



MULTISTATE TAX COMMISSION

Working Together Since 1967 to Preserve Federalism and Tax Fairness

To: Cory Fong, Chair
Members of the Executive Committee

From: Shirley Sicilian, General Counsel

Date: November 23, 2011

Subject: Compact Amendments
Art.IV.17 (Sales Factor Sourcing for Services and Intangibles)
Art.IV.1(g) (Definition of "Sales")

In July, 2011, the uniformity committee forwarded its recommended amendments for compact Art.IV.17 (sales factor sourcing for services and intangibles) and Art.1(g) (definition of "sales") to the executive committee. The recommendations are now before the executive committee for consideration for public hearing. This memorandum provides:

- Procedural background (section I)
- Substantive summary of the model language (sections II.A and II.B)
- Model language (Attachments A and B)

I. Procedural Background –

The history of this project involves not just the Commission, but also the Uniform Law Commission (ULC), which is the entity that promulgated the Uniform Division of Income for Tax Purposes Act (UDITPA) in 1957. Article IV of the Multistate Tax Compact incorporates UDITPA virtually word for word. In September 2006, after a vote of the Commission's executive committee, the Commission formally recommended to the ULC that it initiate a project to revise its model UDITPA. The Commission noted that certain provisions of the 50 year old UDITPA are outdated, and that a revised model is needed in order to preserve a reasonable level of uniformity. We suggested that ULC focus on § 17 (sales factor sourcing for services and intangibles); but should also consider § 1(a) (definition of "business income"), § 1(g) (definition of "sales"), § 9 (factor weighting), and § 18 (distortion relief).

In August 2007, after studying the Commission request and receiving additional input from the Commission, the FTA, COST, and others, the ULC determined that it should review and "revise UDITPA in its entirety." A ULC drafting committee formed and meetings were held to receive additional public comments.

At these meetings and in writing, taxpayer representatives and other groups registered opposition to the effort. Steve Kranz of the Sutherland firm expressed the view that "[n]o matter the

starting point, uniformity in corporate tax treatment is contrary to the legislative desire to serve constituencies.”¹ Even if legislatures did find some value in corporate tax apportionment uniformity, “[g]iven the plentitude of demographic, statutory and political differences among states it is quite clear that the proposed revision of UDITPA is neither desirable nor practicable”² Another coalition of large corporate taxpayers advised that “uniformity in state taxation requires federal action.”³ The Council on State Taxation (COST) agreed.⁴ And two associations of legislators – the American Legislative Exchange Council (ALEC) and the National Conference of State Legislators Task Force on Telecommunications and Electronic Commerce (NCSL task force) expressed concern that uniformity is inconsistent with federalism. ALEC wrote that “a uniform tax on corporate income contravenes ALEC’s mission to support state sovereignty.”⁵

The Commission, the FTA, and several individual state tax administrators disagreed. Proponents commented on the need to preserve a reasonable level of uniformity in order to avoid excessive duplicative taxation, which could invite federal preemption and jeopardize state sovereignty.⁶ They explained that state legislators will have no choice but to address these issues whether ULC moves forward or not, and that the interests of uniformity, tax simplification, compliance and efficient tax administration would best be served if there were uniform model amendments available for legislatures to consider.⁷ Professor Richard Pomp also spoke in favor of the effort, suggesting that if ULC elects not to revise UDITPA, then ULC should consider repealing it.

In June 2009, after considerable comment and controversy, the ULC determined that its UDITPA Study Committee should be discharged and that no further work would be undertaken on UDITPA at this time, with the understanding that it may reconsider the decision at a later time if substantial support for revising UDITPA becomes apparent. ULC noted input from the NCSL Task Force, which had met on May 30, 2009 in Raleigh, North Carolina and, after hearing testimony from Steve Kranz, COST and others,

¹Letter from Steven Kranz, Sutherland, to Charles Trost, p.3. May 14, 2008.

²*Ibid.*

³Letter from coalition of large corporate taxpayers titled “In Opposition to the Project to Revise the Uniform Division of Income for Tax Purposes Act.” Undated, received July 7, 2008.

⁴Comments of Doug Lindholm, Executive Director of the Council on State Taxation, made during the May 2008 Drafting Committee meeting. Reported in “UDITPA Revisions Debated at Initial Meeting of Drafting Committee.” June 3, 2008. CCH Tax Tracker News; COST letter of June 22, 2009 to Dale Higer, Chair, NCCUSL UDITPA study Committee.

⁵American Legislative Exchange Council Resolution to Oppose [ULC] Effort to Rewrite the Uniform Division of Income for Tax Purposes Act.

⁶*See, e.g.*, Letter from Joe Huddleston, Executive Director of the Multistate Tax Commission, to Charles Trost. July 7, 2008; Letter from Royce Chigbrow, Chairman of the Idaho State Tax Commission, to John Sebert, Executive Director of ULC. June 13, 2008.

⁷*See, e.g.*, Letter from Joe Huddleston, *id.*

recommended unanimously that other organizations, including the Multistate Tax Commission, are better positioned to provide options for UDITPA language.⁸

In July 2009, the MTC executive committee directed that “revisions to Article IV of the compact - specifically, the five areas suggested as the focus for the Uniform Law Commission’s revision project - be referred to the uniformity committee and that [the uniformity committee] come back to the executive committee if the uniformity committee recommends the scope of issues be changed.” The five areas are:

Primary focus:

1. Sales factor numerator sourcing for services and intangibles – Art.IV.17

Other:

2. Definition of “Sales” – Art.IV.1(g)
3. Factor Weighting – Art. IV.9
4. Definition of “Business Income” – Art.IV.1(a)
5. Distortion Relief Provision - Art.IV.18

The uniformity committee began its effort in December, 2009, with a series of educational presentations from guest experts *Professor Richard Pomp*, Alva P. Loiselle Professor of Law, University of Connecticut School of Law; *Mr. Prentiss Wilson*, former Ernst & Young National Director of State and Local Tax Practice and Procedure; *Professor Michael McIntyre*, Professor of Law, Wayne State University Law School; and *Professor Charles McClure*, Herbert Hoover Business School, Stanford University. A document library for this project has been created and contains materials from these presentations. The library is available at <http://www.mtc.gov/Uniformity.aspx?id=4562> .

After this educational phase, the Income and Franchise Tax Uniformity Subcommittee determined it would address each of these provisions in turn, starting with Article IV.17., sales factor sourcing for services and intangibles. The subcommittee appointed a drafting group, charged with developing policy questions for the committee’s consideration and then drafting amendments reflecting the subcommittee’s answers. The drafting group met weekly throughout this project. The subcommittee considered the policy issues and reviewed draft language over 6 in-person meetings⁹ and monthly teleconferences. It produced its first draft of a new section 17 by March 2010. It then began its consideration of the definition of “sales” while it continued to review and finalize its draft section 17.¹⁰

In July 2011, after two years of intensive work, the subcommittee recommended a new section 17 and a new definition of “sales” to the uniformity committee. The uniformity committee approved the proposals, also in July 2011, and recommended them favorably to the executive committee for consideration for public hearing.

II. Substantive Summary

⁸ NCSL Task Force letter of June 19, 2009 to Martha Walters, President, and John Siebert, Executive Director, of NCCUSL, available at: http://www.nccusl.org/Update/Docs/UDITPA_NCSL%20letter_June%2019%2009L.pdf

⁹ December 1-2, 2009, March 2-3, 2010, July 25-26, 2010; December 7, 2010; March, 2011; and July, 2011. The drafting group and subcommittee received helpful input from Diann Smith, Sutherland, and Todd Lard, COST.

¹⁰ The drafting group and subcommittee are now focused on Art.IV.9 (factor weighting), Art.IV.1(a) (definition of “business income”), and Art.IV.18 (distortion relief).

A. Compact Art. IV.17 – Sales Factor Sourcing for Services and Intangibles

The Current Rule

Sections 16 and 17 of Compact Art. IV contain the UDITPA provisions for sales factor numerator sourcing. Section 16 provides the sourcing rule for receipts from sales of tangible property and endeavors to reflect the taxpayer's market by sourcing receipts to the destination state - the state where the property that was sold is "delivered or shipped" to the purchaser. This section contains a throwback provision. Section 17 provides the sourcing rule for receipts from all other transactions (or "sales") – including sales of services and intangibles – to the location of the income producing activity. This section does not have a throwback provision. Section 17 reads:

Section 17. Sales, other than sales of tangible personal property, are in this State if:
(a) the income-producing activity is performed in this State; or
(b) the income-producing activity is performed both in and outside this State and a greater proportion of the income-producing activity is performed in this State than in any other State, based on costs of performance.

In contrast to section 16, section 17 does not reflect "market" sourcing. Section 17 sources sales to where the activity that produced the income was performed, rather than where the product – e.g., the service or the intangible – was delivered or received. The location where the activity was performed tends to simply duplicate the property and payroll factors, and may tend to reflect the production state rather than the market state. This result misses the purpose of the sales factor and frustrates legislative intent behind the movement toward more heavily weighted sales. Furthermore, both states and taxpayers have found the "income producing activity" and "cost of performance" concepts vague and difficult to apply in practice.¹¹ Note that for lease of tangible property, and sales or lease of real property, MTC model regulations generally state that income producing activity takes place at the location of the property sold or leased.

Proposed Amendment – See Attachment A

Key Features of Proposed Amendment

- **Market Sourcing.** To achieve the purposes of the sales factor, and to provide guidance on when section 18 should be employed, the draft explicitly states that sales are to be sourced to the market state.

¹¹ The UDITPA drafters acknowledged from the beginning that the COP rule was given short shrift. This fact reflects the practical realities of the time. In 1957 most of the economy was mercantile and manufacturing. The major service industries of the time, financial organizations and public utilities, were excluded from UDITPA altogether. Regarding what was left of the service economy, William Pierce - the original primary drafter - wrote in 1957 that he expected frequent resort to the equitable relief provision of UDITPA § 18. Pierce, William J., "The Uniform Division of Income for State Tax Purposes." *TAXES*, Tax Magazine; Vol. 35, No. 10, October, 1957; See also, Warren, John S.; "UDITPA – A Historical Perspective." presentation to the Multistate Tax Commission Annual Meeting; July 28, 2005.

- **Specify Sourcing for Four Transaction Types.** Section 17 currently sources receipts from all transactions other than sales of tangible personal property according to a single, “income-producing activity” rule. The vagueness of this rule, perhaps necessitated by its enormously broad application to all but one type of transaction, makes it hard to apply, as a practical matter, to the various different categories of transactions. To avoid this problem, the draft breaks down the activity covered by section 17 into four broad categories of transactions, in order to more specifically define a reasonable location of “market” for each:

- Sale of services – to the location of delivery. Because this rule is similar to sourcing for sales of tangible personal property, it has the advantage of not requiring taxpayers or states to differentiate between services and tangible goods, which can be difficult and contentious. Although some Compact member states have already adopted a “benefits received” rule, the two rules should produce the same result in most cases – the location of the benefits should usually be the location of delivery – the main difference being that the “delivery” rule is stated more from the perspective of the taxpayer, while the “benefits received” rule is perhaps more from the perspective of the taxpayer’s customer. Note that location of delivery will not always be taxpayer’s customer’s location (i.e., drop-ships would be sourced to location of customer’s customer).
- Sale or lease of intangibles – to the location of use. This rule is similar to the allocation rule for non-apportionable income from intangibles. Note that only certain types of intangibles transactions – those for which the market is likely to be known by the taxpayer – would be sourced. It’s assumed that the taxpayer would know (or would be able to require the information to know) where its intangibles are used in the case of a lease or license. Sales may be more difficult. So sales of a contract rights, government license¹², or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area are sourced to that area. Other sales are explicitly removed from sourcing. Even where a taxpayer may be able to apply the sourcing rule at the time of the sale, it may be impossible for the tax department to verify later that it had been applied appropriately. Note also that if the intangible property is used in marketing a good or service to a consumer then the sale is sourced to where that good or service is purchased by a consumer (this is a “look through” to where the taxpayer’s customer sells the product to the ultimate consumer).
- Lease of tangible personal property – to the location of the property. This rule is consistent with the current MTC model regulations, in place since the early 1970’s, which hold that the income producing activity associated with a lease of tangible property takes place at the location of the property.
- Sale or lease of real property – to the location of the property. This rule is also consistent with the current MTC model regulations, which hold that the income producing activity associated with the sale or lease of real property takes place at the location of the property.

- **Proportional, rather than “All or Nothing.”** Compact Art. IV.17 sources the entire receipt to the single state with the “greater proportion of income producing activity.” This rule can result in

¹² “Government license” does not refer to patents or copyrights, but rather to franchises or rights of way granted by the government.

unnecessarily volatile and possibly arbitrary sourcing where activity, based on cost of performance, is spread nearly uniformly over several states. The proposal allows a single receipt to be sourced among multiple states “to the extent” the transaction is in that state.

- **Requires “Reasonable Approximation.”** The mode requires a taxpayer to reasonably approximate sourcing if it cannot be determined exactly. Model regulations will provide reasonable approximation methods for various industries or transactions as the need becomes apparent.

- **Throwout.** Compact section 16 dealing with sales of tangible property contains a throwback rule. The throwback rule addresses the potential for “nowhere income” when a receipt is sourced to a state where the taxpayer does not have nexus or is protected by federal statute P.L.86-272. But section 17 does not have a throwback rule. The potential for sourcing to a location where there is not nexus may be low under the current rule; which, by sourcing to the location of performance, tends to source to the location of property or payroll and thus to a state where nexus would likely exist. Moreover, P.L.86-272 only applies to transactions involving tangible property. But, the proposed rule, like section 16, would source receipts to the market state. The existence of a market should generally be enough to support nexus with respect to intangibles and service transactions unimpeded by P.L.86-272. But that has not been determined in all states. And parts of the rule for sourcing receipts from intangibles require a “look through” to the customer’s customer – it’s not perfectly clear that a taxpayer would have nexus in those states solely by virtue of having intangible property there. Thus, nowhere income could arise. The uniformity committee may have liked to have used throwback to be consistent with section 16, but throwback is a difficult concept to apply in the case of services. So the rule includes a throwout provision to address whatever non-nexus situations may arise, and for situations where the specified sourcing rule is cannot be either determined or reasonably approximated.

- **Regulations.** The uniformity committee recognizes that several terms will need to be defined by regulation and has developed a list of items to address in model regulations.

B. Compact Art. IV.1(g) - Definition of “Sales”

The Current Rule

The Compact currently defines “sales” broadly as “all gross receipts of the taxpayer not allocated under paragraphs of this Article.” (Art.IV(1)(g)) Thus, the definition of “sales” appears to include gross receipts associated with apportionable, business income. Under the Compact, apportionable “business income” is income that meets either the transactional test (“income arising from transactions and activity in the regular course of the taxpayer's trade or business”) or the functional test (“income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations”). Gross receipts associated with the transactional test could include, for example, receipts from the sale, lease, or license of the taxpayer’s product – goods or services – that it sells to its customers. Gross receipts associated with the functional test could include receipts from the sale or lease of non-inventory, business assets that are or were used in the operation of the taxpayer’s unitary business to produce or provide the product that it sells to its customers.

But the Commission’s model regulations, in place since 1973, specify “the term ‘sales’ means all gross receipts derived by the taxpayer from transactions and activity in the regular course of the trade

or business.” (Reg. IV.15.(a). Sales Factor: In General.) This clause – “transactions and activity in the regular course of the trade or business” – mirrors the Compact language for the first of the two tests for business income, the transactional test. The second, functional test – “income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations” – is not included. The model regulations also specifically exclude certain types of receipts generally associated with the functional test, such as “substantial amounts of gross receipts from *an incidental or occasional sale of a fixed asset* used in the regular course of the taxpayer's trade or business.”

Proposed Amendment – See Attachment B

Key Features of Proposed Amendment

- **Transactional test limitation.** The proposal would place the transactional test limitation which has been in the regulations since 1973 into the statute. Some would argue that all income should be reflected in the receipts. But the uniformity committee looked to the fact that apportionment is an attempt to reflect certain taxpayer *activities*, not taxpayer *income* or all unitary activities; and considered the type of activities that are intended to be reflected by the sales factor. The role of the sales factor in the apportionment formula is to reflect the contribution of the taxpayer’s market for its product, or the demand side, to the earning of income. It is unnecessary, and in fact may be counter-productive, to include an item in the factor if it does not reflect that particular activity. In Including receipts from the sale of assets used in the business could double count the property already included in the property factor. Because the purpose of the sales factor is to balance the other two factors, the use of those two elements to assign sales, costs of production from property and payroll, should be avoided. Because the sales factor is intended to balance the property and payroll factors it should be defined to offset rather than amplify the effects of the property and payroll factors.

- **Treasury Function Exclusion.** Current regulations limit receipts from treasury function (churning of working capital) from the sales factor. There are two ways to do this: either limiting the inclusion to net rather than gross receipts, or an outright exclusion. If the problem is only distortion, then a limitation to net may be OK. But if there is also a problem of sourcing, then exclusion may be the better approach. The committee chose exclusion.

Attachment A



MULTISTATE TAX COMMISSION

Working Together Since 1967 to Preserve Federalism and Tax Fairness

Uniformity Committee

Proposed Model Compact Art. IV.17 Recommended Amendments

As recommended to the executive committee

July 24, 2011

- 17(a) Sales, other than sales described in Section 16, are in this State if the taxpayer's market for the sale is in this state. The taxpayer's market for a sale is in this state:
- (1) In the case of sale, rental, lease or license of real property, if and to the extent the property is located in this state;
 - (2) In the case of rental, lease or license of tangible personal property, if and to the extent the property is located in this state;
 - (3) In the case of sale of a service, if and to the extent the service is delivered to a location in this state;
 - (4) In the case of, lease or license of intangible property; or sale or other exchange of such property if the receipts from such sale or exchange derive from payments that are contingent on the productivity, use, or disposition of the property; if and to the extent the intangible property is used in this state, provided that intangible property used in marketing a good or service to a consumer is used in this state if the good or service that is marketed using the intangible property is purchased by a consumer who is in this state; and
 - (5) In the case of sale of intangible property other than that referenced in section (4), above; where the property sold is a contract right, government license, or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area; if and to the extent the intangible property is used in or otherwise associated with this state, provided that any sale of intangible property not otherwise described in this section (5) or section (4) above shall be excluded from the numerator and the denominator of the sales factor.
- (b) If the state or states of assignment under subsection (a) cannot be determined, the state or states of assignment shall be reasonably approximated.
- (c) If the taxpayer is not taxable in a state to which a sale is assigned under subsection (a), or if the state of assignment cannot be determined under subsection (a) or reasonably approximated under subsection (b), such sale shall be excluded from the denominator of the sales factor.
- (d) [The tax administrator may prescribe regulations as necessary or appropriate to carry out the purposes of this section.]

Attachment B



MULTISTATE TAX COMMISSION

Working Together Since 1967 to Preserve Federalism and Tax Fairness

Uniformity Committee
Proposed Model Compact Art. IV.1(g) Recommended Amendments
As recommended to the executive committee
July 24, 2011

1(g) “Sales” means 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 other than a securities dealer from hedging transactions and from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities, shall be excluded.