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: June 13, 2011
Subject: Model Compact Art. IV.1(g) Amendments

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."[1] The Subcommittee started with amendments to Art.IV.17, Sales factor numerator sourcing for transactions other than sales of tangible personal property. It then turned its attention to Art.IV.1(g), Definition of sales. The Subcommittee recognized there is overlap between efforts to revise the definition of "sales" under §1(g) and to revise the sourcing for those sales under §17. If the sales are not included in the new definition, then they don't need to be sourced. So, before finalizing its work on §17, the Subcommittee has turned its attention to §1(g). The Subcommittee's stated goal is to finish these two models at its July 2011 in-person meetings.

At its May, 2011 teleconference, the subcommittee reviewed draft amendments to the definition of "sales." These drafts reflected the Subcommittee's preliminary policy choices to clarify in the Compact that "sales" (1) includes only gross receipts associated with the transactional test (the "narrow approach" discussed in the policy checklist attached) and (2) excludes treasury function and other financing type receipts. Both choices are consistent with the current structure of the existing Compact and model regulations. After review, the Subcommittee requested an additional draft that reflects the "broad approach" and another policy checklist to help it consider the competing policy choices. The drafts, put together by the drafting group, are in attachment A.[2] The policy checklist is section II of this memo.

II. Current Definition of "Sales" and Policy Question Checklist for Considering Amendments.

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[1] The five areas are: Sales factor numerator sourcing for transactions other than sales of tangible personal property – Art.IV.17; Definition of Sales – Art.IV.1(g); Definition of Business Income – Art.IV.1(a); Factor Weighting – Art. IV.9; Distortion Relief Provision - Art.IV.18

[2] The drafting group includes Ben Miller and Mellissa Potter, CA-FTB; Ted Spangler, ID; Michael Fatale, MA; Gary Humphrey and Janielle Lipscomb, OR; Joe Garrett, AL.

1. **What activity does the "sales factor" currently reflect?**

   A. **Compact – "all gross receipts of the taxpayer not allocated…"** The Compact currently defines "sales" broadly as "all gross receipts of the taxpayer not allocated under paragraphs of this Article." (Art.IV(1)(g)) Thus, the definition of "sales" appears to include gross receipts associated with apportionable, business income. Under the Compact, apportionable "business income" is income that meets either the transactional test or the functional test: "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." (Art.IV(1)(a)) Gross receipts associated with the transactional test could include, for example, receipts from the sale, lease, or license of the taxpayer's product – goods or services – to its customers. Gross receipts associated with the functional test could include receipts from the sale or lease of non-inventory, business assets that are or were used in the operation of the taxpayer's unitary business to produce or provide the product that it sells to its customers.

   B. **Regulations – reference transactional, but not functional, test; exclude treasury function and other financing receipts.**

      i. **Transactional test.** Since 1973, model regulations have specified: "the term 'sales' means all gross receipts derived by the taxpayer from transactions and activity in the regular course of the trade or business**."** (Reg. IV.15.(a). Sales Factor: In General.) This clause – "transactions and activity in the regular course of the trade or business" – mirrors the Compact language for the first of the two tests for business income, the transactional test. The second, functional test – "income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations" – is not referenced. The regulations also lists specific exclusions as distortive, even though these might be excluded already under transactional limitation in the general definition (Reg.IV.18(c)):

         a. "substantial amounts of gross receipts from *an incidental or occasional sale* of a fixed asset used in the regular course of the taxpayer's trade or business, for example, gross receipts from the sale of a factory or plant;

         b. "insubstantial amounts of gross receipts arising *from incidental or occasional transactions or activities* unless their exclusion would materially affect the amount of income apportioned to this state, for example, the sale of office furniture, business automobiles, etc.." (emphasis added).

      ii. **Excluded treasury function and other financial activity.** Other more recent regulations further limit the definition of gross receipts by listing specific types of receipts from treasury function and other financial activity that is excluded, even though income associated with this activity could arguably meet the transactional test and would be included in apportionable income (Reg. IV(2)(a)):

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;

2. What activity should the "sales factor" reflect?

A. Should the definition continue to reference only the transactional test? Should the sales factor broadly include all receipts associated with business income or should it be more narrowly limited to transactional receipts? Transactional receipts would include receipts from the sale of the taxpayer's product – goods or services – to its customers; functional receipts would include receipts from the sale of the taxpayer's used production assets – factory, equipment. At its March meeting, the Subcommittee chose the narrow approach. But at its May teleconference, the subcommittee asked for the list of issues related to that choice, and to see an alternative that would reflect the broad approach.

i. 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. Rather, they only reflect certain activities by which we will apportion the income that is to be taxed. As such, the items included in any factor do not need to broadly reflect all unitary activity, but need only reflect the activities the particular factor 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 for the taxpayer's product, its sales to its 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 could double count the property already included in the property factor. 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 from property and payroll, should be avoided.

ii. Rationale for Broad approach: 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. Rather, the notion of "market" could be expanded to include the market for *any* things that the taxpayer sells, including things sold to persons other than its customers. e.g., production assets that were once used in the taxpayer's business operations to produce the product that it sold to its customers. Although this approach could potentially double count property already included in the state's property factor, in separate entity taxing states or states with single sales factor apportionment, there might not be double counting, and the inclusion might help to approximate an equitable result.

iii. **An intermediate approach?** The "sales" included through the functional test could be limited to net receipts, or gain on the sale. This may alleviate potential double counting of the property factor, since property is generally included in the property factor at original cost. It might also help prevent distortion that could occur when including functional test receipts, since the gross receipts from such sales may be large, while net income to be apportioned from such sales may be small.

iv. **Drafting.**

a. **If the narrow approach** is maintained, then the drafting question is whether the regulatory language should be moved into the statute for clarity. (See Appendix A, Narrow approach drafts.)

b. **If the broad approach** is chosen, then the Compact language may be fine as is. But the regulatory limitation should be deleted and the regulations reworked. (See Appendix A, Broad approach draft).

B. **Does the Compact need to be amended to properly exclude treasury function receipts?** It is this issue that prompted the Executive Committee to request Uniformity Committee review of the "sales" definition. Assuming the Uniformity Committee continues to believe that treasury function receipts should be excluded from the definition of sales, is it enough that they are excluded by regulation or should the Compact be amended to make the exclusion by statute? If by statute, there are alternative ways to do it, depending on whether the Committee choses to adopt the narrow or the broad approach, above.

1. **If the narrow approach** is maintained, then there are at least two options:
   a. **Statement of the general rule.** The elimination of treasury and other financial type activities could be made clearer by adding the requirement that the transaction which generated the receipt must be with a "customer." Customer could then be defined by regulation or by statute to exclude an entity on the other side of financing transactions. (See Appendix A, Narrow approach, possible regulation.)
   b. **Statement of the general rule, with a specific list of excluded items.** The specific list of excluded transactions, currently in regulation, could be added to the Compact definition for additional clarity. It would be important to specify whether this is a comprehensive list or a list of examples.
   c. **A specific list of excluded items.** Again, it would be important to specify whether this is a comprehensive list or a list of examples. If examples only, then in theory a state could argue that a transaction that is not specifically referenced should be excluded because it is analogous to an item that is listed -- but inclusion of a general rule would help support that analogy.

2. **If the broad approach** is chosen, then a list of excluded transactions could be added to the Compact definition.

Appendix A.

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Model Compact Art. IV.1(g) Amendment

Definition of Gross Receipts – Draft – for Discussion Purposes Only

6-13-2011

Narrow Version – Alternative 1

1(g) "Sales" means amounts that give rise to apportionable income and that are received by the taxpayer from:

(1) transactions and activity in the regular course of its trade or business for:

(A) the sale, rental, lease, or licensing to a customer of real, tangible, or intangible property which would properly be included in the inventory of the taxpayer if on hand at the close of the tax period;

(B) the sale of services to a customer; or

(C) the sale, lending, or other disposition of money or securities to a customer, except that includable amounts from the maturity, redemption, sale, exchange, loan, or other disposition of ~~cash~~ money or securities shall be limited to the overall net gain from such transaction or activity for the tax period;

or from

(2)the sale, lease, or license of a contract right, government license, or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area.

Narrow Version - Alternative 2:

1(g) "Sales" means amounts that give rise to apportionable income and that are received by the taxpayer from:

(1) its customer for transactions and activity in the regular course of its trade or business, except that includable amounts from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities shall be limited to the overall net gain from such transaction or activity for the tax period; or

(2) any person in exchange for a contract right, government license, or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area.

Narrow Version – Alternative 3:

1(g) "Sales" means amounts that give rise to apportionable income and that are received by the taxpayer from its customer for transactions and activity in the regular course of the taxpayer's trade or business, except that includable amounts from maturity, redemption, sale, exchange, loan or other disposition of cash or securities shall be limited to the overall net gain from such transaction or activity for the tax period.

<u>Narrow Version – Example of Regulatory Definition: “Customer</u>” means [based on MTC regulations defining transactional test] a person who purchases, leases or licenses (1) inventory or services which are commonly sold, leased, or licensed by the taxpayer in the regular course of the taxpayer’s trade or business, or (2) property used in the taxpayer’s production of business income of a kind that is sold, leased, or licensed, and replaced with some regularity, even if replaced less frequently than once a year. “Customer” does not include a person who engages with the taxpayer in the taxpayer’s investment activities, such as activities that are for the taxpayer’s mere financial betterment rather than for the operations of the trade or business, even if such activities are conducted frequently by the taxpayer. [OPTIONAL: “Customer” does not include a person whose unitary income is included with the taxpayer’s unitary income in the calculation of the total unitary income subject to apportionment.]

<u>Broad Version – Alternative 1</u>

1(g) “Sales” means all gross receipts of the taxpayer not allocated under paragraphs of this Article, but does not include:

Reg. IV.2.(a)

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 from 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;

CA Regs

11. receipts related to transactions involving liquid assets held in connection with one or more treasury functions of the taxpayer;
12. receipts from hedging transactions involving intangible assets, including options contracts to hedge foreign currency.
13. insurance proceeds

Reg.IV.18(c)

14. substantial amounts of gross receipts from an incidental or occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business, for example, gross receipts from the sale of a factory or plant;
15. insubstantial amounts of gross receipts arising from incidental or occasional transactions or activities unless their exclusion would materially affect the amount of income apportioned to this state, for example, the sale of office furniture, business automobiles, etc.; or
16. business income in the form of dividends received on stock, royalties received on patents or copyrights, or interest received on bonds, debentures or government securities results from the mere holding of the intangible personal property by the taxpayer.

MA Statute

17. interest, dividends, and gross receipts from the maturity, redemption, sale, exchange or other disposition of securities.
18. receipts from the sale of the business "good will" or similar intangible value, including, without limitation, "going concern value" and "workforce in place."