



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: February 19, 2010
Subject: Model Compact Art. IV.17 Amendment

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 chose to start with Article IV.17, sales factor numerator sourcing for transactions other than sales of tangible personal property.¹ Staff produced a list of policy questions, which the Subcommittee answered over the course of 3 teleconferences held January 22, February 3, and February 17, 2010. This policy direction does not reflect any particular state’s formal position on any issue. Rather it provided the drafting group direction for the first draft to be considered by the Subcommittee. The drafting group – Ben Miller, CA-FTB; Ted Spangler, ID; Joe Garrett, AL; Michael Fatale, MA; Eric Smith, OR; Melissa Potter, CA-FTB – and staff including Bruce Fort, produced the attached draft and additional policy questions for the Subcommittee’s consideration.

II. Attached Materials

1. First Draft of Model Art.IV.17
2. Additional Policy Questions
3. Policy Question Checklist with Subcommittee’s Answers
4. Draft Policy Guidelines
5. Spreadsheet of 50 states’ section 17 provisions (from CA-FTB)

¹ At its December, 2009 meeting, the subcommittee heard educational 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. An on-line library for project related document is available at <http://www.mtc.gov/Uniformity.aspx?id=4562>.



MULTISTATE TAX COMMISSION

Working Together Since 1967 to Preserve Federalism and Tax Fairness

DRAFT Model Compact Art. IV.17 Amendment
February 19, 2010
For Discussion Purposes Only

Current Compact Art. IV.17

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.

Draft Amended Compact Art. IV.17

- 17(a) Sales, other than sales described in Section 16, are in this State:
- (1) In the case of sales of services, if [and to the extent]
 - i. the service is delivered to a [customer] location in this state;
 - ii. the [customer] location to which the service is delivered cannot be readily determined and the office of the customer which placed the order for the service is in this state; or
 - iii. the [customer] location to which the service is delivered or the office of the customer which placed the order for the service cannot be readily determined, and the customer's billing address is in this state.
 - (2) In the case of sale, rental, lease or license of real property, if [and to the extent] the property is located in this state;
 - (3) In the case of rental, lease or license of tangible personal property, if [and to the extent] the property is located in this state;
 - (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.
- (b) If the taxpayer is not taxable in a state to which a sale would be assigned pursuant to subsections (a) of this section, such sale shall be excluded from the denominator of the sales factor.

Additional Policy Questions

- I. **“To the Extent.”** Including this language could suggest receipts may be sourced among multiple states, rather than to a single state. Should the rule allow for sourcing a single receipt to multiple states?
- II. **“Customer” and “Payor.”** The use of the term “customer” suggests receipts are sourced to the location of the taxpayer’s customer, rather than “looking through” to where the ultimate customer is located if the service is resold or drop-shipped. Use of the term “payor” is more likely to allow for the alternative: receipts could be sourced to the location of the ultimate consumer. Considerations to help answer these questions:
- A. Theory: Where is the taxpayer’s market?
1. Is the taxpayer’s market reflected by where its customers are or, in some cases, is it better reflected by where the taxpayer’s product will be resold by the taxpayer’s customer?
 2. Would a rule that “looks through” to where the services are provided, even if provided to a customer’s customer, result in something like cost of performance sourcing that duplicates the property and payroll factor?
 3. Does the answer depend in part on the type of product (e.g., service, intangible, or tangible) or the type of transaction (sale vs. lease)(e.g., license of non-marketing intangibles)?
- B. Compliance and Enforcement: Does sourcing to a single location of the taxpayer’s customer create too much opportunity for manipulation? Could a potential for manipulation be better addressed in some way other than through apportionment (e.g., combined reporting or add-back)?
- C. Nexus: Economic presence nexus allows for nexus in a state where the taxpayer has sales or receipts. Would a rule that “looks through” to where the services are provided, even if provided to a customer’s customer, result in more cases where there is a lack of nexus?
- D. Administration: Will taxpayers and the state generally have the information needed to “look through” to the customer’s customer’s location?
1. If the state requires the information, could the taxpayer obtain it at a reasonable administrative cost?
 2. If the state requires the information only if “readily determinable,” would non-uniform apportionment among similarly situated taxpayers rise to an unacceptable level?
- E. Consistency with Other Provisions:
1. Should each of the rule’s provisions source similarly on this point? E.g., if look through is appropriate (or not) for services and intangibles, is it also appropriate (or not) for tangible property?
 2. If the rule is not consistent across provisions, might that raise additional incentive to argue whether a product is an intangible product vs. the equivalent of a tangible product vs. a service?

3. Do the “cascades” reflect an approximation of customer location or customer’s customer location? If the latter is desired, should they be changed (e.g., to something like “percent of population”)?
- III. “Sales.”** Sourcing to the “location of use” seems reasonable for leasing or licensing of intangibles. But it may not work well for sales of intangibles since the taxpayer presumably would not know where the intangible is used once it is sold. Should there be a separate rule for sales of intangibles, or perhaps use of throwback (assigning to the taxpayers office as MA does) or throwout?
- IV. Intangibles.** Should the rule for intangibles include a cascade assignment approach similar to that used for services?
- V. Throwout.** Under the draft, throwout applies to receipts from transactions that would be sourced to a location where the taxpayer does not have nexus. Should application of throwout apply more broadly to receipts from transactions where the application of the rule, even taking into account the cascade alternatives, cannot be determined? An alternative would be to add a “percent of population” rule, or use the apportionment factor of the taxpayer’s customer, as the last resort for each cascade.
- VI. Receipts from Sale of Business Assets.** The overarching goal of the sales factor is to source receipts from sales (or leases) to the taxpayer’s market for its product and the draft is intended to reflect that market. But the definition of receipts may also include receipts from the sale of production assets used in the taxpayer’s business. Is the appropriate goal for these receipts to source to the market for the taxpayer’s product? Or would a more appropriate goal be to source receipts for these types of assets to the location of the asset or of the taxpayer’s business (e.g, if the asset is an intangible asset; perhaps throwout achieves this?)? Or, has the value of these assets already been reflected in the property factor, in which case the value (in the form of receipts) need/should not be reflected in the sales factor (market reflection) at all. The Subcommittee could come back to this question after determining the proper definition of sales under UDITPA.



MULTISTATE TAX COMMISSION

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

**Policy Checklist showing Preliminary Subcommittee Direction
February 19, 2010**

- 1) Should the purpose of the sales factor be to reflect the taxpayer's market?
 - **Yes.**
- 2) Do the section 17 provisions based on "income producing activity" and "cost of performance" reflect the taxpayer's market?
 - **No.**
- 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?
 - **Drafters can decide. But no policy change to Section 16.**
 - 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 institutions and public utilities continue to be excluded from UDITPA?
 - **Cascading rule –**
 - **To "where the service is provided to or for a location."**
[Or: "location to which the service is delivered."]
 - **If unknown, then to the location from which services are ordered.**
 - **If unknown, then to the customer's billing address.**
 - ii) How should receipts from sale or licensing of intangible property be sourced?
 - **To the "location where the intangible property is used."**
 - **Regulations should specify where use is presumed to occur if not readily apparent. E.g., cascading presumptions from "commercial domicile of customer," to "billing address," etc.**
 - iii) How should receipts from lease of tangible property be sourced?
 - **To the "location of the tangible property."**
 - **Regulations should address mobile property, in transit, etc.**
 - iv) How should receipts from sale or lease of real property be sourced?
 - **To the "location of the real property."**
- 4) Should section 17 contain a throwback (or throwout) provision, similarly to section 16?
 - **Throwout**

Criteria for Comparing Alternative Apportionment Options

1. Ease of Administration
 - a. Can the elements of the factor be located geographically?
 - b. Will the proposal minimize cost of administration for both taxpayers and the state?
 - c. Is the information required readily available to the taxpayer? To the state?
2. 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?
3. Constitutionality
 - a. Nexus: Will the factors source to states where the taxpayer is doing business and thus has nexus? Will the definition of apportionable income reflect a rational relationship between the item of income subject to apportionment and the business activity conducted, in part, in the taxing state? *See, e.g., Allied Signal v. Dir., Div. of Taxation*, 504 U.S. 765 (1992).
 - 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 reasonably reflect the manner in which income is earned? *See, Container, id.*
 - d. Fair Reflection of the Benefits: Will the measure of the tax 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).

4. 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 have an acceptable fiscal impact to the states and taxpayers?

25136 (2011): 50 State Analysis

	Greater Cost of Performance	Services-"Benefit of Service"-Statutory Language	Services-"Benefit of Service"-Regulatory Language	Intangibles-"Location of Use"-Statutory Language	Intangibles-"Location of Use"-Regulatory Language
Alabama	X				
Alaska	X				
Arizona	X				
Arkansas	n/a				
California		Cal.Rev.&Tax.Code25136(a)(1)		Cal.Rev.&Tax.Code 25136(a)(2)	
Colorado	X				
Connecticut	n/a				
Delaware	n/a				
Florida	n/a				
Georgia		GA Code Ann.48-7-31(d)(2)(A)(i): Gross receipts are in this state if the receipts are derived from customers within this state or if the receipts are otherwise attributable to this state's marketplace.	GA Comp.R.& Regs. 560-7-7-.03(5)(c): Benefit of the Service. Gross receipts are designed to measure marketplace for tp's goods and services. Customer defined as engaged in trade or business and maintains reg trade or businenss in GA or who is not engaged in a reg trade or business but whose billing address is in GA. Ratio method for numerator sales assignment. Specific industry rules. TP must expend a reasonable amount of effort to obtain marketplace info and if not available, use other reasonable method.		GA Comp.R.&Regs. 560-7-7-.03(5)(c)(viii). Definition of intangible property. Ratio method for assigning sales to the numerator. TP must expend a reasonable amount of effort to otbain marketplace info and if not available, use other reasonable method.
Hawaii	X				
Idaho	X				

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Illinois	X	ILCS 5/304(a)(3)(C-5)(iv): Services Received. Gross receipts from perf of serv provided to corp, partnership, or trust may be only attributed to where c, p or t has a fixed place of business. If not or where receipt is not readily determinable, then services are deemed rec'd at location of customer's office who ordered services in its reegular trade or bus. If ordring office cannot be determined, services are deemed rec'd at office of customer to which services are billed. If TP not taxable in state where services are received, sales are thrown out.			
Indiana	X				Ind.Admin.Code 3.1-1-55: Situs of intangible property is commercial domicile unless the property has acquired a business situs elsewhere. Business situs is the place at which intangible personal property is employed as capital or the place where the property is located if possession and control is localized in connection with a trade or business so that substantial use or value attaches to the property. Example is hot water heater manufacturer who obtains notes for the sales. Property has situs in IN and so interest earned is assigned to IN.

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Iowa			Iowa Admin. Code 701-54.6(422): Benefit of the Service. Ratio method for assignment to sales numerator.		
Kansas	X				
Kentucky	X				Ky. Admin. Regs. 16:270: Receipts assigned regardless of commercial domicile. Possession and control of ip is localized in connection with a trade or business in KY, creating a business situs with KY so that substantial use or value attaches to ip in KY. Factors: (a) use of ip in the continuous course of the trade or business in KY (b) the permanency of the location of the ip in KY (c) independent control and mgt of the ip in KY (d) possession and control of the ip by an independent local agent for the purpose of transacting a permanent business and (e) the establishment or use of the ip in KY in such a manner that attaches substantial use and value of the ip to the KY trade or business.
Louisiana	n/a				

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	Greater Cost of Performance	Services-"Benefit of Service"-Statutory Language	Services-"Benefit of Service"-Regulatory Language	Intangibles-"Location of Use"-Statutory Language	Intangibles-"Location of Use"-Regulatory Language
Maine		Me.Rev.Stat.Ann.5211.16-A.A: Services received. If not readily determinable, deemed rec'd at home of customer or, if business, office of customer where services were ordered in the regular trade or business. If ordering location cannot be determined, services are deemed to be rec'd at the customer's home or office where the services were billed. If TP not taxable in other state or if Fed Gov is purchaser, COP rule.	Code Me.R.801(18-125 CMR 801). (1): Sourced to state where services are rec'd. Nonbusiness customer: if unclear where services are received, sale is deemed to be at home of customer. If business customer, if unclear where services were ordered in the reg course of trade or business. If ordering location cannot be determined then sale is deemed to have occurred at the office to which the services were billed. If TP not taxable in other state or if Fed Gov is purchaser, COP rule.	ME. Rev. Stat. Ann.5211.16-A.B.	Code Me.R.801(18-125 CMR 801.(2)
Maryland			MD. Regs. Code 03.04.03.08.C.(3)©		
Massachusetts	X			Mass. Gen. L. 38(f)	Mass. Regs. Code 63.38.1(9)(d)3: Attributes sales to place of use. License of marketing intangibles: based on MA population in geographic location for use of license. License of non-marketing intangibles: based on the extent of the use in MA. Presumed use takes place at commercial domicile unless the TP or Comm can reasonably establish the location of the actual use. Licensing of mixed intangibles: look at contract; if it is unclear, presumed all marketing intangibles. Goodwill: commercial domicile of TP.

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Michigan		Mich. Comp. Laws Ann. 208.1305.		Intangible property is used in this state if purchaser uses the IP in this state or the right to the IP in the regular course of its business operations in this state.	
Minnesota		Minn. Stat. 290.191(5)(j): Identical to IL and similar to ME.		Minn. Stat. 290.191(5)(h)&(i): Nearly identical to MI.	
Mississippi			Miss. Admin. Code 35.III.8.06(d).		
Missouri	X				
Montana	X				
Nebraska	X				
Nevada	No CIT				
New Hampshire	X				
New Jersey	n/a				
New Mexico	X				
New York	n/a				
North Carolina				N.C. Gen. Stat. 105-130.4(g): Intangible Property is used in NC to the extent that it is employed in the production, fabrication, manufacturing, processing or other use in NC or to the extent that a patented product is produced in NC. If the basis of receipts does not permit allocation to states or if the accounting procedures do not reflect states of utilization,	

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North Carolina, continued				then the sale is assigned to the tp's commercial domicile. For copyrights, sales are assigned to NC to the extent that the printing or other publication originates in NC.	
North Dakota	X				
Ohio	X			Ohio Admin. Code 5703-29-17: situsing rules for CAT.: Ratio method. Physical location where purchaser ultimately uses or receives the benefit is "paramount" in determining assignment of the sale. Tax Comm will not require tps to upgrade systems as long as good faith effort to situs receipts in a reasonable, consistent and uniform method supported by tp's business records that exist at the time or reasonable time thereafter. 54 industry specific rules. See also Ohio Rev. Code Ann. 5733.05(B)(2)(c)(ii): Ultimate use is "paramount" in determination of assigning the sale.	
Oklahoma	n/a				
Oregon	X				
Pennsylvania	X				
Rhode Island	n/a				

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South Carolina	n/a				
South Dakota	n/a				
Tennessee	X				
Texas	X	Tex. Tax Code Ann. 171.103(a)	Tax. Admin. Code 3.591(e)(26)		
Utah	X	Utah Code Ann. 59-7-319			
Vermont	X				
Virginia	X				
Washington	No CIT				
West Virginia	X				
Wisconsin		Wis. Stat. 71.25(9): Benefit of Service. Ratio method for assignment to sales numerator. BOS is rec'd in WI: (a) service relates to real property located in WI (b) service relates to tangible personal property that is delivered directly or indirectly to customers in this state (c) service is provided to a person who is physically present in WI at the time the service is rec'd (d) service is provided to a person engaged in a trade or business in WI and relates to that person's business in WI.			Wis. Admin. Code Tax 2.39(2)(cm) and Wis. Admin. Code Tax 2.39(6)(h): To determine the location of the use, (1) # of licensed sites, volume of property manufactured, produced or sold or other data reflects relative usage. (2) Purchaser or licensee's billing address or commercial domicile shall not conclusively determine that transaction occurred at the purchaser or licensee's commercial domicile. If location of the use cannot be determined under (1) and (2) then look at (3) and (4). (3) Commercial domicile of the purchaser or licensee. (4) If location of the use and commercial domicile cannot be determined, then sale will be assigned to WI if the purchaser or licensee is billed in WI.
Wyoming	No CIT				