## INTRODUCTION

At the request of the Multistate Tax Commission's Executive Director, the undersigned, Bill Thompson, retired Chief Judge of the Alabama Tax Tribunal, presided at a public hearing on February 23, 2018 concerning two proposed model MTC regulations: Proposed model Reg. IV.18.(c) relating to apportioning gross receipts of taxpayers with no or *de minimis* "receipts"; and proposed model Reg. IV.18.(d) relating to the apportioning of the income of bank holding companies and their subsidiaries. Public comments were submitted by Karen Boucher, on behalf of the Financial Institutions State Coalition, LLC, and by Jamie Yesnowitz, Grant Thornton, LLC.

The MTC's legal staff was asked to respond to the public comments, and also to provide a summary explaining the intended purpose and scope of operation of the regulations. Bruce Fort, the MTC's counsel, complied with the above request by submitting a memorandum on March 19, 2018. The memorandum is comprehensive, well-written, and explains the purpose, intent, and rationale behind the various provisions in the regulations. The substantive provisions of the memorandum are set out below.

### A. Summary of Proposed Model Regulation IV.18.(c): Relating to Apportioning Gross Receipts of Taxpayers with No or *De Minimis* "Receipts"

#### 1. Background and history of the development of the proposed model regulation.

At its annual meeting July 30, 2014, the Commission adopted comprehensive changes to Multistate Tax Compact Art. IV. which incorporated almost word for word the original Uniform Division of Income for Tax Purposes Act (UDITPA), developed by the predecessor to the Uniform Law Commission in 1957. These changes to Article IV included adoption of a "market-based" sourcing regime for assigning receipts from sales of services and intangible property (Art. IV.17) to a state's receipts factor numerator, and creating a new definition of "receipts", for designating the receipts to be included in the receipts factor (Art. IV.1.(g)).

At its July 31, 2014, meeting, the Commission's executive committee directed the uniformity committee to consider amendments to existing model uniform regulations (or to develop new model regulations) to reflect these new provisions in Article IV.

The uniformity committee subsequently established two work groups to implement those directives. The first group drafted amendments to the Commission's model General Allocation and Apportionment Regulations to implement changes to the definition of "receipts" and "apportionable income" under Art. IV, Sec. 1. The second group drafted a body of proposed model regulations to replace "cost-of-performance" sourcing rules with extensive regulations implementing market-based sourcing for receipts from sales of services and intangible property.

Under the changes to Art. IV.1.(g) and provisions of Art. IV.17, the types of receipts subject to inclusion in the receipts factor are limited to gross receipts arising from "transactions and activities in the regular course of the taxpayer's trade or business" and also exclude certain other receipts from investment-type activities.[1] Gross receipts from transactions and activities in the regular course" is a category derived from the first sentence of UDITPA's definition of "business income", sometimes referred to as the "transactional test" of business income. (As compared to the second sentence of the business income definition, which is sometimes referred to as the "functional test" of business income.)

This definition of receipts represented the Commission's determination that the receipts factor should reflect the marketplace for the taxpayer's goods and services as a locus of business activity and the creation of income. This role for the receipts factor is not a novel development.[2] The correlation between the receipts factor and the marketplace is also the basis of the "destination" rule for sales of tangible personal property (TPP) in the original Uniform Division of Income for Tax Purposes Act (UDITPA), and Compact Article IV.15 and IV.16 as they stand today.

The new definition is consonant with the changes to Compact Art. IV.17, which now states explicitly that receipts from providing services and from selling, licensing or leasing intangible property are to be assigned to the taxpayer's marketplace. Art. IV.17 then sets forth a series of rules for establishing how that marketplace should be determined for various activities and transactions. These rules were explicated in 2017 with the adoption of a comprehensive model regulation.[3]

As their work progressed, the two work groups became aware of the need for a rule for determining a receipts factor for entities that lacked any gross receipts that would be defined as "receipts" (that is, receipts derived from transactions and activities undertaken in the regular course of business and otherwise not excluded from the definition of "receipts"). Also, because many states have eliminated the property and payroll factors from their apportionment formulas, it is possible that a non-operational subsidiary could have apportionable base income but no apportionment factors. See, e.g., *Blue Bell Creameries, L.P. v. Roberts*, 333 S.W.3d 59 (Tenn. 2011).

Ultimately, the uniformity committee approved a project to address this issue under Compact Art. IV.18, the alternative apportionment provisions of UDITPA. A third work group was thus formed in late 2015 to study the issue and to draft a model regulation based on their findings; that group determined it would be feasible to develop an appropriate model regulation, and commenced work on a draft.

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[1] The full definition reads:
"Receipts" means all gross receipts of the taxpayer that are not allocated under paragraphs of this article, and that are received from transactions and activity in the regular course of the taxpayer's trade or business; except that receipts of a taxpayer from hedging transactions and from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities, shall be excluded.

[2] For a more detailed analysis of relationship between the receipts factor under UDITPA and the taxpayer's marketplace, see J. Swain, *Reforming the Corporate Income Tax: a Market-Based Approach*, 83 Tulane L. Rev. 283 (2008).

[3] http://www.mtc.gov/getattachment/Uniformity/Adopted-Uniformity-Recommendations/FINAL-APPROVED-2017-Proposed-Amendments-to-General-Allocation-and-Apportionment-Regulat.pdf.aspx.

**2. The proposed model regulation reflects certain policy goals set forth below, but includes a pragmatic decision to abandon an effort to achieve full apportionment to a state with jurisdiction to tax for most classifications of gross receipts.**

Early in its deliberative process, the work group made some key policy decisions that guided the development of the draft, described below:

**a. Focus on income types, not entity types**:

Early on, the work group elected to focus on the sourcing treatment for identifiable categories of gross receipts, rather than on particular types of special purpose entities subject to special sourcing rules. The gross receipts categories are: (a) dividends; (b) gains from dispositions of property; (c) income from lending activity; (d) income from accounts-receivable factoring; (e) income from investment activity; and (f) other income.

**b. Retain flexibility:**

The work group tried to balance the goals of specificity and predictability with the need to allow flexibility in application. Some flexibility was desired because the regulation addresses special-purpose entities and the types of receipts that can be easily redirected or transferred among related parties. This balancing effort is evident through-out the draft, including IV.18.(c).(7), which provides that the parties may vary the established rules where necessary to achieve an equitable apportionment result.

**c. Reflect external consistency:**

The draft regulation generally seeks to assign gross receipts based on the location of the underlying economic activity that created those receipts, where possible. In the case of apportionable dividends, for example, the draft regulation will often result in those dividend receipts being assigned to a foreign jurisdiction. Similarly, apportionable gains and losses from the disposition of a taxpayer’s property are assigned in relative proportion to where the taxpayer’s apportionment factors were for the year preceding the sale (with exceptions).

**d. Reflect horizontal equity:**

The work group was guided by the goal of trying to assign gross receipts derived from particular activities, such as banking or investing, in the same way those receipts would be sourced for a taxpayer subject to apportionment under Art. IV.16 and Art.IV.17, or in the same manner those receipts would be sourced under applicable special industry apportionment rules.

**e. Abandonment of the goal of full apportionment:**

The work group attempted to use throw-out rules to ensure full apportionment where receipts would otherwise be assigned to a jurisdiction where the taxpayer lacked nexus. This effort was abandoned because the resulting rules would have been too complex and the results too variable to administer, but throw-out was retained for taxpayers engaged in accounts-receivable factoring.

### 3. Key aspects of the Proposed Model Regulation.

#### a. Scope of operation (IV.18.(c).(2)):

The first issue faced by the work group was establishing the appropriate criteria for triggering the regulation's operation. The work group and uniformity committee concluded that a taxpayer's apportionable income could be fairly apportioned based on a very modest amount of transactional business activity and receipts relative to non-operational gross receipts.

The second decision-point was whether the trigger should be based on subjective criteria or a firm arithmetic percentage. The work group ultimately recommended an objective threshold that limited the proposed regulation's operation to instances where the taxpayer had includable receipts of 3.33% or less of the taxpayer's overall gross receipts. But Sec. 18.(c).(7) of the proposed regulation also affords flexibility to both taxpayers and the tax commissioner to adjust that threshold where appropriate to more fairly reflect business presence within a state. The threshold amount is not directly based on any broader legal criteria or analog from other statutes. It is a percentage that has been used in at least two other states as a general guide in determining when a particular apportionment factor should be disregarded as *de minimis*, and indeed, the same 3.33% threshold is employed later in the proposed model regulation for that purpose.

#### b. Sourcing rules for particular types of gross receipts (IV.18.(c).(3)):

##### i. Dividends. (IV.18.(c).(3).(A))

Dividends are assigned according to the apportionment factors of the payor, if the payor is a related party. No provision is made for sourcing dividends from an unrelated party in this section; those dividends, if apportionable, would likely fall within the investment activity category, 18.(C)(3).(e). Where the years in which the earnings from which the dividends are paid can be reasonably ascertained, the payor's apportionment factors for those years are used; otherwise, the payor's apportionment factors in the current year and the prior year are averaged and used.

The treatment of dividend income occupied many hours of meeting time for the work group. California's proposed treatment of dividend income was the beginning point for those deliberations, but the work group eventually created its own rules.

##### ii. Gains from the disposition of property. (IV.18.(c).(3).(B))

The provisions regarding gains (primarily capital gains) also occupied much of the work group's time and attention. A distinction is made between gains arising from sales of stock in which the taxpayer owned either less than or greater than 20% ownership interest, with the former assigned as gross receipts from investment activity. In the latter case, gains are assigned to a state based on the prior year apportionment factors of the business entity being disposed of, with several exceptions. Significantly, the apportionment factors of the selling business are used even where that business sells only a segment of its business. Once again, the provisions for sourcing gains allow for exceptions to the general rule.

#### iii. Lending activities. (IV.18.(c).(3).(C))

Gross receipts from lending activity (primarily, interest and related charges and fees) are generally sourced as those gross receipts would have been sourced had the entity been a financial institution subject to state financial institution apportionment rules, with an exception for related-party lending and accounts receivable factoring.. The work group added a note that the rule for sourcing gross receipts from lending activity includes a provision from the MTC's *Formula for the Apportionment and Allocation of the Net Income of Financial Institutions.*[4] That provision assigns to the taxpayer's commercial domicile receipts that would otherwise be sourced to states in which the taxpayer was not subject to tax. The work group's discussions suggested an assumption that an entity making loans to customers in a state will generally be subject to tax in that state; gross receipts from such lending activity would generally be sourced to the location of the customer.

It should be noted that example (i) under this subsection references a hypothetical taxpayer (Big Box Holding, Inc.) with two types of non-transactional gross receipts: dividends and lending gross receipts. The example is intended to show how both types of gross receipts would be included in the numerator and denominator of the taxpayer's receipts factor. (Also see the introductory drafter's note cautioning that state dividend treatment varies widely.)

#### iv. Factoring receipts. (IV.18.(c).(3).(D))

The work group was aware that taxpayers can establish related-party accounts receivable factoring companies that can potentially be used to reduce the amount of net income reported by a taxpayer or a taxpayer's apportionment percentages. See generally, *Harley-Davidson, Inc. v. Franchise Tax Board,* Sup. Ct. of California, Co. of San Diego, No. 37-2011-00100846 (2013), *aff'd in part,* 237 Cal.App.4th 193 (2015); *Union Pacific Corporation v. Idaho State Tax Commission*, 83 P.3d 116 (Id. 2004)(factored accounts distorted sales factor). The work group therefore concluded that throw-out of gross receipts attributed to factored receivables from customers in states where the taxpayer lacked nexus presented few complications and was necessary to prevent inappropriate tax-minimization planning.

#### v. Investment activities. (IV.18.(c).(3).(E))

The field of operation of this subsection is narrow, since it only applies to gross receipts attributable to investment activities not otherwise assigned under other provisions of IV.18.(c).(3). Once again, the work group determined that gross receipts from investment activities not otherwise assigned should be treated under the rules of assignment for similar activities undertaken by financial institutions. Under subsection (3)(n) of the MTC's *Formula for the Apportionment and Allocation of the Net Income of Financial Institutions,* gross receipts from investment activities are sourced to where they would be "properly assigned to a regular place of business." Under subsection (3)(p) of that formula, such gross receipts that would otherwise be assigned to a state in which the taxpayer lacked nexus would be assigned to

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[4] http://www.mtc.gov/getattachment/Uniformity/Adopted-Uniformity-Recommendations/Financial-Institutions-Apportionment-Rule-Amended-2015.pdf.aspx.

commercial domicile. The rule goes further and provides that other gross receipts from investment activity would be assigned to where such investments are managed.

**c. Alternative sourcing rules for gross receipts not subject to assignment under specific assignment rules in Reg. IV.18.(c).(3):**

Because the proposed model regulation is generally applicable to special purpose entities that lack "receipts", as defined, the work group decided that it was necessary to employ a catch-all provision. Otherwise, it would be difficult to ensure in advance that gross receipts from all types of apportionable income would be covered. The work group eventually settled on three catch-all provisions, with a cascade of preference among the first three, and a fourth, broader catch-all provision that applies to the entirety of the proposed regulation.

**i. Using remaining apportionment factors allowed under state law to establish a receipts factor (Reg. IV.18.(c).(4))**

The first alternative sourcing methodology provides that where gross receipts cannot otherwise be assigned under the specific rules of IV.18.(c).(3), and the state employs a multi-factor apportionment formula, the taxpayer's gross receipts will be assigned by applying the remaining applicable *non-de minimis* apportionment factors. Regulation IV.18.(c).(1)(E) defines *non-diminis* to mean the factor "is less than 3.33 percent of the entity's apportionable gross receipts or if the factor is insignificant in producing income." The standard is borrowed from a similar definition in Massachusetts' business income statutes.

**ii. Using the combined reporting apportionment factors of a taxpayer. (Reg. IV.18.(c).(5))**

The second alternative sourcing methodology, to be used where the state uses only a receipts factor for apportioning net income, or if the taxpayer's net income cannot be assigned under Reg. IV.18.(c).(4), is to employ the total numerators of the combined reporting group of which the taxpayer is a member and is filing in that state in order to assign the taxpayer's gross receipts. By its terms, this alternative is only available when the taxpayer is included in the relevant combined report filed with that state.

**iii. Using the ratio of income reported to the state on a federal consolidated basis over federal consolidated income reported everywhere. (Reg. IV.18.(c).(6)).**

The third and final alternative, when all other sourcing methodologies are unavailable, is to use the ratio of income reported to the state under the federal consolidated method for the federal consolidated group to the amount of federal consolidated income reported everywhere. Two examples are included that involve gross receipts that would not be subject to assignment under 18.(c).(3) through(5). Both examples involve Windfall Corp.'s receipt of the proceeds of a patent infringement suit. The first example assumes the state requires a combined return but the taxpayer is not included in that return; the second example assumes the state has not adopted Reg. IV.18.(c).(5)(presumably a state that does not permit combined reporting).

**iv. Recognition that all aspects of proposed regulation are subject to general equitable apportionment standards. (Reg. IV.18.(c).(7))**

The final section of the proposed regulation contains an acknowledgment that equitable apportionment provisions apply to all aspects of the proposed regulation and that variance from the regulation may be appropriate to ensure that income is fairly apportioned in particular cases. This section allows either the taxpayer or tax commissioner to petition for a variation that would broaden or narrow the regulation, allowing the regulation's application, for instance, in cases in which the ratio of receipts to gross receipts exceed the 3.33% threshold. A second example is noted, where a look-through to the ultimate source of a dividend is necessary to ensure that the dividend income is assigned to where it was actually earned (the external consistency test.)

**B. Summary of Proposed Model Regulation IV.18.(d):** ***Apportionment of Income of Bank Holding Companies and Subsidiaries.***

Proposed regulation IV.18.(c).(4), the bank holding company regulation, is intended to encourage a broader utilization of special apportionment rules designed to more clearly reflect the business presence of financial institutions in the states. The proposed regulation would expand the scope of a state's financial institutions' apportionment rules to include bank holding companies, bank subsidiaries, and Savings and Loan holding companies and subsidiaries.

The Commission first adopted a financial industries model regulation in 1993 and has revised it twice since then. The model, which includes interest and related charges in the receipts factor, and also includes income arising from investment activities, has been widely adopted by the states. The *Formula for the Apportionment and Allocation of the Net Income of Financial Institutions*[5] ("the MTC regulation") is incorporated by reference in both proposed model regulations.

During the course of its deliberations, it was brought to attention of the work group that the MTC regulation does not include a definition of a financial institution in the body of the regulation, but instead, includes a suggested definition in an Appendix. The drafters of the MTC regulation may have felt that existing variations in state definitions would prevent states from adopting the detailed sourcing rules and definitions in the MTC regulation, inhibiting uniformity in those areas. The proposed definition set forth in the Appendix included bank holding companies and subsidiaries, as well as Savings and Loan holding companies and subsidiaries. A majority of Compact member adopted this inclusive definition but many states have not. For instance, some states have restricted their definition of financial institutions to "operational" entities.

As a result of the states' adoption of narrower definitions, states and taxpayers may lack sufficient guidance for sourcing the income of bank holding companies that receive income from their operating affiliates. Additionally, assets and income may be pushed down from operating entities to special purpose subsidiaries, creating the same uncertainty as to proper apportionment.

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[5] http://www.mtc.gov/getattachment/Uniformity/Adopted-Uniformity-Recommendations/Financial-Institutions-Apportionment-Rule-Amended-2015.pdf.aspx.

Originally, the work group considered the idea of including an additional category of business entities subject to the sourcing rules in proposed Reg. IV.18.(c).(3). This approach was rejected in favor of a stand-alone regulation. We agree with Ms. Boucher's assessment that a majority of Compact states have concluded that income of financial institutions requires special and detailed apportionment rules to fairly reflect the business presence of those institutions in the states.[6] We also agree that the location of income or assets derived from financial institution activity in subsidiaries or holding companies does not change the need for those special apportionment provisions. The first paragraph of the proposed regulation expands the scope of the financial institution definition in states that already have a financial institutions' formula but have adopted a narrower definition. It also provides that states, by adopting the model regulation, will subject bank holding companies and subsidiaries (and Savings and Loan holding companies and subsidiaries) to the MTC financial institutions regulation even if the state lacks any rule for financial institutions generally.

The second paragraph of the proposed regulation specifies that, notwithstanding the identification of specific rules for when an entity should fall within the state's financial institutions' apportionment provisions, it may be necessary for either the taxpayer or the tax commissioner to seek an exception to those provisions under the equitable apportionment provisions of Compact Art. IV.18.

### C. Response to Written Comments

The Hearing Officer received only two written responses to the proposed regulations. We believe the absence of additional responses may be taken as an indication that the proposed regulations are sound and responsive to the public input received during the lengthy drafting and review process.

Mr. Yesnowitz submitted written comments on March 3, 2018, addressed to proposed model regulation IV.18.(c), attached here as Exhibit A. Ms. Boucher had previously submitted written comments, attached as Exhibit B, primarily addressed to proposed model regulation IV.18.(d); she did not submit additional written comments.

The Commission's legal staff appreciates the opportunity to provide our responses to those comments, the substance of which we have paraphrased as italicized captions below.

#### 1. *Apportionment Formulas Should Reflect all Sources of Income***.**

We begin by addressing an issue raised by both Ms. Boucher and Mr. Yesnowitz, which is the concern that the definition of "receipts" in Compact Art. IV.1.g. fails to include in the receipts factor all sources of a taxpayer's apportionable income and thus may fail to properly reflect the

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[6] One of the more important aspects of the Commission's financial institutions regulation is that it defines receipts from certain investment activities as the "net" amount realized from those activities, not the gross amount. This is particularly significant since some investments, such as repurchase agreements are typically turned over on a nightly basis. The proposed Regulation IV.18.(d) continues that treatment in its first paragraph.

amount of income properly attributable to business activities occurring in the states that follow that definition.

Although the comments are not directed to the merits of either proposed regulation, we address them here because the concerns they express were considered during the regulatory development process.

Mr. Yesnowitz prefaces his comments by noting that it is "unsurprising" that the Commission recognized the need for a special rule for taxpayers lacking includable receipts because the states' apportionment formulas exclude some gross receipts giving rise to apportionable income from the receipts factor, which he describes as a growing problem.

This concern is also reflected in the written comments of Ms. Boucher regarding proposed Reg. IV.18.(c).(4), where she notes the FIST Coalition's continuing objection to the failure to include receipts arising from "lending, income from investments, and receipts from securities and hedging transactions" in the definition of "receipts." Exhibit B, page 1. The remainder of Ms. Boucher's comments are in support of proposed Reg. IV.18.(d). She urges approval of the proposed regulation without substantial modification.

Our response to both parties' concerns regarding the scope of the "receipts" definition can be easily summarized: Because the receipts factor is intended to reflect the contributions of the marketplace to income generation, inclusion of gross receipts arising from non-market oriented activities would often defeat that policy.

The Commission did receive extensive public comments during its consideration of the proposed changes to the changes to the definition of "receipts" (Compact Art. IV.1.(g)), which were aimed at expanding that definition to include gross receipts from securities transactions and hedging transactions.[7] Similar comments were made during the course of this regulatory project as it progressed through multiple public meetings. The comments were carefully considered by the Commission's uniformity and executive committees. What the committees did not hear were examples of specific instances where the exclusion of such receipts would result in a failure to reflect the percentage of a taxpayer's business activity within the states.

For instance, while gross receipts from "securities" are explicitly excluded from the definition of "receipts" in Art. IV.1.(g), the *commissions* earned from selling those securities to customers in the regular and ordinary course of business would be included in the taxpayer's receipts as a "professional service" under Model Regulation IV.17.(d)(4). Similarly, while a manufacturer might engage in extensive hedging transactions to counter fluctuations in raw material prices, product demand or currency values, the ability to do so ultimately depends on having a market for the manufactured product. See, e.g., *General Mills Co. v. Franchise Tax Board,* 146 Cal.Rptr.3d 475 (Cal. Ct. App. 1st Dist., Aug. 29, 2012)(excluding hedging transactions from receipts factor under alternative apportionment provision of UDITPA).

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[7] Written comments and the staff's responses to those comments may be found on the Commission's website here under the caption for "Meeting Minutes:" http://www.mtc.gov/Uniformity/Project-Teams/Section-17-Model-Market-Sourcing-Regulations.

The uniformity committee also considered the states' experience in litigation concerning the potential for distortion arising from the inclusion of gross receipts from investment activities, including securities trading on one's own account and hedging transactions, in the receipts factor. See, e.g., *Microsoft Corporation v. Franchise Tax Board,* 139 P.3d 1169 (Ca. 2006)(inclusion of gross receipts arising from overnight investments of securities distorted sales factor); *General Mills Co. v. Franchise Tax Board, supra*. The Commission's member states responded to that experience by enacting statutes and regulations excluding "treasury function" receipts from the receipts factor numerator and denominators. The Commission also responded by amending the Commission's *General Regulation for the Allocation and Apportionment of Income* in 2003 to exclude receipts from hedging transactions, securities, interest and other non-operational activity from the scope of the receipts factor as defined in Reg. IV.1.(a).(5).[8]

Notwithstanding its objection to including gross receipts arising from investment activities, securities trading and hedging activity in the receipts factor generally, on numerous occasions over the course of this project the uniformity committee has invited interested members of the public to submit proposals for developing industry-specific model apportionment regulations which could include these or other non-market-oriented types of gross receipts in the receipts factor. Although no proposals for industry-specific apportionment rules have been received to date, the uniformity committee has expressed its continuing willingness to consider them.

The proposed regulations currently before the hearing officer were developed in response to the two broad areas recognized by the uniformity committee where the market-based definition of receipts may fail to adequately ensure that a taxpayer's receipts factor numerator is reflective of its income-generating activity in taxing states. Proposed model Regulation IV.18.(c) addresses entities lacking receipts that can be attributed to a marketplace, while proposed model Regulation IV.18.(d) provides a means by which states can expand the scope of entities subject to their financial institutions special apportionment rules to include subsidiaries and holding companies.

***2. Correction of Typographical Errors.***

We appreciate Mr. Yesnowitz's sharp eye in noting that "proceeding" should have been "preceding" in Reg. IV.18.(c).(3).(B).1 and (B).2. Staff has corrected the errors.

***3. Criteria for Distinguishing Stock Sales from Asset Sales.***

Mr. Yesnowitz asks for confirmation that in the section dealing with sourcing of gains, proposed Reg. IV.18.(c).(3).(B), it was the drafters' intent that states should rely on their own definitions of what constitutes a stock sale as distinguished from an asset sale.

Reg. IV.18.(c).(3).(B) provides for similar treatment of gains arising from either the disposition of stock (and other intangible interests) or the disposition of physical assets--in both instances, the gains are assigned to the state in the same proportion as the apportionment factors of the legal entity or segment of a legal entity's business being disposed of in the year preceding the

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[8] http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Section-1-Model-Definition-of-Receipts%E2%80%9D-Regulation/Current-MTC-Article-IV-Regs.pdf.aspx. (see page 19)

disposition.[9] The regulation does not further define assets or stocks, so state definitions of those terms would control.
Example (iii) under this same section addresses the specific instance in which a taxpayer has made a federal election under I.R.C. Sec. 338(h)(10) to treat the sale of stock as the sale of assets. The example provides that if the state follows the federal election, then the gain arising from that sale would also be treated as the sale of assets under this regulation. Implicitly, if the state does not follow the federal election, then under this regulation the gains would likewise be treated as the sale of stock, not assets.

Proposed Reg. IV.18.(c).(3).(B) does exclude from its sourcing rule those gains arising from the sale of stock representing less than a 20% ownership interest in a business entity. The work group determined that those gains would be more appropriately sourced as "investment" earnings pursuant to proposed Reg. IV.18.(c).(5). To the extent a state's existing rules were inconsistent with that determination, the state should clarify which sourcing treatment should control.

### *4. The Provisions in Reg. IV.18.(c).(5) and (6) Regarding the Use of Combined Return Receipts Factors and Federal Consolidated Liability, Respectively, Could Result in Unconstitutional Over-Taxation of Income by a State.*

The provisions in Reg. IV.18.(c).(5) and (6) constitute alternatives to the alternatives when all other means of creating a receipts factor have failed. The circumstances under which these provisions would be utilized are difficult to envision in the abstract and the instances in which they would be utilized are presumably few and far between. We do not agree that using a taxpayer's combined report receipts factor to impute a receipts factor for member of that combined group would result in an arbitrary assignment of income in most situations.

We do agree with Mr. Yesnowitz's concern that using the ratio of a federal consolidated taxpayer's income assigned to a state over total federal consolidated income as a proxy to create a receipts factor numerator for that taxpayer could conceivably result in sourcing income in a manner that is out of proportion to the related activities. The provision serves a valuable purpose nonetheless by establishing a rough guideline for apportionment that puts a burden of proof on the party unsatisfied with that result to come forward with evidence identifying the location of taxpayer's business presence within the taxing state. This procedure is available to both the taxpayer and the tax commissioner under Reg. IV.18.(c).(7).

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[9] The section provides:
Gains (net of related losses, but not less than zero) from the disposition of stock (or other intangible property rights) representing at least a 20% ownership interest in a business entity, or from the disposition of assets of a business entity or segment of a business entity, are assigned to the receipts factor numerator in this state in a proportion equal to the apportionment factor in this state as determined pursuant to [ref. to state law] for that business entity as if filing on a separate corporate basis, for the year preceding the disposition. In any case where the apportionment factor of the business entity cannot be reasonably determined, then the receipts from that gain are attributed to the receipts factor numerator of this state under subsections (d), (e), (f) or (g).

## HEARING OFFICER'S FINDINGS

In Alabama, and presumably in most other states, a regulation promulgated after a public hearing must be followed unless it is unreasonable or contrary to the statute to which it relates, see generally, *East Brewton Materials, Inc. v. State, Dept. of Revenue*, 233 So.2d 751 (Ala. 1970). I find the provisions in proposed model Reg. IV.18.(c) to be reasonable, and certainly not contrary to the provisions in, or intent of, the Multistate Tax Compact Art. IV.

The clear intent of the drafters of Reg. IV.18.(c) was to provide taxpayers and tax administrators alike with uniformity and certainty concerning the apportionment of various types and categories of receipts not otherwise included in the general definition of "receipts" in Art. IV.1.(g). Proposed Reg. IV.18.(c) satisfies that intent by giving general guidelines that are both reasonable and, importantly, flexible in that if a taxpayer or the tax administrator believes that a general rule in Reg. IV.18.(c) does not clearly or accurately reflect the taxpayer's receipts attributable to a State, either party may apply for an alternative method pursuant to proposed Reg. IV.18.(c).(7) (Compact Article IV, Sec. 18 or similar State law) that more clearly reflects the amount of receipts attributable to the State.

In her public comments submitted on behalf of the FIST Coalition, Ms. Boucher objects to the narrow definition of "receipts" in Compact Art. IV.1.(g). As discussed in the MTC's March 9, 2018 memorandum, at p.9, that issue is outside of the scope of either proposed regulation, and will not be addressed in this Report. Ms. Boucher otherwise raises no objection to any provision in proposed Reg. IV.18.(c), and asserts that proposed Reg. IV.18.(d) should be adopted without modifications.

Mr. Yesnowitz also objects to the narrow definition of "receipts" in Compact Art. IV.1.(g). Again, that issue is outside of the scope of the two proposed regulations, and will not be addressed in this Report.

Mr. Yesnowitz also asks for confirmation that pursuant to proposed Reg. IV.18.(c)(3)(B), the State specific definition of what constitutes a stock sale versus an asset sale should be used. The MTC's March 19, 2018 memorandum gives that confirmation, at pp. 11, 12.

I agree with the MTC memorandum, at p. 9, that "the absence of additional responses (or objections to proposed Reg. IV.18.(c)) may be taken as an indication that the proposed regulations are sound and responsive to the public input received during the lengthy drafting and review process". The MTC, and the working group that drafted proposed Reg. IV.18.(c), should be congratulated for the transparency of the drafting process and their willingness to accept, and in some cases agree to, comments from the taxpaying public.

Given the lack of any public comments objecting to proposed Reg. IV.18.(c), I find that a provision by provision analysis of the regulation is not necessary in light of the MTC's March 19, 2018 memorandum. I agree with the memorandum, and accordingly recommend that proposed Reg. IV.18(c) be adopted in its entirety, with one possible modification discussed below.

The MTC memorandum, at pp. 4, 5, explains that in determining "the appropriate criteria for triggering the regulation's operation . . . .[t]he work group ultimately recommended an objective threshold that limited the proposed regulation's operation to instances where the taxpayer had includable receipts of 3.33% or less of the taxpayer's overall gross receipts". See, proposed Reg.IV.18(c)(2).

I find the above objective threshold to be reasonable. Proposed Reg. IV.18.(1)(E) also defines "[a]n entity's apportionment factor as *'de minimis'* if the denominator is less than 3.33 percent of the entity's apportionable gross receipts. . . . ". I likewise find that objective threshold to be reasonable. But proposed Reg. IV.18.(1)(E) goes on to declare that an apportionment factor is also *de minimis* "if the factor is insignificant in producing income".

My concern is in determining when a factor is "insignificant" in producing income. Can the denominator of a factor be more than 3.33 percent of the entity's apportionable gross receipts and still be insignificant, and thus *de minimis*? In substance, by adding an alternative "insignificance" test, the regulation is opening the *de minimis* definition to subjective determination.

I would suggest removing the "insignificant in producing income" test in proposed Reg. IV.18.(1)(E) and let the objective less than 3.33 percent test govern. As discussed, Sec. 18.(c).(7) can be used by any party to adjust the 3.33 percent threshold to more fairly reflect a taxpayer's business presence in the State. Likewise, that section can also be used in determining what is *de minimis*. Of course, if the working group drafters included the alternative "insignificant" test for valid reasons I am unaware of, then the phrase should remain.

Proposed Reg. IV.18.(d) addresses the apportionment of the income of bank holding companies and their subsidiaries. The MTC's memorandum addresses that regulation at pp. 8,9. I find the regulation to be reasonable, and given that the only public comment on the regulation, by Ms. Boucher, urges the hearing officer to recommend adoption of the regulation without modification, a detailed analysis of the regulation is unnecessary here. The MTC memorandum adequately explains the rationale behind the regulation. I recommend adoption of the proposed Reg. IV.18.(d) as currently written.

Dated this the 10th day of April, 2018.

/s/*William Thompson*

**WILLIAM THOMPSON**
**HEARING OFFICER**