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Chis Coffman, Chair, Section 18 Regulatory Working Group

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Models for Special Allocation and Apportionment of Income Under Article IV
Where Taxpayer Has No or Minimal “Transactional” Receipts

At its last meeting on March 8, 2016, the “Section 18” working group agreed to look at methods to apportion income of entities with no or minimal receipts derived from “transactions and activity in the regular course of the taxpayer’s trade or business.” The definition of “receipts” also excludes receipts from hedging transactions and the disposition of cash and securities. Article IV, Section 17 and the proposed model regulation issued under that section also exclude receipts from the sale of certain types of intangible property including “...without limitation, the sale of a partnership interest, the sale of business ‘goodwill,’ the sale of an agreement not to compete, or similar intangible value.” The potential for uncertainty in apportioning income of “special purpose” entities and non-operational taxpayers is especially acute for states utilizing separate-entity reporting and single sales (“receipts”) factor apportionment.¹

We received two suggestions for possible solutions to the problem of sourcing income from special purpose (usually non-operational) entities. Staff has added three more for the group’s consideration.

The working group identified several possible scenarios where alternative apportionment may be appropriate. Those include:

- (a) A corporate structure which includes a parent company or holding company earning apportionable income derived from dividends (to the extent not excluded from the tax base), partnership distributive shares, intercompany or third-party interest payments or capital gains. The parent/holding company may have no or minimal receipts from market-based transactions;
- (b) A special purpose, limited life subsidiary intended to facilitate the transfer or sale of assets or a business segment to an unrelated party (“SaleCo”).

¹ This memorandum is intended to be educational and explanatory in nature and does not represent the Commission’s legal interpretation of Article IV of the Compact, proposed or existing model regulations, or committee discussions and deliberations. Additionally, this memorandum is intended to offer drafting suggestions for the working group’s consideration and does not constitute a recommendation by the Commission or its staff as to the advisability of any suggestion, idea or proposal.

- (c) A corporate structure established to manage “unitary” assets such as short-term investment portfolios, cash, loan participation agreements, franchise payments, or similar securities;
- (d) A start-up company with no “transactional” receipts but substantial net operating losses (or capital losses) which may require apportionment in subsequent tax years; and
- (e) An operating company receiving income from a very substantial capital gain, where the operating company’s current-year factors does not reflect historic factors and deductions.

Introductory Language Proposal for All Alternatives:

In some cases, application of the definition of “receipts” in Article IV, Section 1.(g) and the sourcing rules contained in Article IV, section 17 may fail to reflect the business presence of the taxpayer in this state, because, for instance, the taxpayer has no receipts arising from transactions and activity in the regular course of the taxpayer’s trade or business. In that event, the taxpayer’s income shall be apportioned to this state as follows:

Alternative One (edited for clarity):

If the entity has no receipts at all (such that its receipts factor numerator and denominator are zero), then

- a. For states using multiple factor apportionment systems, eliminate the receipts factor and use the property factor plus the payroll factor, divided by two (as long as this will fairly represent the business activity in the state);
- b. For combined filing states using single receipts factor apportionment, if the entity is not includable in a combined group, but is commonly-owned by a combined group, use the average receipts factor for the entire combined group;
- c. For separate filing states using single factor (receipts) sourcing, if the entity also has no property or payroll factor then use the apportionment percentage calculated for the entity in the prior year’s state tax return;
- d. If there were no factors for any apportionment percentage in the prior year, then, apply the provisions of section 17 to calculate a receipts factor percentage treating all your apportionable income as if it had all been included within the definition of receipts provided in UDITPA IV(1)(g).

Alternative Two:

If the numerator and denominator of the sales factor are zero or if the sales factor is otherwise determined to be insignificant in producing income, the taxpayer shall determine its sales factor by:

- (1) adding to its sales any interest, dividends and gross receipts from the maturity, redemption, sale, exchange or other disposition of securities, and applying the sourcing provisions for

receipts under [the MTC financial institutions statute] to the total adjusted sales amount, as if the taxpayer were a financial institution for purposes of that section; or

(2) if, notwithstanding the adjustments in subsection (1), the numerator and denominator of the sales factor remains zero or if the factor is otherwise determined to be insignificant in producing income, the whole of the taxpayer's net income shall be taxable net income allocated to the state, provided that the taxpayer may apply to the commissioner or the commissioner may require the taxpayer to have its income determined by alternative apportionment.

Alternative Three:

Income from otherwise non-apportionable or excluded receipts shall be included in the receipts factor and apportioned as follows:

[Alternative: receipts from the taxpayer's predominant source of income or income-producing activity shall be apportioned as follows; all other receipts shall be excluded:]

(1) The taxpayer's **dividend income** shall be apportioned to the location(s) of the dividend payors' property and payroll during the period in which the dividend was paid, unless it is demonstrated that the business activity generating the dividend was conducted in a different year or by a different taxpayer;

(2) **Capital gains from the disposition of a business or business segment** shall be apportioned as follows:

If the capital gain is recognized in a tax period of six months or less, using the prior year's property and payroll factors of the business entity or business segment being disposed of; provided that, if more than 50% of the capital gain represents goodwill or other intangible value, by using the receipts factor of the business entity;

If the capital gain is recognized in a tax period of six months or longer, using the current year's property and payroll factors of the business entity or business segment being disposed of; provided that, if more than 50% of the capital gain represents goodwill or other intangible value, by using the receipts factor of the business entity;

(3) **Interest income** shall be apportioned under the financial institutions regulation/statute of this state as if the entity were a financial institution. [generally, location of borrower or security interest in real property]

(4) **Income from Cash, Securities, Short-Term Investments, Other Capital Gains and all other Transaction and Activities generating income subject to apportionment** shall be apportioned as follows:

(a) To the locations where the underlying economic activity generating the cash, securities, capital and intangible assets was conducted;

- (b) To the extent the locations where the underlying economic activity cannot be determined, to the location(s) where the day-to-day investment decisions of the taxpayer are made; and
- (c) To the taxpayer's commercial domicile if those locations cannot be determined;

Alternative Four

Income from otherwise non-apportionable or excluded receipts shall be included in the receipts factor and apportioned as follows:

[Alternative: receipts from the taxpayer's predominant source of income or income-producing activity shall be apportioned as follows; all other receipts shall be excluded:]

- (1) Where the taxpayer is filing a return as a separate entity, but is a member of a unitary group of corporations as defined by Reg. IV.1.(b) [Multistate Tax Commission's Model Apportionment Regulation Unitary Business Definition] the taxpayer shall source its income based on the apportionment factors applicable to that combined group;
- (2) Where the taxpayer is a filing as a separate entity, but is not a member of a unitary group of corporations as defined by Reg. IV.1.(b) [Multistate Tax Commission's Model Apportionment Regulation Unitary Business Definition], then the taxpayer shall apportion its income based on the apportionment factors of the owner of the preponderance of beneficial interests in said taxpayer, unless those factors fail to represent the business presence of the taxpayer in this state.

Alternative Five (General Instruction):

In the event the taxpayer has no income meeting the definition of receipts or subject to apportionment, or the receipts which are subject to apportionment fail to reflect the taxpayer's business presence in this state, the taxpayer's income shall be apportioned to this state in a manner which reflects (a) the extent to which the taxpayer's income was derived from this state in comparison to other states; (b) the extent to which apportioning receipts pursuant to this section to this state would result in the taxpayer's income being subject to tax in multiple states; (c) the extent to which such income would not otherwise be subject to tax in any state; and (d) the application of other such other factors as the [tax commissioner] deems appropriate.

Appendix

Summary of MTC Financial Institutions Model Regulation Sourcing Rules for Primary Income Types:

A. Interest Income from Loans (location of borrower/secured property):

- 1. The numerator of the receipts factor includes interest, fees, and penalties imposed in connection with loans secured by real property if the property is located within this state. If the property is located both within this state and one or more other states, the receipts described in this subsection are included in the numerator of the receipts factor if more

than fifty percent of the fair market value of the real property is located within this state. If more than fifty percent of the fair market value of the real property is not located within any one state, then the receipts described in this subsection shall be included in the numerator of the receipts factor if the borrower is located in this state.

2. The numerator of the receipts factor includes interest, fees, and penalties imposed in connection with loans not secured by real property if the borrower is located in this state. In the case of an unrelated business, the borrower's location is its commercial domicile. In the case of a related business, the borrower is located in this state to the extent it has property and payroll in this state.

B. Investment Activity (place where investment managed with commercial domicile as default):

The numerator of the receipts factor includes interest, dividends, net gains (but not less than zero) and other income from investment assets and activities and from trading assets and activities described in paragraph (1) of this subsection that are attributable to this state.

1. (A) The amount of interest, dividends, net gains (but not less than zero) and other income from investment assets and activities in the investment account to be attributed to this state and included in the numerator is determined by multiplying all such income from such assets and activities by a fraction, the numerator of which is the average value of such assets which are properly assigned to a regular place of business of the taxpayer within this state and the denominator of which is the average value of all such assets.
2. (C) The amount of interest, dividends, gains and other income from trading assets and activities, including but not limited to assets and activities in the matched book, in the arbitrage book and foreign currency transactions (but excluding amounts described in subparagraphs (A) or (B) of this paragraph), attributable to this state and included in the numerator is determined by multiplying the amount described in subparagraph (B) of paragraph (1) of this subsection by a fraction, the numerator of which is the average value of such trading assets which are properly assigned to a regular place of business of the taxpayer within this state and the denominator of which is the average value of all such assets.

The taxpayer shall have the burden of proving that an investment asset or activity or trading asset or activity was properly assigned to a regular place of business outside of this state by demonstrating that the day-to-day decisions regarding the asset or activity occurred at a regular place of business outside this state. Where the day-to-day decisions regarding an investment asset or activity or trading asset or activity occur at more than one regular place of business and one such regular place of business is in this state and one such regular place of business is outside this state, such asset or activity shall be considered to be located at the regular place of business of the taxpayer where the investment or trading policies or guidelines with respect to the asset or activity are established. Unless the taxpayer demonstrates to

the contrary, such policies and guidelines shall be presumed to be established at the commercial domicile of the taxpayer.