How Should the UDITPA Sales Factor Treat Receipts from Transactions Involving Financial Instruments?

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Focus of this presentation

- Treatment of receipts from transactions involving financial instruments (e.g., stocks and bonds) in the sales factor
  - “Treatment of financial receipts” (in the sales factor)
- Including gross financial receipts in the denominator can dramatically reduce the sales factor of non-domiciliary states
  - Financial receipts are commonly attributed to the state where the treasury function is located

Alternative views of proper treatment:

- That drafters of UDITPA intended “sales” to be receipts from the sale of goods and services.

- Taxpayers argue that UDITPA’s definition, “... all gross receipts of the taxpayer ...” includes *gross* financial receipts.

  – Courts generally have not allowed inclusion of gross receipts, because it distorts apportionment of income

Alternative views of proper treatment:

- Walter Hellerstein favors dividing receipts from transactions involving intangibles “on the basis of the factors derived from the taxpayer’s other business activities.”

- California eliminates *all* receipts from financial transactions from its sales factor.

  – This is where I come down

Contents of Article in *State Tax Notes* (February 16 and 23, 2009) – to be republished in *The Tax Lawyer*

- Review of the legal landscape
  - Relevant provisions of UDITPA
    - Business and non-business income: Apportionment vs. allocation
    - UDITPA's definition of sales
    - Attribution of sales other than of tangible property
    - Financial receipts in business income and in the sales factor

- MTC regulations and recent California law
  - MTC would include only *net* financial receipt
  - California excludes *all* financial receipts

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- Court cases opining on state practice
  - In *Microsoft*, the California Supreme Court found that:
    - Gross financial receipts do constitute “gross receipts” under California law, but
    - Inclusion of gross receipts would distort the measurement of income
- Economic equivalence between sales of goods and services and gross financial receipts

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- Revenue consequences of three alternatives
  - Including gross financial receipts
  - Excluding such receipts
  - Including only net receipts

- The so-called distortion issue

- The UDITPA attribution rule reconsidered
  - Where does income-producing activity occur?
  - What is the destination of financial transactions?
  - Possible alternatives to the present UDITPA rule

The Economic Similarity of Gross Financial Receipts and Other Sales

- Profits can be defined as:

  Profit = Sales minus costs minus return on investment.

- It can be restated as:

  Sales = costs + return on investment + profit

The Economic Similarity of Gross Financial Receipts and Other Sales

Investment in financial instruments

- Sales (or receipts) equal:
- Cost of financial instruments, plus
- Return on investment in financial instruments, plus
- Other costs, plus
- Profit (or loss)

Retail business with inventories, but no capital assets

- Sales equal:
- Cost of goods sold, plus
- Return on investment in inventory, plus
- Labor and other costs, plus
- Profit (or loss)

The Economic Similarity of Gross Financial Receipts and Other Sales

Similarity of investment in financial instruments and investment in wine

- Purchase of bonds is analogous to purchase of wine
- Interest on financial instruments is analogous to increase in the value of wine; both are return on investment
- Recovery of investment in financial instruments, plus interest (explicit or implicit), is analogous to return of investment in wine, plus wine's appreciation in value

The Economic Similarity of Gross Financial Receipts and Other Sales

In short: gross *financial receipts are no different than receipts from other types of investment*

- Thus: MTC's inclusion of only net receipts from financial transactions is conceptually flawed

But there is one crucial difference: *receipts from financial transactions have neither an origin nor a destination.* (We will return to this.)

Implications for the sales factor of non-domiciliary states

- The sales factor is greatest if financial receipts are excluded from the sales factor
- It is smallest if gross receipts are included
- The effect of including only net receipts is intermediate, but closer to excluding receipts

Implications for the sales factor of non-domiciliary states

1. Exclusion of receipts vs. inclusion of gross receipts

The percentage difference in the sales factor (compared to exclusion of financial receipts)

$$= \frac{\text{gross financial receipts}}{\text{gross financial plus non-financial receipts}}.$$

If financial are much larger than non-financial receipts, this difference approaches 100% and the sales factor approaches zero

Implications for the sales factor of non-domiciliary states

2. Exclusion of receipts vs. inclusion of net receipts

The percentage difference in the sales factor (compared to exclusion of financial receipts)

$$= \frac{\text{net financial receipts}}{\text{net financial receipts plus non-financial receipts}}.$$

- Much smaller than in previous case (because gross receipts exceed net receipts)
- Small if net financial receipts are very small, relative to non-financial receipts

Implications for the sales factor of non-domiciliary states

3. Inclusion of net receipts vs inclusion of gross receipts

The percentage difference in the sales factor (compared to inclusion of net financial receipts)

$$= \frac{\text{difference in gross and net financial receipts}}{\text{gross financial receipts plus non-financial receipts}}.$$

- If gross financial receipts are large, relative to non-financial receipts and net financial receipts, this approaches 100% and the sales factor approaches zero

Implications for the sales factor of non-domiciliary states

Ranking the revenue consequences of the alternatives

- The difference between excluding financial receipts and including net receipts may be relatively small

- The difference between either of these and including gross receipts can be relatively large

Distortion and Equitable Apportionment

California Supreme Court in *Microsoft*:

- In 1991 Microsoft's short-term investments produced less than 2 percent of the company's income, but 73 percent of its gross receipts

- The 0.2% profit margin on Microsoft's financial transactions was far below the profit margin of 31% on its sales of goods and services.

- Thus inclusion of gross receipts in the sales factor distorted the apportionment of income to California

Distortion and Equitable Apportionment

- Separate accounting cannot divide the income of a unitary business between states, entities -- or corporate functions
- Formula apportionment is used instead
- There is no logically defensible benchmark against which to measure distortion
- But it is useful to formalize the Court's analysis, based on the implicit assumptions underlying it.

Distortion and Equitable Apportionment

The bottom line:

- Whether including gross financial receipts in the sales factor creates distortion depends on the facts of the case

- Including only net receipts and excluding financial receipts both inevitably create “reverse distortion,” overstating the sales factor of non-domiciliary states

Distortion and Equitable Apportionment

3 assumptions underlying the benchmark:

- Financial receipts are like sales of goods and services
- Financial receipts should be attributed to the state where the treasury function is performed
- Separate functional accounting can distinguish between income earned in financial investments and that from sales of goods and services

Distortion and Equitable Apportionment

- Implications of the assumptions

- Income from financial transactions is apportioned entirely to the state where the treasury function is located

- The non-domiciliary state would tax only an apportioned part of the taxpayer's income from the sales of goods and services

- The non-domiciliary state's share of sales of goods and services would be used to apportion that income

- Distortion to the detriment of that state occurs if (and only if) less income is apportioned to it is than under this benchmark

Examples of Distortion and Reverse Distortion

1. Inclusion of gross financial receipts

- The Court would find distortion if the ratio of income to financial receipts is less than the margin on sales of goods and services

- Reverse distortion can occur (if the profit margin on the sale of financial instruments exceeds that from the sale of goods and services)

Examples of Distortion and Reverse Distortion

2. Exclusion of all financial receipts

- Excluding all financial receipts inevitably results in *reverse distortion*: more income is apportioned to the non-domiciliary state than under the benchmark

- Why: Sales of goods and services are used to apportion income from financial investments, as well as income from sales of goods and services

Examples of Distortion and Reverse Distortion

3. Inclusion of only net financial receipts (the MTC rule)

- Reverse distortion is inevitable
- Net receipts are both income and a surrogate for gross receipts
- This is tantamount to assuming a 100% profit margin on sales of financial instruments

The Problem of Rapid Turnover of Financial Instruments

- Whether or not distortion appears to occur depends on:
  - the profit margin on sales of goods and services,
  - the yield on financial instruments
  - whether the yield is received currently, and
  - the holding period of the financial instruments
- Cash flow considerations may limit investment of working capital to low-yield short-term investments,
- California Supreme Court said manipulation could occur

Is Equitable Apportionment the Way to Avoid "Distortion"?

- Including gross financial receipts in the sales factor is conceptually attractive
- But it may lead to claims of distortion – or to reverse distortion
- Equitable apportionment does not provide a satisfactory solution
  - Including gross receipts, except where it is distortionary
- More fundamentally, all claims of distortion involves bootstrapping

Categorical rules without bootstrapping

- A rule that does not rely on bootstrapping is needed
- Using net financial receipts provides a clear rule but is conceptually flawed and produces reverse distortion
- Two approaches that would provide a clear rule that can be defended on conceptual grounds:
  - Attributing them on the basis of the taxpayer's tangible activities (the Hellerstein approach)
  - Excluding financial receipts (California/McLure approach)

Where Does Income-producing Activity Occur?

- Economic activity that produces income from financial instruments does not occur only where the investments are managed
  - Clearly true if income-producing activity is measured by the cost of performance
  - The primary cost of the treasury function is the cost of funds
- The cost of funds has no obvious situs
  - The location of the treasury function has no special claim

Is a destination-based rule better?

- What Is the destination of financial transactions?

- “Intangible property has no obvious or generally accepted location for tax purposes.” – Hellerstein and Hellerstein

- Transactions involving financial assets have neither an origin or a destination

The Hellerstein Approach

- Attribution of financial receipts should be based on something that has an identifiable location
- “a rule assigning the factors associated with the intangible income according to the factors associated with the corporation’s tangible operations is justified.” – Hellerstein and Hellerstein
- Rapid turnover of financial assets would not inflate the sales factor.
- But rapid turnover can (anomalously) increase the importance of factors other than sales of goods and services in the sales factor

A Case for Disregarding Financial Receipts (“throwout”)

- Consider a stream of unitary business income:
  - Income from sales of goods and services and
  - Income from investment in financial instruments
- Suppose *arguendo* it were possible to isolate and quantify the two income flows
- The standard formula would be used to apportion the income from sales of goods and services

A Case for Disregarding Financial Receipts (“throwout”)

- Financial receipts have no origin of destination
- Since this is a unitary business, the sensible way to apportion financial income is to use the formula used to apportion non-financial income.
  - This arguably *does* reflect where investment income is earned
- This is equivalent to using the standard formula to apportion the total of the two types of income
- It gives the same result as "throwout"

Summary and Conclusions

- Including only net financial returns is conceptually flawed; like excluding financial receipts, it distorts apportionment in favor of non-domiciliary states;

- Neither origin (the location of treasury function) nor destination provides a satisfactory basis for attributing receipts from financial instruments;

- Dividing gross financial receipts on the basis of the taxpayer's tangible factors (the Hellerstein approach) is conceptually justifiable, but not simple;

- Excluding financial receipts from the sales factor ("throwout") is simple and conceptually defensible.