

Financial Institutions State Tax Coalition

May 11, 2016

Demesia Padilla
Executive Committee Chair
Multistate Tax Commission
444 N. Capitol Street NW
Suite 425
Washington, DC 20001

Re: Proposed Draft Amendments to the Commission’s Model General Allocation and Apportionment Regulations

On behalf of the Financial Institutions State Tax (“FIST”) Coalition, I am submitting these written comments regarding the proposed draft amendments to the Commission’s model general allocation and apportionment regulations. The FIST Coalition respectfully requests that the draft amended Regulations IV.1 and IV.17 (“Sections 1 and 17 Regulations”) be sent back to the uniformity committee to address the issues outlined below and to give taxpayers/practitioners adequate (non-tax season) time to review and provide comments.

1. It appears that the current draft amendments to the Model General Allocation and Apportionment Regulations do not reflect the intent of the revised UDITPA provisions that the Commission voted on.

When reviewing recent draft language of the Section 18 work group, we became curious as to why interest income on lending activities and interest and dividends on investment activities were not addressed in the general apportionment sourcing rules (i.e., Section 17 Regulations), rather than now being addressed as exceptions under Section 18.

From the May 3, 2012 MTC staff document provided to the Executive Committee, it is clear that receipts that were not considered to be receipts from the treasury function or receipts where there is no customer were intended to be included in the receipts factor and thus should be addressed in the Model General Allocation and Apportionment Regulations. According to examples in the May 3, 2012 document:

4. Taxpayer routinely sells and replaces a certain type of equipment used in the production of its product (e.g., fleet vehicles). Taxpayer’s income from these sales meets the transactional test and is treated as business income.
The gross receipts are “sales” for sales factor purposes.
5. Taxpayer makes an installment sale and receives interest income on the installment payments.

The interest on installment payments is included as gross receipts for sales factor purposes.

In addition, the FIST Coalition believes that the revised receipts factor definition does NOT exclude interest from lending, and interest and dividends on investments. The revised definition is:

(g) “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.** (Emphasis added)

This definition excludes receipts “from the maturity, redemption, sale, exchange, loan or other disposition” of cash or securities, but does NOT exclude receipts from holding securities or loans as long as they are from transactions and activity in the regular course of the taxpayer’s business.

Also, a review of Mr. Pomp’s Hearing Officer’s report on the UDITPA rewrite indicates that the Hearing Officer interpreted the latter part of the revised receipts factor definition to exclude from the factor certain treasury function receipts and not fees and interest from lending transactions. See for example, page 107 of the Hearing Officers Report where Mr. Pomp notes:

“[t]he Report defends its exclusion of receipts from hedging and from the so-called treasury function (which is a shorthand for the maturity, redemption, sale, exchange, loan or other disposition of cash or securities) . . .”

Additionally, draft Regulation IV.2.(a)(6)(A) provides:

In the case of a taxpayer engaged in manufacturing and selling or purchasing and reselling goods or products, "receipts" includes all gross receipts from the sales of such goods or products (or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the tax period) held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. Gross receipts for this purpose means gross sales less returns and allowances, and includes all interest income, service charges, carrying charges, or time-price differential charges incidental to such sales. Federal and state excise taxes (including sales taxes) shall be included as part of such receipts if the taxes are passed on to the buyer or included as part of the selling price of the product. (Emphasis added)

Moreover, in order to ensure a level playing field, taxpayers who lend to customers (whether or not the taxpayer falls within the financial institution definition) should be required to source fees and interest from their lending activity in the same manner as required of financial institutions.

The FIST Coalition acknowledges that the reason that interest on lending and interest and dividends on investments may have been inadvertently excluded from the draft amendments to the Section 17 receipts sourcing regulation is because the work group started with the Massachusetts market-sourcing regulations and the Massachusetts law specifically excludes interest and dividends from the sales factor.

Accordingly, the FIST Coalition believes that the Commission's model general allocation and apportionment regulations should be sent back to the uniformity committee to include sourcing for fees and interest on lending and receipts on investments that are part of the taxpayer's regular trade or business.

- 2. The FIST Coalition agrees with Mr. Hamer's Hearing Officer's Report that "given the complexities of the modern economy, it seems likely that some parts of the section 17 rules will be found wanting."**

The Coalition has already identified several of those wanting parts above, and believes there likely are other inadequate areas in these complex regulations that would be identified if the regulations were not finalized until the Section 18 Regulations were completed. In addition, issuing draft regulations and requesting comments during the busy annual financial statement/tax season will always result in limited taxpayer/practitioner review and input. Accordingly, the Coalition believes that during the period that the Uniformity Committee works on adding the interest and investment sourcing provisions, the entire proposed draft amendments to the Commission's model general allocation and apportionment should remain open for additional comments that taxpayers and practitioners may identify during a non-tax season review.

- 3. Adoption of the draft amendments to Section 1 and Section 17 Regulations before the Section 18 Regulations are written will cause turmoil for taxpayers whose regular trade or business is dealing in hedging and securities.**

It is clear from the documents supporting the UDITPA rewrite, including Mr. Pomp's Hearing Officer's Report, that the exclusion of the hedging and securities transactions from the receipts factor was not intended to apply to securities dealers. Mr. Pomp's Hearing Officer's report notes that the exclusion should also apply to other taxpayers such as market makers and similar taxpayers who deal in securities and hedging. In reaction to Mr. Pomp's comment, in an effort to move the UDITPA rewrite forward, the exclusion for securities dealers was removed from the receipts definition, and instead was to be addressed in special industry apportionment provisions under Section 18.

It is also clear from MTC staff documents regarding the UDITPA rewrite that the hedging exclusion was meant to deal with the issue presented in *General Mills v. Franchise Tax Board* [No. A131477 (Cal. Ct. App 2012)] and was not meant to apply to securities dealers.

For securities dealers, market makers and similar taxpayers, receipts from securities and hedging transactions reflect the contribution of the taxpayer's market to the earning of income and should be included in their receipts factor.

Adoption of the draft amendments to the Section 1 and Section 17 Regulations before the Section 18 Regulations are written will cause turmoil for taxpayers whose regular trade or business is dealing in hedging and securities. It would have both tax compliance and financial statement implications – how would such taxpayers determine their current and deferred state

effective tax rates and prepare tax returns if there is no apportionment guidance and adoption of the narrow receipts factor results in over 50% of their receipts from transactions with customers being excluded from the receipts factor?

It also would raise constitutional issues to exclude such large components of the taxpayers' receipts from the receipts factor.

Accordingly, the FIST Coalition believes that the draft amended Regulations IV.1 and IV.17 should not be adopted until the Section 18 Regulations are completed to ensure that other issues that are more fitting under the Section 17 Regulations are identified and taxpayers whose trade or business include hedging and dealing in securities are not left in limbo as to how to compute their financial statement effective tax rates and how to complete their tax returns.

Conclusion

The FIST Coalition requests that the draft amended Section IV.1 and IV.17 Regulations be sent back to the uniformity committee to address the above issues and to give taxpayers/practitioners adequate (non-tax season) time to review and provide comments.

Otherwise, if the draft regulations are adopted, they should first be amended to provide that until industry regulations are adopted, taxpayers that deal in securities and hedging will continue to apportion their income in the same fashion as the state laws and regulations provided as of 12/31/2015 and will not be bound by the provisions in the amended regulations.

Please contact me if you have any questions regarding the above comments.

Sincerely,

Karen Boucher

Karen Boucher
Financial Institution State Tax Coalition LLC
Managing Member