motion 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 the MTC had suggested as focal points are:

Primary concern -
1. Sales factor numerator sourcing for services and intangibles – Art.IV.17

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

The Subcommittee began the project at its December, 2009 meeting with an educational phase that included presentations from Professor Richard Pomp, Alva P. Loiselle 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. A document library for this project has been created and contains materials from these presentations. The library is available at http://www.mtc.gov/Uniformity.aspx?id=4562 .

The Subcommittee decided it would address each of these provisions in turn, starting with Article IV.17., sales factor numerator sourcing for services and intangibles.

## II. Current Compact Language.

Sections 16 and 17 of Art.IV contain the provisions for sales factor numerator sourcing. Section 16 provides the sourcing rule for receipts from sales of tangible property and endeavors to reflect the taxpayer's market by sourcing receipts to the destination state - the state where the property that was sold is "delivered or shipped" to the purchaser. This section contains a throwback provision.

Section 17 provides the sourcing rule for receipts from all other transactions (or "sales") – including sales of services and intangibles. In contrast to section 16, section 17 arguably does not reflect a "market based" approach. Section 17 sources sales to where the activity that produced the income was performed, rather than where the product – e.g., the service or the intangible – was delivered or received. The location where the activity was performed may tend to reflect the production state rather than the market state. Section 17 does not have a throwback provision. Note that for lease of tangible property, and sales or lease of real property, MTC model regulations generally state that income producing activity takes place at the location of the property sold or leased.

16. Sales of tangible personal property are in this State if:
    (a) the property is delivered or shipped to a purchaser, other than the United States Government, within this State regardless of the f.o.b. point or other conditions of the sale; or
    (b) the property is shipped from an office, store, warehouse, factory, or other place of storage in this State and (1) the purchaser is the United States Government or (2) the taxpayer is not taxable in the State of the purchaser.

17. Sales, other than sales of tangible personal property, are in this State if:
    (a) the income-producing activity is performed in this State; or
    (b) the income-producing activity is performed both in and outside this State and a greater proportion of the income-producing activity is performed in this State than in any other State, based on costs of performance.

## III. Foundational Questions.

**1)** Should the purpose of the sales factor be to reflect the taxpayer's market?

**2)** Do the section 17 provisions based on "income producing activity" and "cost of performance" reflect the taxpayer's market?

**3)** If section 17 does not reflect the taxpayer's market, how should it be amended to do so?

a) Should sections 16 and 17 be merged if the purpose of the two is the same?

b) Can a single sourcing rule be stated that covers all transactions, or all transactions other than sales of tangible property? If so, what is it? If not:

i) How should receipts from sales of services be sourced? Should financial organizations and public utilities continue to be excluded from the general rule?

ii) How should receipts from sale or lease of intangibles be sourced?

iii) How should receipts from lease of tangible property be sourced?

iv) How should receipts from sale or lease of real property be sourced?

**4)** Should section 17 contain a throwback (or throwout) provision, similarly to section 16?

## IV. Examples of Existing Alternatives.

At least 14 states have moved away from the "income producing activity" rule for sales of services and, in some cases, intangibles. [1] Five of these states – California, Michigan, Utah, Minnesota, and Texas – are MTC Compact member states. The states' new language roughly falls into three categories (compact states in bold italic):

- Where Benefit Received: ***California***, Georgia, ***Michigan***, Ohio, Wisconsin, ***Utah***[2]

- Where Service Received: Maine, ***Minnesota***[3]

- Where Service is Performed: Connecticut (relative time spent performing service), New Jersey, New York (relative time, value or other reasonable measure), Rhode Island (relative time spent performing service), South Carolina (relative time spent performing service), ***Texas*** (relative value of services performed)[4]

Note, the MTC has developed model special apportionment rules for financial institutions and virtually all of the large common carriage industries, including telecommunications, airlines, railroads, trucking companies, and television and radio broadcasting. [5] Some of these industries did not originally come under the Compact's general apportionment provisions. (*See*, Compact Art.IV.2, which excluded financial organizations and public utilities from the general rule.) But many states that have not yet revised their general "income producing activity" or "cost of performance" rule, have nonetheless taken steps toward a more market-based approach to the extent they have adopted these special rules.

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[1] In addition, some states have moved to a proportional, rather than "greater of" cost of performance rule. *See, e.g.*:
*Mississippi*: Miss. Code Ann § 27-7-23(c)(3); Miss. Reg. 35.III.8.06(III)(9)(c);
*North Carolina*: N.C. Gen. Stat. §105-130.4(l)(3).

[2] *California*: Senate Bill 15 (February 19, 2009; effective TY 2011 )
*Georgia*: Ga. Comp. R. & Regs. r 560-7-7-.03;
*Michigan*: Mich. Comp. Laws §208.1305(2); Mich. Comp. Laws §208.53;
*Ohio*: Ohio Rev. Code Ann. §5733.05(B)(2)(c);
*Wisconsin*: Wis. Stat. §71.25(9)(dh);
*Utah*: Utah Code Ann. §59-7-319(3)(a).

[3] *Maine*: Me. Rev. Stat. Ann. tit. 36, §5211.16;
*Minnesota*: Minn. Stat. §290.191(5).

[4] *Connecticut*: Conn. Gen. Stat. §12-218;
*New Jersey*: N.J. Stat. Ann. §54:10A-6(B)(4);
*New York*: N.Y. Comp. Code R. & Regs. tit. 20, §4-4-3(f);
*Rhode Island*: R.I. Gen. Laws §44-11-14(a)(2);
*South Carolina*: S.C. Code Ann. §12-6-2280(C)(2);
*Texas*: 34 Tex. Admin. Code §3.557(e)(33).

[5] *Available at* http://www.mtc.gov/Uniformity.aspx?id=496 .