



MULTISTATE TAX COMMISSION

Working Together Since 1967 to Preserve Federalism and Tax Fairness

**Minutes of the
Income/Franchise Tax Subcommittee Meeting
Amway Grand Plaza
187 Monroe Ave. NW
Grand Rapids, Michigan 49503
Sunday, July 29, 2012
1:00 P.M. to 5:00 P.M.**

I. Welcome and Introductions

The Chair called the meeting to order at 1:00 P.M. and welcomed the attendees. The following persons attended the meeting either in person or by telephone.

| Name | State or Affiliation | Name | State or Affiliation |
|--------------------|----------------------|---------------------|----------------------|
| Robynn Wilson | AK | Emily Thompson | ND |
| Mike Mason | AL | Matt Peyerl | |
| Christy Edwards | | Ryan Rauschenberger | |
| Kelley Gillikin | | Rebecca Abbo | NM |
| Craig Banks | | Janielle Lipscomb | OR |
| Walter Anger | AR | Gary Humphrey | |
| Tom Atchley | | Frank Hales | UT |
| Ben Miller | CA FTB | Private Sector | |
| Phillip Horwitz | CO | Deborah Bierbaum | A T & T |
| Aaisha Hashmi | DC | Nora Macaluso | BNA |
| Marshall Stranburg | FL | Sandra Potter | CCH |
| Edward Beal | HI | Todd Lard | COST |
| Randy Tilley | ID | Karen Boucher | Deloitte Tax |
| Brian Fliflet | IL | Terry Frederick | Sprint |
| Richard Cram | KS | Amy Hamilton | State Tax Notes |
| Jennifer Hays | KY | Diann L. Smith | Sutherland |
| Stewart Binke | MI | Dan De Jong | TEI |
| Sara Clark Pierson | | Jamie Fenwick | Time Warner Cable |
| Keith Getschel | MN | MTC Staff | |
| Wood Miller | MO | Roxanne Bland | Sheldon Laskin |
| Eugene Walborn | MT | Joe Huddleston | Thomas Shimkin |
| Lee Baerlocher | | Elliott Dubin | Bruce Fort |
| Lennie Collins | NC | Shirley Sicilian | Ken Beier |
| Dee Wald | ND | Greg Matson | |

II. Public Comment Period

There was no public comment at this time.

III. Approval of In-Person Meeting March 7, 2012

CA moved to accept the minutes as read. The motion was unanimously accepted.

IV. Reports and Updates

A. *Federal Issues Affecting State Taxation*

Roxanne Bland, MTC Counsel gave the report on federal issues. She informed the Committee that Congress is in recess from August 8th to October 5th therefore there would be no action on these bills until after the recess.

1. H.R. 1439, Business Activity Tax Simplification Act of 2011
2. H.R. 1864 Mobile Workforce State Income Tax Simplification Act of 2011

Ms. Bland noted that Senator Lieberman wants a bill, Law Enforcement and Corporate Transparency to move forward. The bill would require disclosure of ownership in every state-chartered corporation.

B. *Report on Commission Action on Uniformity Projects*

Recommended Amendments to Compact Article IV (UDITPA)

Shirley Sicilian, MTC General Counsel, informed the members of the subcommittee that the following five projects, which are part of the MTC Article IV [UDITPA], were sent to the Executive Committee to consider at its May meeting of this year. The Executive Committee had earlier asked for clarification of the proposed language of Section 17 – sourcing of sales of services and intangibles. The Executive Committee decided it would hold all 5 of the recommended amendments in order for the members of the Executive Committee to consult with revenue agency staff, executive and legislative branch personnel, and other stakeholders. Mr. Huddleston informed the subcommittee that the Executive Committee is also currently in consultation with NCSL groups.

The recommended amendments are for: §17, sales factor sourcing for services and intangibles; §1(g) definition of “sales;” §1(a) definition of “business income;” §9 factor weighting; and, §18 distortion relief.

C. *Gillette Case*

Ms. Sicilian informed the members of the subcommittee that on July 26th the California Court of Appeals decided that the Multistate Tax Compact, which CA adopted in 1974, supersedes CA law; and that CA cannot amend CA law in a manner inconsistent with the Compact without

withdrawing from the Compact. The court of appeals also held that the form of amendment chosen in 1993, when California adopted mandatory double-weighted sales “notwithstanding” the requirements in the Compact, was invalid. CA withdrew from the Multistate Tax Compact effective July, 2012. Ben Miller stated that the California will consider filing a petition for review with the state Supreme Court.

V. Project to Amend MTC Model Financial Institutions Apportionment Rule

A. Report from the Work Group

Ms. Sicilian gave a brief report of the work group efforts. She reminded the subcommittee that they have tentatively approved amendments to the definitions and receipts factor provisions of the model rule. The last provision under consideration now is the property factor, and specifically the treatment of loans in the property factor. The Working Group has agreed to recommend that a sale of a loan or a loan bundle to a member of the controlled group would not be considered as a change in material fact that triggers resourcing the loan. For combined reporting states, the institution would identify its “controlled group” as the combined group with the customary unitary analysis. For separate entity states, with addback statutes, the institutions would use the definition of controlled group contained in those statutes. For separate entity states without addback statutes, the institution would use federal rules for defining a controlled group.

The working group is now working on situsing groups of similar standard business and consumer loans. They are grappling with figuring out how to apply the elements of Solicitation, Investigation, Negotiation, Approval, and Administration (SINAA).

B. Public Comment

There was no public comment.

C. Committee Discussion

There was no committee discussion.

VI. Project Regarding Partnership or Pass-Through Entity Income Ultimately Received by an Entity That Is Not Subject to Income Tax

A. Staff Memorandum

Sheldon Laskin, MTC Counsel reminded the members of the subcommittee that the original intent of this project was to foster tax neutrality among businesses, regardless of what type of entity owns the business. For example, the tax on the income of a business organized as an LLC would, in all likelihood, be imposed on the individual owners. If the owner(s) is a an entity not subject to state income tax, such as an insurance company, would receive this income free of state business income tax. Therefore, a pass-through entity owned by an entity not subject to state income tax would be tax advantaged vis a vis the same type of pass-through entity owned by an entity that is subject to state income tax.

Phil Horwitz (CO) and Mr. Laskin and Ms. Dara Bernstein of the National Association of Real Estate Investment Trusts (NAREIT) presented the members of the subcommittee with the objections of NAREIT to the inclusion of REIT's as a partnership or excluded entity. One basis for NAREIT's objection is the potential for multiple taxation of the income since many REITs hold other REITs. Mr. Laskin suggested that the REIT would not receive the dividends-paid-deduction on the portion of the income of a REIT that is passed through to a non-income tax paying entity. Mr. Horwitz explained that the operations of REITs; and, of mutual funds, generate income for non-income tax paying entities; and, that income goes untaxed, which results in unequal tax treatment of these types of entities. In addition, Ben Miller, CA FTB, wants to wait until representatives of the mutual fund industry are heard from.

CO moved that the proposal be moved to the Full Uniformity Committee. This motion was superseded by CO motion to move this proposal to the full uniformity committee with mutual funds and REITs excluded from the group of pass-through entities which would be subject to the model statute, and that the model statute as amended (striking out the hearing officer's suggested amendment to the draft statute which would have denied the dividend paid deduction to REITs under certain circumstances) be approved for recommendation to the full uniformity committee. . The motion passed with 16 affirmative votes, no negative votes, and 2 abstentions. (The subcommittee agreed it could continue to work on treatment of REITs and mutual funds separately if necessary.)

VII. Process Improvement Discussion

A. Presentation of Staff Memorandum

Ms. Sicilian summarized the memorandum for the subcommittee and noted that this segment of the meeting was to coordinate the activities of the Uniformity Committee with the Strategic Planning project. She noted that the Commission is the administrative agency for the Multistate Tax Compact, and that Article I of the Compact lists as one of its purposes the promotion of uniformity or compatibility among the states in significant components of state tax systems. The Uniformity Committee is the working committee charged with addressing that purpose.

The Strategic Planning Committee wants the MTC to be regarded as the "gold standard" of state tax policy development. The primary efforts currently are engagement and compliance, but, increasing the vitality and the reputation of MTC are goals that will eventually also be addressed.

Ms. Sicilian outlined the current eight step uniformity process. She noted the process can be cumbersome, but it does have some strengths. First, anyone can suggest a topic. Further, the projects begin with an education phase and then the development of a policy checklist. Once the policy choices have been made in concept, the drafting begins. All steps in the process are undertaken with public input and if specialized knowledge is needed a public/private work group may be created. A completed draft is presented to executive committee. The executive committee reviews the draft, and if that committee believes its reasonable, it approves the proposal for more formal public input through a public hearing. The Executive Committee has, in the past, designated priority projects. Further, work processes have become more accessible to

the public over the years. There are several ways of evaluating the process. For example, we could look at the time it takes from initiation to adoption of a proposed model (for proposals that get that far). We could look at the number of states that adopt the proposals. Few adoptions might mean we could improve on project choices, timeliness, or quality of the final product.

B. Discussion

The primary question is: Are enough of the proposals adopted by states? The consensus was: no. But members noted that even unadopted projects serve a purposes of educating member states on the issues and providing a model for those that want to address it that way. The key is to undertake such proposal with “eyes wide open” – making a conscious choice to study the issue even though a uniform adoption may not be a high probability. And sometimes the scope of an issue is not fully understood until significant discussion and research has taken place.

Michael Mason (AL) suggested that the committee should not come up with projects unilaterally, but should also consult with outside groups such as AICPA and COST. It was noted that the State/Local Compliance Working Group, set up in 2004, generated a number of projects that were their recommendations.

A suggestion was made to do something like a Bylaw 7 survey prior to undertaking a project. Also, each possible project should start with a concept paper that identifies the problem, gives one or more possible solutions, gives a timeframe for developing a model solution, and estimates the required level of resources. The concept paper should be clear as to what the problem is to be addressed and whether it is occurring in fact or is a theoretical possibility. Others noted that there were no conduits between the Uniformity Committee and the Nexus Committee; and, that liaison with other organizations can result in undertaking projects that can be adopted by the states.

Mr. Huddleston informed the subcommittee members that the Engagement Group of the Strategic Planning Process is exploring additional ways to communicate with incoming commissioners.

1. Selection Process

It was suggested that each possible project begin with a Bylaw 7 survey to gauge whether there is any interest among the states for the project. If there is sufficient interest, then there should be outreach to the business community. Frank Hales (UT) noted that coordination with outside groups can lead to expectations that all projects will have a resolution. The ULC standard for undertaking projects is gauging the desirability and practicability of the project.

2. Development Process

It was suggested that projects are sent back from executive committee too often. Several suggestions were offered.

- a. Make better use of Executive Committee liaison

- b. Treat the Executive Committee as if it were a legislative body – explain project in non-technical language from the top down.
- c. Increase the level of involvement of each member of the subcommittee
- d. Produce a “Concept Paper” for each project; avoid legalese.
- e. Committee members follow up with revenue agency administrator after each MTC meeting
- f. Present the “Concept Paper” to the Executive Committee and other stakeholders with a pro/con matrix before developing the model in earnest.
- g. Continually update the “Concept Paper.”
- h. Continually inform the Executive Committee.
- i. Need more active and consistent involvement by committee members. Too much recapping and reconsideration is required.
- j. Develop ability to track and review projects progress.
- k. Make it easier to find adopted models, models in progress, and related materials.

VIII. Possible New Project

A. Staff Presentation

Bruce Fort, MTC Counsel, proposed to the members of the subcommittee that they consider taking up a project that would clarify the states’ ability to use I.R.C. Section 482 authority to adjust income and expenses among related parties in situations where a clear imbalance between income and expenses is demonstrated. The test for distortion and the “remedies” for making such adjustments would be based on state formulary apportionment principles, not arm’s-length transfer price policing as used by the federal government. Mr. Fort offered these questions:

- (1) Do states currently have Section 482 authority?
- (2) If they do, why don’t they use it more frequently?
- (3) Can states design their own distortion and relief standards; or, must they use Internal Revenue Service transfer pricing regulations?
- (4) Is this project necessary?

Mr. Fort suggested that this project is necessary to address income-shifting enabled by the states’ reliance on the federal tax code, which does not control domestic transfers of property between related taxpayers. Internal Revenue Code (IRC) Section 351 allows for non-recognition transfers of assets in exchange for a controlling interest in the stock of new domestic entities. That is, a firm can establish a holding company or REIT and donate valuable assets such as real property, logos, patents, trademarks, etc. in exchange for stock in the holding company on a tax free basis. The donee can then charge a rent for the use of those assets, while the donor continues to carry the expenses of developing the assets. If the donee company is outside of the states’ separate-entity jurisdiction, or cannot be included on a combined return, there are few remedies available to the states to prevent the subsequent income distortion. Mr. Fort averred that states sometimes invoke Sec. 482 principles to force combined reporting, but lack the resources to truly prosecute Sec. 482 “arm’s length” pricing. Mr. Fort listed several areas in which Section 351

transfers have cause the states problems which could be remedied with some type of Section 482 authority::

- For separate-entity states, transfers of mortgage derivatives in the financial industry to non-nexus holding companies;
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- Transfers to REITs with out-of-state shareholders
- Indirect or embedded royalty payments not covered by add-back statutes.
- For combined filing states, transfers to 80/20 companies not included on the unitary report;
- Transfers to captive insurance companies not included on a combined report.

B. General Discussion

Michael Mason (AL) suggested that the timing and source of this project was problematic, as it was sure to be met with a negative reaction from the taxpaying community and unlikely to become a widely adopted model. He suggested that the subcommittee establish a liaison group to meet with other stakeholders and the subcommittee should attempt to get business input at this stage.

CO moved that the subcommittee authorize the formation of a liaison committee to seek input from the private sector and other stakeholders to see if this project is feasible and desirable. A liaison committee of Mike Mason and Keith Getschel (Mn.) was formed with staff support on the outreach effort from Shirley Sicilian. There were 9 affirmative votes, 8 negative votes; and 2 abstentions.

IX. New Business

There was no new business.

X. Adjournment

CA FTB moved to adjourn. The motion carried unanimously. The meeting was adjourned at 5:17 P.M. EST.