



To: Wood Miller, Chair, Uniformity Committee

From: Holly Coon, Chair, Section 18 Regulatory Working Group
Bruce Fort, Counsel, Multistate Tax Commission

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The Uniformity Committee's "Section 18" working group¹ has been meeting telephonically on a weekly-basis since our last in-person meeting in July 2016 to draft a proposed model regulation for apportioning the income of entities which lack "receipts" derived from transactions and activities in the regular course of business.² 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.

These "special purpose entities" can include companies holding intangible assets created by affiliated entities, entities receiving interest from securitized loan portfolios or inter-company loans, accounts-receivable factoring companies for affiliated entities, dividend recipients, pure holding companies, and entities created as a vehicle for mergers, divestitures and acquisitions. The lack of "receipts" defined by Compact Article IV, Section 1(g) may present particular problem for states which permit or require separate-entity filings.³

¹ The working group is chaired by Holly Coon of Alabama and includes Matt Peyerl, North Dakota, Phil Skinner and Nate Nielson, Idaho, Jason Larimer, Don Jones and Katie Lolley, Oregon, Chris Coffman (ret.) and David Hesford, Washington, Michael Fatale, Massachusetts, Jennifer Hays, Kentucky (Legislature), James Savage, Virginia, Richard Botwright, Pennsylvania, Scott Fryer, Arkansas, Wood Miller, Missouri, with additional and valuable participation from other state officials and practitioners, with particular thanks to Karen Boucher for her insightful comments.

² Article IV, Section 1(g) defines receipts as:

"...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."

³ Three recent cases highlight some of the possible applications for this regulation:

In *Blue Bell Creameries, LLP v. Roberts*, 333 S.W.3d 59 (Tenn. 2011), the taxpayer created a special purpose entity with no employees or property, and which sold no products or services. The entity's only function was to facilitate the reorganization of BBC USA, Inc. from a C corporation to a Subchapter S corporation, recognizing a \$142 million capital gain from the reorganization. The taxpayer argued that the entity was not operationally unitary with the underlying business activity of BBC USA, Inc., which was making ice cream products.

The working group concluded that it would be feasible and appropriate to draft a broad regulation that would provide guidance for apportioning the various types of “functional” income receipts an entity might receive, rather than try to classify particular entity types. The goals of the drafting project can be summed up as follows: (a) to provide a predictable means of apportionment; (b) attempt to impose market-based sourcing rules where the market can be identified; (c) limit the ability to assign income to low-tax jurisdictions through intercompany transactions; and (d) retain flexibility in application for unanticipated circumstances.

The working group would like to solicit advice and suggestions from the full Uniformity Committee regarding its efforts and direction to date. The latest draft of the proposed model regulation is attached hereto as an appendix. Additional information on the working group’s activities and prior drafts may be found on the group’s MTC web page, here: <http://www.mtc.gov/Uniformity/Project-Teams/Section-18-Regulatory-Project>.

In particular, the working group would like the committee’s advice in resolving a few technical issues which may nonetheless prove to be significant down the road. Certain key features of the draft (set out in red) are annotated below for the Committee’s consideration. The technical issues needing resolution are set out in blue.

**Proposed Model Regulation under Compact Article IV, Section 18
for Taxpayers Who Lack “Receipts”:**

Where the taxpayer’s receipts, as defined by [Compact Article IV.1.g] are less than 3.33% of the taxpayer’s gross receipts [as defined by Model Allocation and Apportionment Regulation IV.2.(a)(5),] the rules set forth herein shall be applied in calculating the taxpayer’s receipts factor. These rules for calculating the receipts factor may also apply, in the discretion of the tax commissioner, in other circumstances in which the apportionment formula does not fairly represent the extent of the taxpayer’s business activity in the state.

Notes:

- Limits regulation’s application to taxpayers with less than 3.33% of gross receipts subject to apportionment under Compact Article IV, Section 15-17 (lease, license or sale tangible personal property, real property, intangible property and services);
- Allows flexibility to apply rules to taxpayers with a higher “transactional test” receipts ratio in discretion of tax commissioner.

The Tennessee Supreme Court disagreed, and allowed Tennessee to impose its apportioned franchise tax on the special purpose entity using the apportionment factors of the underlying business.

In *First Marblehead Corp v. Commissioner of Revenue*, 56 N.E.3d 132 (Mass. 2016), the taxpayer, Gate Holdings, Inc., was a holding company which held securitized student loan portfolios on behalf of 16 separate trusts, receiving interest income from loan repayments and guarantees. The underlying loans were originated by its parent First Marblehead and securitized for sale on the financial markets. Gate’s status as a financial institution was contested by the parties. Gate had no operations, no employees, no tangible property, and no sales of property or services.

In *Harley-Davidson, Inc. v. Franchise Tax Board*, 237 Cal. App. 4th 193 (Cal. Ct. App. 2015), the taxpayer was a Nevada corporation which received income from accounts receivable transferred to it from related parties but was not subject to combination with those entities. The taxpayer claimed it lacked nexus in California.

1) In the case of any taxpayer with gross receipts consisting of interest, investment income, dividends from related parties, or proceeds from the disposition of a business or business segment, those gross receipts, to the extent included in apportionable income, shall be assigned as follows:

Notes:

- Introductory paragraph lists possible categories of “functional test” receipts and clarifies that only the amounts included in apportionable income will be part of the apportionment formulas set out in subsequent sections.

(a): Dividends paid by a related party [as defined in Sec. 17 or other state law], shall be included in the receipts factor denominator and included in the receipts factor numerator of this state to the extent the dividend payor’s apportionment factor for the year in which the dividend was paid is in this state, provided that, where the payor’s apportionment factor in that year fails to reflect of the source of the earnings from which the dividends were paid, the dividends shall be included in the receipts factor numerator to the extent the dividend income was derived from business activity [or: sources] within this state;

Notes:

- Apportions dividends based on apportionment factor(s) of dividend payor, with exception (below);
- Where dividend payor’s location is not the location of the business activity which created the income from which dividends were paid, allows further look-through to place of business activity;
- Only applies to dividends from related parties.
- Rule will often result in “foreign” dividend income being apportioned outside of water’s edge, with no throw-out or throw-back.

Questions for Committee’s Consideration:

- Is this proviso, calling for “look-through” to the source of the dividend income, too broad?
- If yes, how could the look-through be limited and better defined?
- Are examples an appropriate means to provide guidance on look-through?

(b) Capital gains (but not capital losses) deriving from the disposition of the stock or other intangible property rights representing an ownership interest of a business entity shall be included in the denominator and shall be included in the numerator in [this state] to the same extent as the entity’s apportionment factor was assigned to this state in the year preceding the disposition. Capital gains (but not capital losses) deriving from the disposition of the assets of a business or business segment shall be included in the denominator and shall be included in the numerator in [this state] to the same extent as [that business or business segment’s assets were located in this state] [that business’ apportionment factor was assigned to this state] in the year preceding the disposition.

Notes:

- Apportions capital gains from disposition of stock and partnership interests based on apportionment factors for business entity in year proceeding the sale;

Questions for Committee's Consideration:

- **Should capital gains from sale of business assets or business segment be apportioned based on "location" of business assets, or, using the business's or business segment's apportionment factors for the prior year?**

(c) Receipts arising from those activities described in Sections 3(d) through 3(j) of the MTC's Formula for the Apportionment and Allocation of the Net Income of Financial Institutions Model Statute (as adopted July 29, 2015) shall be included in numerator of the receipts factor for this state to the extent those receipts would be sourced to this state under [this state's financial institution receipts factor rules] or [under the MTC's Formula for the Apportionment and Allocation of the Net Income of Financial Institutions Model Statute (as adopted July 29, 2015)]

Notes:

- Assigns interest income and other types of income deriving from loans (e.g., loan origination fees and sale of loans) based on the states' financial institutions apportionment rules, if any, and based on the MTC's model apportionment regulation for financial institutions if the state has no special industry sourcing rules. This is a market-based approach based on location of borrower or secured property interest for original loan, even if loan is resold.
- Does not follow financial institutions apportionment rule providing that receipts assigned to states in which the taxpayer is not subject to tax shall be re-assigned to taxpayer's commercial domicile.
- Should apply to special purpose entities holding loan portfolios.

(d) Receipts derived from accounts receivable sold to or otherwise transferred to the taxpayer, to the extent they are not sourced under Subsection C shall be included in the denominator of the receipts factor and shall be included in the numerator of the receipts factor for this state to the extent those amounts are collected from borrowers in this state.

Notes:

- Assigns account receivables to location of borrower to the extent not sourced as loan-related activity under Financial Institutions regulations. This is listed as a separate category of business activity, recognizing the particularized use of such entities as a tax reduction method may not be adequately covered Subsection (c). Rule should result in similar market-based apportionment based on location of assigning entity's borrowers (i.e., the assignor's customers).

(e) The net amount [but not less than zero] of receipts not sourced under Sections (b-d) arising from other investment activities, including the holding of or the maturity, redemption, sale, exchange or other disposition of marketable securities or cash, shall be included in numerator of the receipts factor for this state to the extent those receipts would be sourced to this state under [this state's financial institution receipts factor rules] or [under the MTC's Formula for the Apportionment and Allocation of the Net Income of Financial Institutions Model Statute (as

adopted July 29, 2015), Section 3(n), if this state has not adopted a special apportionment rule or statute for financial institutions];

Notes:

- Assigns income from miscellaneous investment activities to location where “properly assigned” for financial institution regulatory purposes. Generally this means assignment to where the investment activities are managed on a day-to-day basis. In some instances, presumption arises favoring assignment to commercial domicile.
- This is not a market-based sourcing rule but ensures that the state to which such receipts are assigned will have constitutional authority to impose a tax on the income.
- Does not follow financial institutions apportionment rule that receipts assigned to states in which the taxpayer is not subject to tax shall be assigned to taxpayer’s commercial domicile.
- The types of receipts arising from investment activity identified in this subsection are not co-extensive with the types of investment activity listed in Section 3(n) of the Financial Institutions Model Statute. Receipts from those activities not described under 3(n) would be sourced under Sections 2, 3, or 4, below.

Question for Committee Consideration:

- **Should “miscellaneous” investment activity receipts be assigned to the place where day-to-day management of those investments occurs, or to some other determinable location, without reference to FIT apportionment statute?**
- **Should this subsection be eliminated entirely, so that those receipts will be sourced under Sections 2, 3 or 4, below?**

2) If the taxpayer has gross receipts that are not apportioned pursuant to Section (1), and the state requires the use of multiple factor apportionment formulas, those gross receipts shall be included in the denominator of the receipts factor and included in the numerator of the receipts factor of this state by using the remaining apportionment factors and percentages applicable to that taxpayer where those factors are *non-de minimis*.

Notes:

- This is primary “default” rule for receipts not covered under Section 1, above, in states which use multiple apportionment factors: if there are no “receipts”, the taxpayer’s income would be sourced according to the property and/or payroll factors.
- Includes a *de minimis* exception, so that, for instance, a holding company’s income would not be sourced to location of its single employee or a rented office space.

3) If the taxpayer has gross receipts that are not apportioned pursuant to Sections (1) and (2), those gross receipts shall be included in the denominator of the receipts factor and shall be included in the numerator of the receipts factor of this state in the same ratio as:

- (a) the receipts factor of the remainder of the combined or consolidated group if the taxpayer’s income and factors are included on a combined or consolidated return filed in this state; or**

(b) the receipts factor applicable to the owner of a preponderance of beneficial interests in that taxpayer, if the taxpayer is filing as a separate entity in this state.

Notes:

- This is the primary “default” rule for single “receipts” factor apportionment states. Instead of creating a receipts factor by reference to property or payroll, the rule calls for using the taxpayer’s combined or consolidated group factors if the taxpayer is filing in the state using those methodologies.
- If the taxpayer is filing as a separate entity, by sourcing receipts based on the receipts factor of the preponderant owner of the business entity.

4) To the extent application of the preceding subsections fails to result in an equitable apportionment of the taxpayer’s gross receipts, the taxpayer’s receipts factor shall be calculated in a manner which reflects the extent of the taxpayer’s business presence in this state.

Notes:

- This is a “catch-all” rule that recognizes that in some circumstances, use of the rules set forth in sections 1 through 3 would lead to incongruous results that would not fairly reflect how and where the taxpayer earns its income. The provision is broadly worded since those circumstances cannot be easily anticipated in advance.
- Other catch-all rules may be considered by the working group (please see attached .

Looking Forward:

The working group continues to meet on a regular basis. The working group believes it is nearing the end of the drafting project.