



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: February 18, 2011
Subject: **Model Compact Art. IV.1(g) Amendments**

I. The Need to Review Art.IV.1(g) Definition of “Sales” before Completing Review of Art.IV.17 Sales Sourcing

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 for non-TPP transactions, including lease of TPP, sale/lease of real property, sale of services, and sale/lease of intangibles. But in doing so, the Subcommittee also recognized that there is overlap between the effort to revise the definition of “sales” under Art. VI.1(g) and the sourcing for those sales under Art. VI.17. If the sales are not part of the definition, then they don’t need to be sourced. The overlap becomes most obvious with respect to the last transaction type: sourcing receipts from sales and licensing of intangibles.

During its December 7, 2010 in-person meeting, the Subcommittee began to address transactions involving intangibles. It recognized that some intangibles are held as taxpayer’s product for sale or license to its customers.¹ And the current draft of section 17 reflects the Subcommittee’s view of how those should be sourced. But there are also intangibles that are or were used by the taxpayer as an asset in its unitary business. These could include receipts from non-inventory assets such as good will, working capital, treasury function related investment assets, or sale of patents/copyrights that had

¹ These would include receipts from intangible transactions occurring in the ordinary course of the taxpayer’s regular trade or business – e.g., license of trademarks, or sale or license of patents or copyrights.

previously been used by the taxpayer to manufacture its own product for sale to its customers. Receipts from transactions involving some of these types of “asset” intangibles, as well as some “asset” tangibles, are currently excluded from the definition of “gross receipts” under the MTC’s model regulations.² And the potential for a clearer, statutory exclusion is what led the Executive Committee to identify the definition of “sales” as one of the UDITPA provisions in need of review.

If these types of sales will be excluded under the revised definition of “sales,” then there is no reason to address how they should be sourced under section 17. Thus, during its February 8, 2010 teleconference, the Subcommittee decided to turn its attention to Article IV.1(g), the definition of “sales.”

II. Concerns Related to the Current Definition of “Sales”

UDITPA defines “sales” as “all gross receipts of the taxpayer....” But the term “gross receipts” is not defined.³ Many states have been confronted with questions of whether “gross receipts” includes receipts from certain investments and payments that do not necessarily have any relation to the taxpayer’s “market” for its product. Because the purpose of the sales factor is to reflect the contributions of the taxpayer’s “market” state, some states, and the MTC’s regulations, take the position that many of these types of receipts can produce distortion if/when they are included in the receipts factor and sourced according to current rules. On the other hand, some suggest that if an item of income is included in the pool of income to be apportioned, then the receipt that is the basis for that income should be included in the sales factor.

One example is the return of investment principal in the case of the repayment of a loan or other short-term investment of working capital. The MTC has promulgated two model regulations interpreting the existing language of UDITPA and the Compact to exclude returns of principal. This approach is consistent with the current rule in the overwhelming majority of states that have addressed the issue.⁴ Some states have held that a return of a taxpayer’s property is inconsistent with the commonly-understood concept of a “sale”; other states have found that UDITPA’s definition of “sales” could include returns of principal, but nonetheless exclude such amounts to prevent distortion of the sales factor. Although states have had to fill this gap with litigation, legislation or regulation, the uniform result has been to exclude returns of principal. the definition of “sales” by further defining “gross receipts,” including definitions that would exclude return of investment principal in the case of the repayment of a loan or a short-term investment of working capital.

III. The Policy Question Checklist for Reviewing the Definition of “Sales”

² See, e.g., MTC Regulations. IV.2(a)(5), IV.18(c)(1), IV.18(c)(3), and IV.18(c)(4).
http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/AllocaitonandApportionmentReg.pdf

³Section 1(g). “‘Sales’ means all gross receipts of the taxpayer not allocated under Sections 4 through 8 of this Act.”

⁴Research performed by the California Franchise Tax Board and reported in briefing for *General Motors Corp. V. Franchise Tax Bd.*, 39 Cal.4th 773, 139 P.3d 1183 (Cal.,2006), indicates 36 states that do not treat returned principal as a receipt for sales factor purposes.



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

**Policy Question List
February 18, 2011**

- 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 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. (*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 MTC 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 (or tangible) 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, and perhaps different rules for some or all types of these asset sales (*e.g.*, receipts from sale of goodwill sourced to location of the associated tangible assets, while receipts from treasury function transactions sourced to location where function performed).

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 to Attachment C -
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.