Multistate Tax Commission

Review

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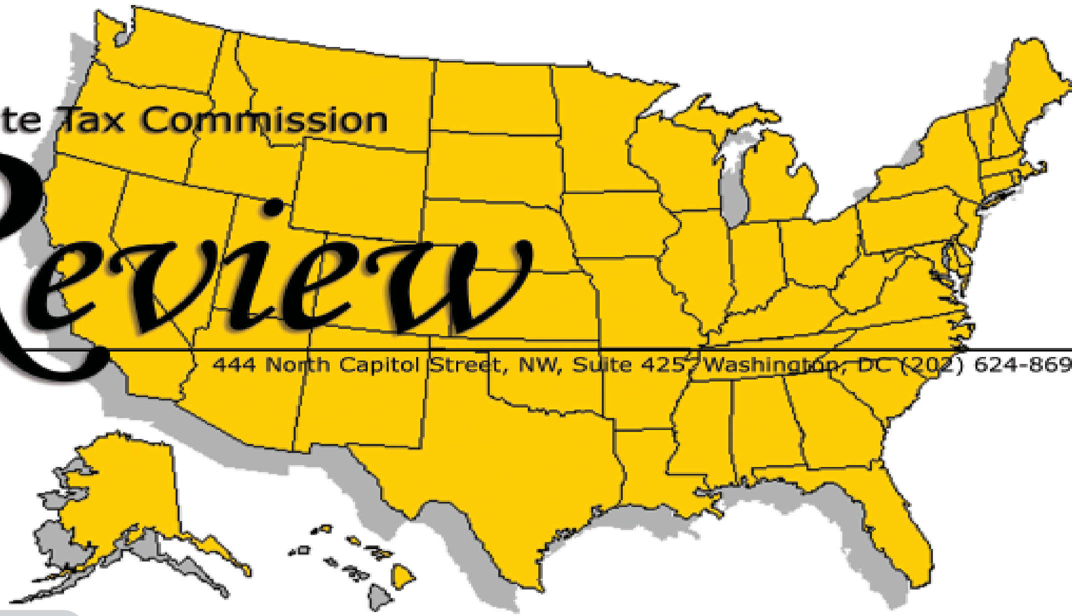

Revenue Impact on State and Local Governments of Permanent Extension of the Internet Tax Freedom Act

Dan Bucks, Elliott Dubin and Ken Beier[1]
Staff of the Multistate Tax Commission

The following study was issued on September 24, 2003, during a news briefing hosted by the Multistate Tax Commission. The study estimates that H.R. 49, passed on September 17, 2003, by the U.S. House of Representatives, could reduce revenues a minimum of $4 billion and up to $8.75 billion. The language of H.R. 49, if enacted, could have the unintended consequences of providing a broad exemption to the telecommunications industry from sales, excise, income, property and other taxes. To hear a replay of the news briefing, visit the MTC's website at www.mtc.gov and click on the link for the study on the Internet tax moratorium.

Short-Term Fiscal Impact of H.R. 49 as Approved by the House Judiciary Committee and Comparison with Impact If the Bill Were Amended to Reflect Congressional Intent

Based on the best available information, H.R. 49—by preempting a variety of activities that go beyond access by customers to the Internet and by expanding the scope of the preemption to income, property and other business taxes—will reduce revenues from current taxes levied by the 50 states, the District of Columbia and local governments a minimum of $4 billion and up to $8.75 billion annually by 2006. Whether the losses rise to the higher level depends on the outcome of anticipated litigation over the provisions of H.R. 49 if enacted.

The estimates above are conservative because they do not include the full impact of services, information and content that can be exempted from tax by being bundled with Internet access or offered as a service over the Internet.

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In contrast, if the language of H.R. 49 were amended to conform to Congress' intent of preempting only sales taxes on solely Internet access to customers, including broadband, and extending the preemption to "grandfathered" sales taxes of certain states, the cost to state and local governments would be limited to approximately $500 million in 2006. This estimate is based on amending the language to reflect the original intent of the Internet Tax Freedom Act, with modifications to reflect the objectives of technological neutrality and national uniformity expressed in the deliberations of the House Judiciary and Senate Commerce Committees. However, the current language of H.R. 49 has a much broader scope and impact than what appears to be Congress' intent.

Long-Term Fiscal Impact of H.R. 49 as Approved by the House Judiciary Committee

H.R. 49 will eventually exempt all or nearly all of the telecommunications industry from major state and local taxes: sales, excise, income, property and other taxes. The date when the virtual exemption from state and local taxes occurs depends on the speed at which the industry completes the conversion of its services to the Internet—a technological change now clearly underway. The point of virtually complete exemption from state and local taxes will occur earlier in some states and localities than others. If the current language of H.R. 49 had been in effect in 2002 and if the industry had completed the transfer of its services to the Internet, the revenue loss to state and local governments would have been $22 billion.

A fundamental change is occurring in the telecommunications industry that will enable it to qualify its services as "Internet access" and thus eligible for a state and local tax exemption under the current terms of H.R. 49. The traditional telephone system is in the process of being replaced by the Internet operating at increasingly higher speeds. *Business Week* magazine reports that Verizon is basing its future business plan on the "conviction that telecom as we know it is history. In its place will emerge a 'broadband industry' that will use the new, superfast Net links and high capacity networks to deliver video and voice communications with all the extras."[2] *The Wall Street Journal* reports that MCI by year-end will have moved 25% of its voice traffic to the Internet backbone and by 2005, plans to have 100% of the voice traffic there.[3] In this article, MCI Senior Vice President Vint Cerf (one of the original co-authors of the TCP/IP formula) discusses the future of telecommunications in terms of how some day customers will buy all voice services for one flat rate when "voice will be just one more application traveling . . . across the Net."[4]

Under existing law, telecommunication services were excluded from the definition of Internet access and thus not within the scope of the preemption of state and local taxes. Under the current language of H.R. 49, telecommunications would benefit from the tax preemption to the extent that they provide Internet access. As noted above, all telecommunications will eventually qualify as Internet access as they become a service offered over the Internet. When that point is reached—and the transition is unfolding rapidly—telecommunications will be exempt from all major state and local taxes.

Functional Impact on State and Local Governments

The revenues that would be preempted under this proposed legislation can also be thought of in terms of what public services could be affected. For example, the National Center for Education Statistics projects that it will cost state and local governments $8,557 for each pupil enrolled in public elementary and secondary schools in 2005.[5] Every $1 billion that would be preempted by this proposed legislation, and not made up by other revenues, or reductions in other services

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could have been used to provide education for nearly 117,000 pupils. Similarly, at 2001 compensation rates, each $1 billion in state and local revenues preempted by this legislation translates to nearly 20,000 fewer policemen on "the beat" or nearly 20,000 fewer firefighters, or more than 27,000 hospital workers. Similarly, for each $1 billion preempted, there could be nearly 25,000 fewer instructional staff in public elementary and secondary schools or more than 17,000 fewer instructional personnel in college classrooms and laboratories (Summary Table 1).[6]

Summary of Fiscal Estimate Data

Short Term Fiscal Estimates

The Summary Table below presents the data for the short-term fiscal estimates and the assumptions on which they are based.

Row 1 row presents data for the estimate that the current language of H.R. 49 will cost state and local governments a minimum of $4 billion from current taxes. Row 2 presents data for the estimate that the current language could cost up to $8.75 billion in revenue, again, from current taxes. Row 3 presents the estimate for the slightly more than $500 million cost to state and local governments of a permanent preemption of only sales taxes on solely Internet access—the result if the language of H.R. 49 were amended to reflect Congress' intent. The footnotes in the table detail the types of taxes affected and the types of telecommunications services that would be exempted in the short-term.

Long-Term Fiscal Estimate

Because the date when the telecommunications industry converts its services to operate over the Internet is not known at this time, this paper places in perspective the impact of a virtually complete exemption for the industry from state and local taxes by estimating the total amount of taxes paid by the industry in 2002. This amount was projected by adding to total state and local telecommunications taxes, other than corporate income taxes, in 1999 an estimate of such income taxes and then projecting that amount forward to 2002. The estimated amount of total state and local telecommunications taxes in 2002 is $22.3 billion.[7]

Summary Table 2 Short-Term Fiscal Impact in 2006 of Extension of Internet Tax Preemption under Three Assupmtions[1] (millions of dollars)			
Assumptions	Total Preempted Taxes	Transactions Taxes[2]	Business Taxes[3]
1. HR 49: Ambiguities Interpreted Moderately by Courts[4]	$3,977	2,074	1,903
2. HR 49: Ambiguities Interpreted More Broadly by Courts[5]	$8,751	5,091	3,660
3. Legislation Amended to Conform to Congressional Intent to Preempt Sales Taxes on Only Internet Access[6]	$529	529	

Footnotes

[1]These estimates do not include the full impact of services, information, and content that can be bundled with Internet access or offered as another service over the Internet. They also do not include potential transactions taxes that state and local governments could impose if the current moratorium were allowed to expire because such estimates would not reflect any losses from current

[2]Include gross receipts taxes, consumer sales taxes, 911 fees, and other transactions taxes.

[3]Includes sales taxes on business inputs, property taxes, capital stock taxes, and business income taxes.

[4]Internet access plus Voice over Internet Protocal (VoIP) and wireless communications over the Internet (WoIP)+Internet backbone

[5]Internet access, VoIP, WoIP, and other telecommunications services interpreted as an "other service offered over the Internet".

[6]Internet access clearly defined as a service that connects retail users to an initial point of presence on the Internet by any means, including DSL and wireless access. Preemption limited, as under current law, to only sales and other transaction taxes, but extended to those states currently allowed to collect preexisting transactional taxes on Internet access.

(Footnotes)

[1]The authors of this report are, respectively, the Executive Director, Director of Policy Research and Senior Policy Analyst with the Multistate Tax Commission.

[2]Steve Rosenbush with Tom Lowry, "Verizon's Gutsy Bet," *Business Week Online*, August 4, 2003.

[3]Holman W. Jenkins, Jr., "Internet Pioneer Meets the Telecom Wars," *The Wall Street Journal Online*, August 6, 2003.

[4]Ibid.

[5]U.S. Department of Education, National Center for Education Statistics, ***Projections of Education Statistics to 2011***, May 2001, Table 33., http://nces.ed.gov/pubs2001/proj01/tables/table33.asp.

[6]U.S. Bureau of the Census, ***Public Employment in 2001***, ttp://www.cbo.gov/showdoc.cfm?index=4434&sequence=0.

[7]Robert Cline, "Telecommunications Taxes: 50-State Estimates of Excess State and Local Tax Burden," Tax Analysts, **State Tax Notes**. June 30, 2002, p. 932; and IRS Statistics of Income, **Corporate Income Tax Returns, 1999.** State corporate taxes for telecommunications companies were assumed to be 20% of the federal tax liability of those companies.

Recently Adopted Uniformity Recommendations

At its annual meeting held August 1, 2003, in Salt Lake City, UT, the Multistate Tax Commission adopted three (3) new uniformity recommendations. In pursuit of one of its core purposes, that is, "promot[ing] uniformity or compatibility in significant components of tax systems", the Commission develops (usually through the MTC Uniformity Committee), authorizes public hearings and ultimately decides whether to adopt proposals as uniformity recommendations to the states. Adoption by the Commission, however, does not require any state, Member or non-Member, to adopt the recommended provision. Each state individually chooses whether or not to adopt a recommended proposal through its administrative or legislative processes.

The first of the three newly-adopted uniformity provisions published below amends the existing MTC Regulations defining business and nonbusiness income. The adoption of this proposal is the culmination of nearly decade-long effort by the MTC to draft a comprehensive, modern definition of business income and nonbusiness income under UDITPA (Uniform Division of Income for Tax Purposes Act). The "Model Uniform Statute for Reporting Federal Tax Adjustments with Accompanying Model Regulation" establishes, among other things, a uniform limitations period for filing amended returns with the states following a final adjustment of a taxpayer's federal tax liability. Finally, the "Uniform Statute/Regulation, Sales and Use Tax Priority—Construction Inventory" sets forth the priority status of states for the collection of sales and use tax with respect to the purchase and use of building materials. This latter proposals is just one step of a larger project to establish sales and use tax priority rules among the state to avoid duplicative taxation.

Amendments to Multistate Tax Commission Allocation and Apportionment Regulations Regarding Classification of Income as Business or Nonbusiness

Adopted August 1, 2003
[**Language in brackets is optional**]

••• Reg. IV.1.(a). Business and Nonbusiness Income Defined.

(1) **Apportionment and Allocation.** Article IV.1(a) and (e) require that every item of income be classified either as business income or nonbusiness income. Income for purposes of classification as business or nonbusiness includes gains and losses. Business income is apportioned among jurisdictions by use of a formula. Nonbusiness income is specifically assigned or allocated to one or more specific jurisdictions pursuant to express rules. An item of income is classified as business income if it falls within the definition of business income. An item of income is nonbusiness income only if it does not meet the definitional requirements for being classified as business income.

(2) **Business Income.** Business income means income of any type or class, and from any activity, that meets the relationship described either in IV.1.(a).(4), the "transactional test", or (5), the "functional test". The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, nonoperating income, *etc*., is of no aid in determining whether income is business or non-business income.

(3) **Terms Used in Definition of Business Income and in Application of Definition.** As used in the definition of business income and/or in the application of the definition,

(A) "Trade or business" means the unitary business of the taxpayer, part of which is conducted within [this State].

(B) "To contribute materially" includes, without limitation, "to be used operationally in the taxpayer's trade or business." Whether property materially contributes is not determined by reference to the property's value or percentage of use. If an item of property materially contributes to the taxpayer's trade or business, the attributes, rights or components of that property are also operationally used in that business. However, property that is held for mere financial betterment is not operationally used in the taxpayer's trade or business.

(4) **Transactional Test.** Business income includes income arising from transactions and activity in the regular course of the taxpayer's trade or business.

(A) If the transaction or activity is in the regular course of the taxpayer's trade or business, part of which trade or business is conducted within [this State], the resulting income of the transaction or activity is business income for [this State]. Income may be business income even though the actual transaction or activity that gives rise to the income does not occur in [this State].

(B) For a transaction or activity to be in the regular course of the taxpayer's trade or business, the transaction or activity need not be one that frequently occurs in the trade or business. Most, but not all, frequently occurring transactions or activities will be in the regular course of that trade or business and will, therefore, satisfy the transactional test. It is sufficient to classify a transaction or activity as being in the regular course of a trade or business, if it is reasonable to conclude transactions of that type are customary in the kind of trade or business being conducted or are within the scope of what that kind of trade or business does. However, even if a taxpayer frequently or customarily engages in investment activities, if those activities are for the taxpayer's mere financial betterment rather than for the operations of the trade or business, such activities do not satisfy the transactional test. The transactional test includes, but is not limited to, income from sales of inventory, property held for sale to customers, and services which are commonly sold by the trade or business. The transactional test also includes, but is not limited to, income from the sale of property used in the production of business income of a kind that is sold and replaced with some regularity, even if replaced less frequently than once a year.

(5) **Functional test.** Business income also includes 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. "Property" includes any interest in, control over, or use in property (whether the interest is held directly, beneficially, by contract, or otherwise) that materially contributes to the production of business income. "Acquisition" refers to the act of obtaining an interest in property. "Management" refers to the oversight, direction, or control (directly or by delegation) of the property for the use or benefit of the trade or business. "Disposition" refers to the act, or the power, to relinquish or transfer an interest in or control over property to another, in whole or in part. "Integral part" refers to property that constituted a part of the composite whole of the trade or business, each part of which gave value to every other part, in a manner which materially contributed to the production of business income.

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(A) Under the functional test, business income need not be derived from transactions or activities that are in the regular course of the taxpayer's own particular trade or business. It is sufficient, if the property from which the income is derived is or was an integral, functional, or operative component used in the taxpayer's trade or business operations, or otherwise materially contributed to the production of business income of the trade or business, part of which trade or business is or was conducted within this State. Property that has been converted to nonbusiness use through the passage of a sufficiently lengthy period of time (generally, five years is sufficient) or that has been removed as an operational asset and is instead held by the taxpayer's trade or business exclusively for investment purposes has lost its character as a business asset and is not subject to the rule of the preceding sentence. Property that was an integral part of the trade or business is not considered converted to investment purposes merely because it is placed for sale.

(B) Income that is derived from isolated sales, leases, assignments, licenses, and other infrequently occurring dispositions, transfers, or transactions involving property, including transactions made in liquidation or the winding-up of business, is business income, if the property is or was used in the taxpayer's trade or business operations. (Property that has been converted to nonbusiness use (see IV.1.a.(4)(A)) has lost its character as a business asset and is not subject to the rule of the preceding sentence.) Income from the licensing of an intangible asset, such as a patent, copyright, trademark, service mark, know-how, trade secrets, or the like, that was developed or acquired for use by the taxpayer in its trade or business operations, constitutes business income whether or not the licensing itself constituted the operation of a trade or business, and whether or not the taxpayer remains in the same trade or business from or for which the intangible asset was developed or acquired.

(C) Under the functional test, income from intangible property is business income when the intangible property serves an operational function as opposed to solely an investment function. The relevant inquiry focuses on whether the property is or was held in furtherance of the taxpayer's trade or business, that is, on the objective characteristics of the intangible property's use or acquisition and its relation to the taxpayer and the taxpayer's activities. The functional test is not satisfied where the holding of the property is limited to solely an investment function as is the case where the holding of the property is limited to mere financial betterment of the taxpayer in general.

(D) If the property is or was held in furtherance of the taxpayer's trade or business beyond mere financial betterment, then income from that property may be business income even though the actual transaction or activity involving the property that gives rise to the income does not occur in [this State].

(E) If with respect to an item of property a taxpayer (i) takes a deduction from business income that is apportioned to [this State] or (ii) includes the original cost in the property factor, it is presumed that the item or property is or was integral to the taxpayer's trade or business operations. No presumption arises from the absence of any of these actions.

(F) Application of the functional test is generally unaffected by the form of the property (*e.g.*, tangible or intangible property, real or personal property). Income arising from an intangible interest, as, for example, corporate stock or other intangible interest in a business or a group of assets, is business income when the intangible itself or the property underlying or associated with the intangible is or was an integral, functional, or operative component to the taxpayer's trade or business operations. (Property that has been converted to nonbusiness use (see IV.1.(a).(4)(A)) has lost its character as a business asset and is not subject to the rule of the preceding sentence.) Thus, while apportionment of income derived from transactions involving intangible property as business income may be supported by a finding that the issuer of the intangible property and the taxpayer are engaged in the same trade or business, *i.e.*, the same unitary business, establishment of such a relationship is not the exclusive basis for concluding that the income is subject to apportionment. It is sufficient to support the finding of apportionable income if the holding of the intangible interest served an operational rather than an investment function of mere financial betterment.

(6) **Relationship of transactional and functional tests to U.S. Constitution.** The Due Process Clause and the Commerce Clause of the U.S. Constitution restrict States from apportioning income as business income that has no rational relationship with the taxing State. The protection against extra-territorial state taxation afforded by these Clauses is often described as the "unitary business principle." The unitary business principle requires apportionable income to be derived from the same unitary business that is being conducted at least in part in [this State]. The unitary business that is conducted in [this State] includes both a unitary business that the taxpayer alone may be conducting and a unitary business the taxpayer may conduct with any other person or persons. Satisfaction of either the transactional test or the functional test complies with the unitary business principle, because each test requires that the transaction or activity (in the case of the transactional test) or the property (in the case of the functional test) to be tied to the same trade or business that is being conducted within [this State]. Determination of the scope of the unitary business being conducted in [this State] is without regard to extent to which [this State] requires or permits combined reporting.

(7) **Nonbusiness income.** Nonbusiness income means all income other than business income.

* * * * *

••• Reg. IV.1.(c). Business and Nonbusiness Income: Application of Definitions. The following applies the foregoing principles for purposes of determining whether particular income is business or nonbusiness income. [(The examples used throughout these regulations are illustrative only and are limited to the facts they contain.)]

(1) Rents from real and tangible personal property. Rental income from real and tangible property is business income if the property with respect to which the rental income was received is or was used in the taxpayer's trade or business and therefore is includable in the property factor under Regulation IV.10. Property that has been converted to nonbusiness use (see IV.1.(a).(4)(A)) has lost its character as a business asset and is not subject to the rule of the preceding sentence.

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[*Example (i):* The taxpayer operates a multistate car rental business. The income from car rentals is business income.

Example (ii): The taxpayer is engaged in the heavy construction business in which it uses equipment such as cranes, tractors, and earth-moving vehicles. The taxpayer makes short-term leases of the equipment when particular pieces of equipment are not needed on any particular project. The rental income is business income.

Example (iii): The taxpayer operates a multistate chain of men's clothing stores. The taxpayer purchases a five-story office building for use in connection with its trade or business. It uses the street floor as one of its retail stores and the second and third floors for its general corporate headquarters. The remaining two floors are held for future use in the trade or business and are leased to tenants on a sort-term basis in the meantime. The rental income is business income.

Example (iv): The taxpayer operates a multistate chain of grocery stores. It purchases as an investment an office building in another state with surplus funds and leases the entire building to others. The net rental income is not business income of the grocery store trade or business. Therefore, the net rental income is nonbusiness income.

Example (v): The taxpayer operates a multistate chain of men's clothing stores. The taxpayer invests in a 20-story office building and uses the street floor as one of its retail stores and the second floor for its general corporate headquarters. The remaining 18 floors are leased to others. The rental of the eighteen floors is not done in furtherance of but rather is separate from the operation of the taxpayer's trade or business. The net rental income is not business income of the clothing store trade or business. Therefore, the net rental income is nonbusiness income.

Example (vi): The taxpayer constructed a plant for use in its multistate manufacturing business and 20 years later the plant was closed and put up for sale. The plant was rented for a temporary period from the time it was closed by the taxpayer until it was sold 18 months later. The rental income is business income and the gain on the sale of the plant is business income.

Example (vii): The taxpayer operates a multistate chain of grocery stores. It owned an office building which it occupied as its corporate headquarters. Because of inadequate space, taxpayer acquired a new and larger building elsewhere for its corporate headquarters. The old building was rented to an investment company under a five-year lease. Upon expiration of the lease, taxpayer sold the building at a gain (or loss). The net rental income received over the lease period is nonbusiness income and the gain (or loss) on the sale of the building is nonbusiness income.]

(2) Gains or losses from sales of assets. Gain or loss from the sale, exchange or other disposition of real property or of tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used in, or was otherwise included in the property factor of the taxpayer's trade or business. However, if the property was utilized for the production of nonbusiness income or otherwise was removed from the property factor before its sale, exchange or other disposition, the gain or loss will constitute nonbusiness income. See Regulation IV.10.

[*Example (i):* In conducting its multistate manufacturing business, the taxpayer systematically replaces automobiles, machines, and other equipment used in the business. The gains or losses resulting from those sales constitute business income.

Example (ii): The taxpayer constructed a plant for use in its multistate manufacturing business and 20 years later sold the property at a gain while it was in operation by the taxpayer. The gain is business income.

Example (iii): Same as (ii) except that the plant was closed and put up for sale but was not in fact sold until a buyer was found 18 months later. The gain is business income.

Example (iv): Same as (ii) except that the plant was rented while being held for sale. The rental income is business income and the gain on the sale of the plant is business income.

Example (v): The taxpayer operates a multistate chain of grocery stores. It owned an office building which it occupied as its corporate headquarters. Because of inadequate space, taxpayer acquired a new and larger building elsewhere for its corporate headquarters. Because the taxpayer did not intend to reoccupy the old building, the taxpayer rented the old building to an unrelated investment company under a five-year lease. Upon expiration of the lease, taxpayer sold the building at a gain (or loss). The gain (or loss) on the sale is nonbusiness income and the rental income received over the lease period is nonbusiness income.]

(3) Interest. Interest income is business income where the intangible with respect to which the interest was received arose out of or was created in the regular course of the taxpayer's trade or business operations or where the acquiring and holding the intangible is an integral, functional, or operative component of the taxpayer's trade or business operations, or otherwise materially contributes to the production of business income of the trade or business operations.

[*Example (i):* The taxpayer operates a multistate chain of department stores, selling for cash and on credit. Service charges, interest, or time-price differentials and the like are received with respect to installment sales and revolving charge accounts. These amounts are business income.

Example (ii): The taxpayer conducts a multistate manufacturing business. During the year the taxpayer receives a federal income tax refund pertaining to the taxpayer's trade or business and collects a judgment against a debtor of the business. Both the tax refund and the

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judgment bear interest. The interest income is business income.

Example (iii): The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business, the taxpayer maintains special accounts to cover such items as workmen's compensation claims, rain and storm damage, machinery replacement, etc. The moneys in those accounts are invested at interest. Similarly, the taxpayer temporarily invests funds intended for payment of federal, state and local tax obligations pertaining to the taxpayer's trade or business. The interest income is business income.

Example (iv): The taxpayer is engaged in a multistate money order and traveler's check business. In addition to the fees received in connection with the sale of the money orders and traveler's checks, the taxpayer earns interest income by the investment of the funds pending their redemption. The interest income is business income.

Example (v): The taxpayer is engaged in a multistate manufacturing and selling business. The taxpayer usually has working capital and extra cash totaling $200,000 which it regularly invests in short-term interest bearing securities. The interest income is business income.

Example (vi): In January, the taxpayer sold all of the stock of a subsidiary for $20,000,000. The funds are placed in an interest-bearing account pending a decision by management as to how the funds are to be utilized. The interest income is nonbusiness income.]

(4) Dividends. Dividends are business income where the stock with respect to which the dividends was received arose out of or was acquired in the regular course of the taxpayer's trade or business operations or where the acquiring and holding the stock is an integral, functional, or operative component of the taxpayer's trade or business operations, or otherwise materially contributes to the production of business income of the trade or business operations.

[*Example (i):* The taxpayer operates a multistate chain of stock brokerage houses. During the year, the taxpayer receives dividends on stock that it owns. The dividends are business income.

Example (ii): The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business, the taxpayer maintains special accounts to cover such items as workmen's compensation claims, etc. A portion of the moneys in those accounts is invested in interest-bearing bonds. The remainder is invested in various common stocks listed on national stock exchanges. Both the interest income and any dividends are business income.

Example (iii): The taxpayer and several unrelated corporations own all of the stock of a corporation whose business operations consist solely of acquiring and processing materials for delivery to the corporate owners. The taxpayer acquired the stock in order to obtain a source of supply of materials used in its manufacturing business. The dividends are business income.

Example (iv): The taxpayer is engaged in a multistate heavy construction business. Much of its construction work is performed for agencies of the federal government and various state governments. Under state and federal laws applicable to contracts for these agencies, a contractor must have adequate bonding capacity, as measured by the ratio of its current assets (cash and marketable securities) to current liabilities. In order to maintain an adequate bonding capacity the taxpayer holds various stocks and interest-bearing securities. Both the interest income and any dividends received are business income.

Example (v): The taxpayer receives dividends from the stock of its subsidiary or affiliate which acts as the marketing agency for products manufactured by the taxpayer. The dividends are business income.

Example (vi): The taxpayer is engaged in a multistate glass manufacturing business. It also holds a portfolio of stock and interest-bearing securities, the acquisition and holding of which are unrelated to the manufacturing business. The dividends and interest income received are nonbusiness income.]

(5) Patent and copyright royalties. Patent and copyright royalties are business income where the patent or copyright with respect to which the royalties were received arose out of or was created in the regular course of the taxpayer's trade or business operations or where the acquiring and holding the patent or copyright is an integral, functional, or operative component of the taxpayer's trade or business operations, or otherwise materially contributes to the production of business income of the trade or business operations.

[*Example (i):* The taxpayer is engaged in the multistate business of manufacturing and selling industrial chemicals. In connection with that business, the taxpayer obtained patents on certain of its products. The taxpayer licensed the production of the chemicals in foreign countries, in return for which the taxpayer receives royalties. The royalties received by the taxpayer are business income.

Example (ii): The taxpayer is engaged in the music publishing business and holds copyrights on numerous songs. The taxpayer acquires the assets of a smaller publishing company, including music copyrights. These acquired copyrights are thereafter used by the taxpayer in its business. Any royalties received on these copyrights are business income.

Example (iii): Same as example (ii), except that the acquired company also held the patent on a method of producing digital audio recordings. The taxpayer does not manufacture or sell digital audio recordings. Any royalties received on the patent would be nonbusiness income.]

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●●● Reg. IV.2.(a). Definitions.

(1) "Taxpayer" means [each state should insert the definition in Article II.3. or the definition in its own tax laws].

(2) "Apportionment" refers to the division of business income between states by the use of a formula containing apportionment factors.

(3) "Allocation" refers to the assignment of nonbusiness income to a particular state.

(4) "Business activity" refers to the transactions and activities occurring in the regular course of a particular trade or business of a taxpayer or to the acquisition, management, and disposition of property that constitute integral parts of the taxpayer's regular trade or business operations.

[Ed. Note: The term "business activity" is used in the following MTC regulations:

- IV.1.(b)., *example*;
- IV.2.(b).(1);
- IV.3.(a).;
- IV.3.(a).(1);
- IV.3.(a).(2);
- IV.3.(b).(1);
- IV.3.(b).(1)(A);
- IV.3.(b).(1)(B);
- IV.3.(b).(1)(B), *example*;
- IV.3.(b).(2);
- IV.3.(b).(2), *example (i)*;
- IV.3.(b).(2), *example (iv)*;
- IV.3.(c).;
- IV.18.(a).;
- IV.18.(a).(3);
- IV.18.h.(4)(iii)A.2.;
- IV.18.(j).(1);
- IV.18.(j).(3)(i)B.2.;
- IV.18.(j).(3)(i)B.3.; and
- The financial institution apportionment principles to the extent that States adopt the uniformity recommendation as a regulation that is folded into the existing MTC regulations and thereby picks up the floating definition of "business activity".]

* * * * *

●●● Reg. IV.10.(b). Property Factor: Property Used for the Production of Business Income. Property shall be included in the property factor if it is actually used or is available for or capable of being used during the tax period in the regular course of the trade or business of the taxpayer. Property held as reserves or standby facilities or property held as a reserve source of materials shall be included in the factor. For example, a plant temporarily idle or raw material reserves not currently being processed are includable in the factor. Property or equipment under construction during the tax period (except inventoriable goods in process) shall be excluded from the factor until such property is actually used in the regular course of the trade or business of the taxpayer. If the property is partially used in the regular course of the trade or business of the taxpayer while under construction, the value of the property to the extent used shall be included in the property factor. Property used in the regular course of the trade or business of the taxpayer shall remain in the property factor until its permanent withdrawal is established by an identifiable event such as its conversion to the production of nonbusiness income, its sale, or the lapse of an extended period of time (normally, five years) during which the property is no longer held for use in the trade or business.

[*Example (i):* Taxpayer closed its manufacturing plant in State X and held the property for sale. The property remained vacant until its sale one year later. The value of the manufacturing plant is included in the property factor until the plant is sold.

Example (ii): Same as above except that the property was rented until the plant was sold. The plant is included in the property factor until the plant is sold.

Example (iii): Taxpayer closed its manufacturing plant and leased the building under a five-year lease. The plant is included in the property factor until the commencement of the lease.

Example (iv): The taxpayer operates a chain of retail grocery stores. Taxpayer closed Store A, which was then remodeled into three small retail stores such as a dress shop, dry cleaning, and barber shop, which were leased to unrelated parties. The property is removed from the property factor on the date on which the remodeling of Store A commenced.]

* * * * *

●●● Reg. IV.11.(b). Property Factor: Valuation of Rented Property.

(1) Multiplier and subrentals. Property rented by the taxpayer is valued at eight times its net annual rental rate. The net annual rental rate for any item of rented property is the annual rental rate paid by the taxpayer for the property less the aggregate annual subrental rates paid by subtenants of the taxpayer. (See Regulation IV.18.(a) for special rules when the use of such net annual rental rate produces a negative or clearly inaccurate value or when property is used by the taxpayer at no charge or is rented at a nominal rental rate.) Subrents are not deducted when they constitute business income because the property which produces the subrents is used in the regular course of a trade or business of the taxpayer when it is producing such income. Accordingly there is no reduction in its value.

Example (i): The taxpayer receives subrents from a bakery concession in a food market operated by the taxpayer. Since the subrents are business income, they are not deducted from rent paid by the taxpayer for the food market.

[*Example (ii):* The taxpayer rents a 5-story office building primarily for use in its multistate business, uses three floors for its offices and subleases two floors to various other businesses on a short-term basis because it anticipates it will need those two floors for future expansion of its multistate business. The rental of all five floors is integral to the operation of the taxpayer's trade or business. Since the subrents are business income, they are not deducted from the rent paid by the taxpayer.

Example (iii): The taxpayer rents a 20-story office building and uses the lower two stories for its general corporation headquarters. The remaining 18 floors are subleased to others. The rental of the eighteen floors is not incidental to but rather is separate from the operation of the taxpayer's trade or business. Since the subrents are nonbusiness income they are to be deducted from the rent paid by the taxpayer.]

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Allocation and Apportionment continued on page 16

Allocation and Apportionment continued from page 15

••• Reg. IV.13.(a). Payroll Factor: In General.

(2) The total amount "paid" to employees is determined upon the basis of the taxpayer's accounting method. If the taxpayer has adopted the accrual method of accounting, all compensation properly accrued shall be deemed to have been paid. Notwithstanding the taxpayer's method of accounting, compensation paid to employees may, at the election of the taxpayer, be included in the payroll factor by use of the cash method if the taxpayer is required to report such compensation under that method for unemployment compensation purposes. The compensation of any employee on account of activities which are connected with the production of nonbusiness income shall be excluded from the factor.

[*Example (i):* The taxpayer uses some of its employees in the construction of a storage building which, upon completion, is used in the regular course of the taxpayer's trade or business. The wages paid to those employees are treated as a capital expenditure by the taxpayer. The amount of those wages is included in the payroll factor.

Example (ii): The taxpayer owns various securities which it holds as an investment separate and apart from its trade or business. The management of the taxpayer's investment portfolio is the only duty of Mr. X, an employee. The salary paid to Mr. X is excluded from the payroll factor.]

Model Uniform Statute for Reporting Federal Tax Adjustments with Accompanying Model Regulation

Adopted August 1, 2003

STATUTE

Section A. Reporting Federal Adjustments; assessment of additional tax

(1) As used in this section and Section B, unless the context requires otherwise, "final determination" shall refer to

(a) the allowance of a refund or credit under Section 6407 of the Internal Revenue Code of 1986; or

(b) the official act of assessment under Section 6203 of the Internal Revenue Code of 1986, except assessments that result from the following shall not be considered final determinations:

1. tax under a partial agreement,
2. tax in jeopardy, and
3. advance payments; or

(c) a final denial of a refund claim where a state refund claim has been filed or any other final action by the Internal Revenue Service that increases or decreases the state tax liability of a taxpayer for any tax year.

(2) Every Taxpayer or group of taxpayers whose federal taxable income, federal tax liability or federal tax return has been changed, adjusted, or corrected for any income tax year pursuant to a final determination under Section A.(1) shall, within one hundred eighty (180) days of the date of the final determination, file the report of federal changes or state amended return as prescribed herein reporting the changes, adjustments or corrections to taxpayer's federal taxable income, federal tax liability or federal tax return resulting from the final determination under Section A.(1) and pay additional state tax due. The taxpayer shall also submit available documentation sufficiently detailed to allow computation of the tax change.

(3) (a) If the taxpayer files the report of federal changes or state amended return as prescribed in and within the time limit specified in Section A.(2), any additional state tax resulting from the final determination under Section A.(1) may be assessed and a notice of assessment issued to the taxpayer by the [State Agency] on or before the later of:

{(i) The expiration of the limitations period specified in [citation to state statute setting forth normal limitations period]; *optional*} or

(ii) The last day of the one (1) year period following the due date of the report of federal changes or state amended return prescribed in Section A.(2).

(b) If the taxpayer fails to file a report of federal changes or state amended return as prescribed in and within the time limit specified in Section A.(2), any additional state tax resulting from the final determination under Section A.(1) may be assessed

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Federal Tax Adjustments continued from page 17

and a notice of assessment issued to the taxpayer by the [State Agency] on or before the later of:

{(i) The expiration of the limitations period specified in [citation to state statute setting forth normal limitations period]; *optional*} or

(ii) The last day of the one (1) year period following the date the report of federal changes or state amended return is actually filed with the [State Agency]; or

(iii) The last day of the one (1) year period following the date the [State Agency] is notified by the Internal Revenue Service in writing or by electronic means that a final determination has been made, provided the taxpayer has not filed a report of federal changes or state amended return prior to the [State Agency's] receipt of the IRS notification.

(4) The time periods provided for in this section may be extended by agreement between the taxpayer and the [State Agency]. Any extension granted for filing the report of federal changes or state amended return shall also be considered as extending the last day prescribed by law for any additional tax resulting from the final determination being assessed and a notice of assessment being issued to the taxpayer by the [State Agency].

Section B. Claim for refund or credit of tax

(1) Any claim for refund or credit related directly to changes, adjustments or corrections to the taxpayer's federal taxable income, federal tax liability or federal tax return resulting from a final determination under Section A.(1) shall be filed on or before the expiration of the later of the limitations period specified in [citation to state statute setting forth normal limitations period for allowing refund or credit {*optional*}] or the last day of the one (1) year period from the due date of the report of federal changes or state amended return prescribed in Section A.(2).

(2) An extension of time for filing the report of federal changes or state amended return extends the last day prescribed for filing the claim for refund to the extended date.

REGULATION

A. Examples of assessments considered to be final determinations include, but are not limited to:

1. A final judicial decision;
2. A closing agreement under Section 7121 of the Internal Revenue Code of 1986;
3. An uncontested assessment as defined by Regulation; or
4. The execution of a waiver of restriction on assessment that is not a partial agreement. Examples of an assessment that results from the execution of a waiver of restriction on assessment include assessments that result from the signing of Forms 870, 870AD, or 4549.

B. The term "uncontested assessment" shall mean:

1. An assessment pursuant to an amended return filed by the taxpayer or
2. an assessment that follows a taxpayer's receipt of a statutory notice of deficiency wherein the taxpayer does not petition the Tax Court.

Uniform Statute/Regulation, Sales and Use Tax Priority—Construction Inventory

Adopted August 1, 2003

When a construction contractor has purchased building materials in another state that are

a) resold in this state, or
b) manufactured into other building components that are
   1. resold in this state; or
   2. installed into a construction project in this state; or
   3. that are placed in inventory and then withdrawn

for one of the uses enumerated in subsection (a) and (b)(1) or (b)(2), a credit against sales or use tax paid to this state up to the amount of tax paid shall be allowed as follows:

a. for sales tax properly paid upon the initial purchase of the building materials in the other state;

b. for use tax properly paid upon the withdrawal of the building materials from inventory in the other state.

☛ ATTENTION ☚
State Tax Administrators

Please submit MTC Executive and Standing Committee designations as soon as possible. Forms can be sent to tnelson@mtc.gov, faxed to (202) 624-8819 or mailed to 444 North Capitol Street, NW, Suite 425, Washington, DC 20001. We would like to make sure the correct contact person(s) from your state for each committee receives meeting materials in a timely manner.

If you have any questions, please contact Teresa Nelson at 202-624-8699.

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April 2001

October 2001

February 2002

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Calendar of Events

Sunday, October 12 - Friday, October 17, 2003
Fall Program & Committee Meetings
Washington Court Hotel
525 New Jersey Avenue NW
Washington, DC

Wednesday, January 14 & Thursday, January 15, 2004
Winter Executive Committee Meetings
Hilton San Diego Resort
San Diego, California

Monday, March 15 - Thursday, March 18, 2004
Winter Program Committee Meetings
Holiday Inn on the Bay
San Diego, California

Sunday, July 25 - Friday, July 30, 2004
37th Annual Meeting & Committee Meetings
Hilton Mystic
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