



**Uniformity Committee
Income and Franchise Tax Subcommittee
Minutes of Teleconference, May 24, 2011**

State	Industry
Robynn Wilson, AK	Karen Boucher, Deloitte
Wood Miller, MO	Michael Colavido, Sutherland
Richard Cram, KS	Karen Nakamura, PricewaterhouseCoopers
Michael Fatale, MA	Amy Hamilton, State Tax Notes
Jennifer Hays, KY Legislature	
Myles Vosberg, ND	MTC Staff
Bill von Tagen, ID	Shirley Sicilian
Phil Skinner, ID	Roxanne Bland
Tyler Rice, ID	
Ted Spangler, ID	
Brenda Gilmer, MT	
Ben Miller, CA-FTB	
Melissa Potter, CA-FTB	
Gary Humphrey, OR	
Carol Rubart, CA-BOE	

I. Welcome

Wood Miller, Uniformity Committee Chair, opened the meeting.

II. Public Comment

None.

III. Model Compact Article IV.1(g) – Definition of Sales

A. Staff Presentation

Shirley Sicilian, MTC General Counsel, described the progress made on this project so far, and summarized the materials provided for the meeting, including alternative draft amendments for the definition of “sales” developed by the drafting group. Both drafts reflect the subcommittee’s preliminary policy choice that sales factor is intended to reflect the market for the taxpayer’s product, and thus the language should be clear in the Compact that “sales” (1) includes primarily gross receipts associated with the transactional test, the narrow approach, and (2) does not include or limits treasury function receipts, financing type receipts, and other

receipts that are not sales to a customer. The exception to the narrow rule was to include receipts from the sale, lease or license of certain intangible production assets - contract rights or government licenses that are associated with a specific geographical location. The idea was that intangibles are not in the property factor, and these particular intangibles could be sourced, so they are picked up in the sales factor even if they were not sold in the regular course of business. At the April 26, 2011 teleconference, the subcommittee considered receipts from other transactions, such as sale of taxpayer's tangible production assets used in business, or byproducts not regularly sold, and chose not to include unless they meet the transactional test.. In addition, treasury function receipts should not be included as gross receipts, unless they are the taxpayer's primary business. The first alternative draft attempts to list the types of transaction encompassed by the transactional test. The second alternative omits the list in order to prevent leaving out some types of transactions, and just states the transactional test. Regulations could list example transaction types. Ms. Sicilian noted that page 5 contains possible regulatory definitions of some terms, but these are just examples – proof of concept – and not meant to be scrutinized. The definition of security was derived from a MA statute, while the definition of “customer” is based closely on the existing MTC regulation defining income arising from the transactional test.

B. Public Comment

None

C. Committee Discussion

Brenda Gilmer asked how the drafts would apply to a single sales factor state. Ms. Sicilian responded that at the March 2, 2011 meeting, the subcommittee recognized that states that have moved to single sales factor no longer have a property factor to reflect the contributions to income from production. Without a property factor, there may be nothing in the apportionment formula that reflects the location of production assets. This may increase the need to use section 18. Or it could create pressure to reflect more activity in the sales factor – such as activity associated with the sale of these production assets, so that receipts could be sourced to the production state. Of course the sales factor would then reflect more than just the market for the taxpayer's product. These drafts are written narrowly. They do not include receipts from production assets, with the exception of intangible production assets that are not included in the property factor and that can be sourced. This is consistent with current MTC regulations which limit sales to transaction type sales, and explicitly exclude substantial receipts from sale of property used in taxpayer's business, such as a factory or plant, though insubstantial receipts, such as from sale of office furniture, may be excluded or included.

Ms. Gilmer asked if this was so because the sale is an unusual event. Ms. Sicilian said yes, such sales would not meet the transactional test. They would only be included, if at all, because they meet the functional test. Ms. Gilmer gave an example of a business, like a cable company, engaged in other lines of business sold its property frequently, the business is not really selling its franchise area, and wouldn't using the definition of customer exclude a large amount of these transactions. Ms. Sicilian agreed that if production assets are sold regularly then those sales meet the transactional test and would be included. She pointed to the current regulations which give an example of a rental car company. It purchases cars and uses them in its rental business, but

also routinely sells the cars to purchase new ones. Even though the assets are used in the business, under current MTC regulations, and the draft, these sales would be included in gross receipts. In Ms. Gilmer's example, it depends on how often an entity is engaged in these transactions and whether it would meet the transactional test. Ms. Gilmer asked would the buyers be viewed as customers. Ms. Sicilian said yes, because they are engaged in a transaction for the sale, lease, or license of the taxpayer's product – a transaction that meets the transactional test.

Ms. Sicilia noted that paragraph 2 in the definition of sales would allow the inclusion of receipts from the sale of certain types of intangible production assets, a franchise or government license specific to a geographic area, even if the sale didn't meet the transactional test. Ben Miller, CA, said he thinks paragraph 2 should be deleted. These receipts should only be included if they meet the transactional test of paragraph 1. Mr. Miller said a more difficult question is when selling off the business, what happens with the sales factor then, and is it a Section 18 relief situation. In three-factor states, it raises issues of whether the sale is consummated at the beginning or end of the year. If at the end of the year, then there will be payroll and property reflected. If at the beginning of the year, then there won't be.

A Subcommittee member asked if excluding these items would mean that we might be using section 18 more often. Ms. Sicilian replied that it might, but that a lot or all of this is already excluded under current regs, so there might not be any more use of 18. The draft just brings these regulatory concepts into the statute.

Michael Fatale asked whether the current MTC regulations contemplate a three-factor situation. Ms. Sicilian said no. One of the five provisions that the executive committee asked the subcommittee to consider is factor weighting. Early on in this project, the subcommittee recognized that all of these provisions are related, policy choices in one are dependent on others, and so we can't just walk through them one at a time. Some simultaneous thinking is needed.

Robynn Wilson acknowledged the concern for single factor states. Mr. Fatale said that the most basic question raised at the meetings was whether the narrow approach or broader approach is the way to go. He suggested that the draft the working group has come up shows there are two problems with the narrow approach. First, it requires a lot of definitions. Second, alternative one, though not alternative two, requires specifying the transactions to include, and that creates the possibility that something will be left out. Other concerns are how frequent transactions have to be for the transactional test to be met, who is a customer and what inventory is. He suggested that the work group come up with a proposal that takes a broad approach to see what it would look like and how they stand in relation to one another.

Ms. Sicilian said the subcommittee was presented in March with example drafts of the narrow and broad approach. Mr. Fatale said because the narrow approach raises so many questions in his mind, it might be useful to work on a broad approach by way of comparison. Ms. Sicilian asked Mr. Fatale to elaborate on what he means when he says broad approach; whether he means the statute should be left the way it is without change, i.e. "all gross receipts," or something less than that. Mr. Fatale said he meant that the statute should start big and work its way down. Mr. Fatale said that there was discussion to that effect, but it cuts both ways. If we go the broad route,

we have to define the exceptions. If we go the narrow route, we have to define what's included. He thought it worked better to start out broad, cover all possibilities and subtract from there.

Ms. Gilmer said that the draft affects single factor states more than three factor states, but it will affect three factor states too, to some extent. She expressed concern that a taxpayer could artificially allocate sales away from Montana using the current narrow approach. She always assumed that the model would retain a three-factor approach. Ms. Sicilian said there may be reasonable options beyond just three-factor equal weighting. Some of the options suggested to the UCL would come up again as the subcommittee considers factor weighting. One option may be double weighted sales, for example. Or, some suggested during the ULC effort that a model could list alternative weights for states to choose among, such as three factor, double weighted, or single sales factor, etc. The alternatives approach assumes that the definition is more important than the weight. If one is trying to capture property in the sales factor, are you saying you don't want the sales factor to solely reflect the market for the taxpayer's product? Ms. Gilmer said she was thinking more in terms of how entities are formed to convert straightforward transactions into something else. What could a taxpayer do with other entities to distance itself from being a customer? Another concern she has is whatever the subcommittee does, it shouldn't mire us in litigation for the next 20 years. A new definition that departs from the current policy would do that.

Ms. Sicilian pointed out the second sentence, which is intended to address the treasury function. Treasury function transactions could possibly meet the transactional test. So the draft says the transactions must be with customers. Financial transactions, and hedging, are through secondary markets. It is a financial transactions distinction.

Ms. Gilmer suggested that it might be helpful if the subcommittee developed a side by side broad and narrow approach with the pros and cons of each. Ms. Wilson pointed out that that had been supplied to the subcommittee for the March meeting.

Mr. Fatale said these issues didn't stay still since the documents were put together months ago. He suggests that there is difficulty in figuring out what these things mean. Ms. Sicilian asked whether MA is a state that doesn't distinguish between the functional and transactional tests. Mr. Fatale agreed. But Mr. Fatale said it doesn't mean there aren't issues. Ms. Sicilian agreed, saying all issues should be raised, if there are new issues those should be raised, and the subcommittee should be clear on the resolution. Mr. Fatale suggested that the drafting group bring back to the table a broad statute so people can revisit the question. He appreciates Ms. Wilson's comment that these have been gone through before, but we want to be sure.

Ms. Wilson had a question for the drafters on Alternative 1, the lending of money to a customer. It seems to her that that's where we have comments: was that meant to modify what came before? Ms. Sicilian said rather than state the general rule and list all transactions included, state the general rule and list the exceptions. From this you can see the problem with trying to list all the transactions included, and that Alternative 2 might be a better approach.

Ms. Wilson said that Alternatives 1 and 2 have a subsection that refers to the sale or license of contracts. If we're including only transactions that meet the transactional test, why do we want

these intangible production asset sales there? Mr. Fatale said he wasn't sure the inclusion had any purpose to serve in a narrow approach. A sale of this type could meet the transactional test, but possibly just in theory. Mr. Miller recalled that it had been suggested by Mr. Fatale. Ms. Sicilian agreed that those transactions may be includable as transactional receipts if they happen often enough. But, the reason they're separately mentioned is that she understood the subcommittee at one point had intended to include them even if they don't meet the transactional test. She thought that the intent of the subcommittee's section 17 draft was to source these items whether transactional or functional, and the definition is attempting to be consistent with that. Ms. Sicilian suggested this inclusion might have arisen from a misunderstanding because, as Mr. Miller suggests, the exception comes from Massachusetts, which starts by including all gross receipts and then subtracting receipts from intangible assets except for this type. But she suggested that there may also be a policy rationale for including them even if starting from the narrow approach. Unlike tangible production assets, intangible production assets are not represented in the property factor. So a policy question was whether to reflect intangible asset sales in the sales factor, where possible. Most intangible production assets would be hard to source, but intangible contract rights and government licenses associated with a specific geographic area can be reasonably sourced and thus could be included in receipts. Alternatively, they could be included in the property factor. Mr. Miller said that that policy rationale was interesting, but probably not thought of at the time. He added that including these items in the draft has helped illustrate the issue and problem of the broad approach.

Mr. Fatale moved that the drafting group should draft a proposal for a broad approach to juxtaposed with a narrow approach.

Mr. Miller referenced an earlier point by Ms. Wilson and said we are already there. The material is here to look at. Mr. Fatale said that his main idea is to put it back on the table. Ms. Sicilian asked the subcommittee whether it wanted a broad approach that would include transactional sales plus sales of production assets like plant and equipment; or did it want the broad approach to include everything, all gross receipts, and then consider specifying some exclusions. Mr. Fatale asked if that could be left to the drafting group and Ms. Sicilian replied that it could not as she's asking if the subcommittee has made a policy decision on whether it wants to include just sales of production assets or everything except perhaps treasury etc. Ms. Sicilian then asked for further instruction on whether to continue with narrow approach 1 or 2 and whether intangible assets with a geographic location should be retained. Mr. Miller said he does not see any distinction between the sale of a factory and the sale of intangible assets. Ms. Gilmer said to think about how interjecting one or two intermediate companies could give the customer definition a weakness. Ms. Sicilian said the customer definition wouldn't distinguish between Alternatives 1 or 2 since both would benefit from a definition of a customer.

Ms. Wilson asked for a vote on the motion. A member indicated he would be willing to compare a broad option. The vote was 5-4 in favor. The motion passed. Ms. Sicilian said she would put together a memo that more fully develops the policy choices.

The meeting was adjourned.