COST Council On State Taxation

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Via E-Mail

Gregory Matson
Executive Director

Wood Miller
Chair, Uniformity Committee

Multistate Tax Commission
444 N. Capitol Street, NW
Suite 425
Washington, DC 20001

Re: COST Comments on Proposed Section 17 Model Market Sourcing Regulations

Dear Messrs. Matson and Miller;

This letter is a follow up to the comments submitted on behalf of the Council On State Taxation (COST) during the MTC Fall Committee Meetings in December. At the time I expressed our concerns regarding certain provisions within the Section 17 model market-sourcing regulations drafted by the UDITPA Section 17 Work Group. This letter provides some suggested language changes to the draft regulations that would address our concerns. Please share our comments and suggested language changes with the members of the Executive Committee.

Even-Handedness in Tax Administration

The COST Board of Directors has also adopted a formal policy statement on fair, efficient, and customer-focused tax administration.[1] That policy statement position is:

> *Fair, efficient and customer-focused tax administration is critical to the effectiveness of our voluntary system of tax compliance. A burdensome, unfair, or otherwise biased administrative system negatively impacts tax compliance and hinders economic competitiveness.*

[1] COST's Policy Statements are available at: http://cost.org/Page.aspx?id=3140.

To that end, COST is concerned that several provisions within the proposed regulations undermine fair and efficient tax administration. To begin with, the "reasonable approximation" rules, which are a key feature of the proposed Section 17 market sourcing regulations, are currently drafted in a manner that tilts the playing field in favor of the state tax agency. The Section 17 model market sourcing statute allows taxpayers to use a "reasonable approximation" method when the state or states of assignment of receipts cannot be determined. However, once a taxpayer has chosen a reasonable approximation method, the taxpayer is not allowed to change that methodology on a retroactive basis (by amending open returns) – even if new sources of information have become available. Conversely, a taxing agency is allowed to audit a taxpayer for prior open years and challenge the methodology utilized by the taxpayer.

The proposed regulations provide six criteria by which a tax agency can retroactively challenge a taxpayer's assignment of receipts or reasonable approximation methodology including if the tax agency "determines the method of approximation employed by the taxpayer is not reasonable." This one-sided approach is particularly troubling given the novelty of the "reasonable approximation" rules and the likely learning curve companies will embark on as they try to comply with these rules. The proposed regulations should be changed to allow companies to amend returns, where necessary, to modify their reasonable approximation methodology.

With that in mind, COST suggests the following changes to Sec. (a)(4)(A):

> (A) A taxpayer shall apply the rules set forth in Reg. IV.17 based on objective criteria and shall consider all sources of information reasonably available to the taxpayer at the time of its tax filing including, without limitation, the taxpayer's books and records kept in the normal course of business. A taxpayer shall determine its method of assigning receipts in good faith, and apply it consistently with respect to similar transactions.~~ and year to year~~…

In addition, to address taxpayer's inability to amend open returns, COST suggests the following change to Section (a)(7)(B):

> (B) General Rules Applicable to Original Returns. In any case in which a taxpayer files an original return for a taxable year in which it properly assigns its receipts using a method of assignment, including a method of reasonable approximation, in accordance with the rules stated in Reg. IV.17., the application of such method of assignment shall be deemed to be a correct determination by the taxpayer of the state or states of assignment to which the method is properly applied. However, the taxpayer may adjust its assignment of receipts on a previously filed return (through the form of an audit adjustment, amended return, abatement application or otherwise) to reflect another reasonable approximation method as long as the taxpayer does so consistently with the rules or standards of Reg. IV.17. ~~In those cases, neither t~~The [tax administrator] ~~nor the taxpayer (through the form of an audit adjustment, amended return, abatement application or otherwise)~~ may not modify the taxpayer's methodology as applied for assigning those receipts for the taxable year, except as provided in Section (a)(7) (C). Provided, however, the [tax administrator]and the taxpayer may each subsequently, through the applicable administrative process, correct factual errors or calculation errors with respect to the taxpayer's application of its filing methodology.

Moreover, on a prospective basis, a taxpayer is allowed to change its reasonable approximation method, but only in a manner unduly burdensome to the taxpayer. On a prospective basis, a taxpayer may only "make this change for purposes of improving the accuracy of assigning its receipts" and "must disclose, in the original return filed for the year of the change, the fact that it is has made the change, and must retain and provide to the [tax administrator] upon request documents that explain the nature and extent of the change, and the reason for the change." This places an undue burden on taxpayers, and this restriction should be removed from the proposed regulations. A taxpayer should not be required to establish that the new methodology "improves the accuracy" of assigning the receipts – but only to be able to defend on audit (if necessary) that the new method is a "reasonable" one. There could be many different reasons for a change in methodology – new technology, audit experience in other states, a changing customer base, and/or new sources of data – and a taxpayer should not be required to compare one reasonable method to another and demonstrate to the satisfaction of the tax administrator that the new method is an "improvement." The purpose of the "reasonable approximation" rules is to provide flexibility to taxpayers in the assignment of receipts of services and intangibles that are frequently difficult to source. That purpose is defeated when taxpayers find it difficult to comply with an ill-defined requirement in the regulations.

To address the taxpayer's inability to change filing methods going forward, COST suggests the following changes to Section (a)(7)(D):

> (D) Taxpayer Authority to Change a Method of Assignment on a Prospective Basis. In filing its original return for a tax year, a taxpayer may change its method of assigning its receipts under Reg. IV.17, including changing its method of approximation, from that used on previous returns. ~~However, the taxpayer may only make this change for purposes of improving the accuracy of assigning its receipts consistent with the rules set forth in Reg. IV.17, including, for example, to address the circumstance where there is a change in the information that is available to the taxpayer as relevant for purposes of complying with these rules.~~ <u>A</u> ~~Further, a~~ taxpayer that seeks to change its method of assigning its receipts must disclose, in the original return filed for the year of the change, the fact that it is has made the change, and ~~must retain and provide to the [tax administrator] upon request documents that~~ explain the nature and extent of the change, and the reason for the change. ~~If a taxpayer fails to adequately disclose the change or retain and provide the required records upon request, the [tax administrator] may disregard the taxpayer's change and substitute an assignment method that the [tax administrator] determines is appropriate.~~

COST is also troubled by the five percent rule that restricts a taxpayer from assigning receipts to the customer's billing address if its sales to one customer exceed five percent of its total receipts. This requirement places an undue constraint on a rule that otherwise encourages flexibility and ease of compliance.

To eliminate this requirement, COST suggests the following changes to (d)(3)(B)2.b.iii:

> iii. Secondary Rule of Reasonable Approximation. In the case of the delivery of a service to a business customer by electronic transmission where a taxpayer does not have sufficient information from which it can determine or reasonably approximate the state or states in which the service is received, the taxpayer shall reasonably approximate the state or states as set forth in this regulation. In these cases, unless the

> taxpayer can apply the safe harbor set forth in Reg.IV.17.(d).(3)(B)2.b.iv., the taxpayer shall reasonably approximate the state or states in which the service is received as follows: … third, if the customer's place of order is not reasonably determinable, by assigning the receipts from the sale using the customer's billing address~~; provided, however, if the taxpayer derives more than 5% of its receipts from sales of services from any single customer, the taxpayer is required to identify the state in which the contract of sale is principally managed by that customer~~.

The safe harbor provision of Section (d)(3)(B)2.b.iv should also be changed accordingly:

> iv. Safe Harbor….Under this safe harbor, a taxpayer may assign its receipts from sales to a particular customer based upon the customer's billing address in a taxable year in which the taxpayer ~~(1)~~ engages in substantially similar service transactions with more than 250 customers, whether business or individual~~, and (2) does not derive more than 5% of its receipts from sales of all services from that customer~~. This safe harbor applies only for purposes of [omitted reference] services delivered by electronic transmission to a business customer, and not otherwise.

Sections (d)(4)(C)1.a and (d)(4)(C)1.b and the safe harbor provision of Section (d)(4)(C)1.c should be similarly changed in order to eliminate the five percent requirement.

Finally, in the licensing of production intangibles, there is a presumption that if any of the intangible is used in production in a state, then 100 percent of the use is deemed in that state unless the taxpayer can demonstrate that some use is also outside the state. This places an undue burden on the taxpayer to refute the presumption. This rule should be eliminated and the assignment of receipts from the source of income should be put on an equal footing with other types of intangibles.

To eliminate this presumption, COST suggests the following change to Section (e)(3):

> (3) License of a Production Intangible.
> If a license is granted for the right to use intangible property other than in connection with the sale, lease, license, or other marketing of goods, services, or other items, and the license is to be used in a production capacity (a "production intangible"), the licensing fees paid by the licensee for that right are assigned to [state] to the extent that the use for which the fees are paid takes place in [state]. Examples of a license of a production intangible include, without limitation, the license of a patent, a copyright, or trade secrets to be used in a manufacturing process, where the value of the intangible lies predominately in its use in that process. ~~If the [tax administrator] can reasonably establish that the actual use of intangible property pursuant to a license of a production intangible takes place in part in [state], it is presumed that the entire use is in this state except to the extent that the taxpayer can demonstrate that the actual location of a portion of the use takes place outside [state].~~ In the case of a license of a production intangible to a related party, the taxpayer must assign the receipts to where the intangible property is actually used. In the case of a license of a production intangible to a party other than a related party where the location of actual use is unknown, it is presumed that the use of the intangible property takes place in the state of the licensee's commercial domicile (where the licensee is a business) or the licensee's state of primary residence (where the licensee is an individual).

Conclusion

As highlighted above, the proposed Section 17 Model Market-Based Sourcing Regulations have several provisions that we believe should be addressed and modified before the regulations are approved. COST respectfully requests that the Executive Committee make the above changes to the proposed regulations to ensure that taxpayers and tax agencies are treated in an even-handed manner and that the regulations provide flexibility for taxpayers consistent with the goals of the fair and efficient tax administration.

Sincerely,

Karl Frieden

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cc: COST Board of Directors
Douglas L. Lindholm, COST President & Executive Director