

The inclusion of gross income from securities (including hedges) and interest income from lending of securities is appropriate and necessary to accurately reflect income for all taxpayers for whom such activity and income is from the ordinary course of the taxpayer's trade or business. To exclude such income will not accurately reflect a taxpayer's business conducted within the state. A number of states have already addressed the inclusion of such income in the definition of receipts as well as determined the appropriate methodology to source such income.

Income from securities, including hedging and derivative activity, are a significant driver of net income and receipts for a number of industries including securities broker-dealers, security dealers, mortgage originators, proprietary traders, asset managers, commodity dealers and holding companies. By excluding receipts from securities and interest income from lending of securities from the sales factor, it could significantly reduce the relevance of the receipts factor or result in a manner completely inconsistent with the true business of these industries.

The inclusion of receipts from this business activity has been addressed in the development of the MTC financial organization apportionment model act as well as within a number of specific state statutes. In developing these provisions standards have been established that should not be ignored as the MTC has proposed in Section 17. A complete exclusion of such receipts from the factor would result in numerous taxpayers and states to consider adopting alternative apportionment methodologies for a significant number of taxpayers. This would seem to be contrary to the purpose of the Model Act and the development of a more standard formulary apportionment model.

It is important to note that a significant number of states have considered the complexity of inclusion of such income in the receipts factor and have addressed a number of the issues that the Committee has considered. As such there are numerous examples of a frame work that can and should be considered before any proposal is submitted. None of these states have removed income from securities completely from the receipts factor. Instead they have adopted rules that address the industries and businesses that have significant income from such activity.

The following are a few examples of where states have addressed hedging transactions with respect to the receipts factor. All of the states listed have tried to distinguish between certain types of securities transactions. By not issuing a blanket exclusion of all hedging transactions, each state acknowledges that there are certain types of industries reliant on securities transactions as the core of their business and as such should be taken into account for the receipts factor. As you will notice, the states that have addressed this issue tend to be those states in which the financial services industries significantly contribute to the economy of those states or are near financial services centers and we respectfully request the MTC take these into consideration.

New York: As part of their recent tax reform, New York includes receipts and net gains from securities transactions in the sales factor under N.Y. Tax Law §210-A.¹ It includes those receipts, net income, net

¹ N.Y. Tax Law §210-A.1 states, "Business income and capital shall be apportioned to the state by the apportionment factor determined pursuant to this section. The apportionment factor is a fraction, determined by including only those receipts, net income, net gains, and other items described in this section that are included in

gains, and other items that are included in the computation of the taxpayer's business income for the taxable year, and provides taxpayer's with a couple of options for sourcing receipts and net gains from securities transactions depending on the type of transaction. For sales of securities that essentially constitute inventory (those marked-to-market federal tax purposes under IRC 475 and 1256) of the taxpayer, such receipts and net gains are sourced either based on a customer sourcing method or fixed percentage method at the election of the taxpayer. Otherwise, securities transactions are required to be sourced under the relative customer sourcing method prescribed by the state. New York provided specific sourcing rules for a number of securities transactions including: loans; federal, state, and municipal debt; asset backed securities and other government agency debt; corporate bonds; reverse repurchase agreements and securities borrowing agreements; federal funds; physical commodities; and any other financial instrument. In addition, New York provides specific sourcing provisions for other receipts from broker or dealer activities and receipts from investment companies.

California: California defines "gross receipts" as the gross amounts realized (the sum of money and the fair market value of other property or services received) on the sale or exchange of property, the performance of services, or the use of property or capital (including rents, royalties, interest, and dividends) in a transaction that produces business income, in which the income, gain, or loss is recognized under the Internal Revenue Code, as applicable for purposes of this part.² California then specifically enumerates certain receipts that are not included in the definition of "gross receipts." Amounts specifically excluded from gross receipts include amounts received from transactions in intangible assets held in connection with a treasury function of the taxpayer's unitary business and the gross receipts and overall net gains from the maturity, redemption, sale, exchange, or other disposition of those intangible assets, as well as amounts received from hedging transactions involving intangible assets.³ However, taxpayers principally engaged in these types of transactions are not subject to this exclusion. Under Cal. Rev. & Tax Code §25120(f)(2)(K), a taxpayer principally engaged in the trade or business of purchasing and selling intangible assets of the type typically held in a taxpayer's treasury function, such as a registered broker-dealer, is not performing a treasury function with respect to income so produced.

Furthermore, California adopts a narrower definition of a hedging transaction to include only those transactions related to the taxpayer's trading function involving futures and options transactions for the purpose of hedging price risk of the products or commodities consumed, produced, or sold by the taxpayer.⁴ Under the proposed MTC definition, any type of receipt arising from a business activity will be considered from a hedging transaction if the primary purpose of engaging in the business activity is

the computation of the taxpayer's business income (determined without regard to the modification provided in subparagraph nineteen of paragraph (a) of subdivision nine of section two hundred eight of this article) for the taxable year. The numerator of the apportionment fraction shall be equal to the sum of all the amounts required to be included in the numerator pursuant to the provisions of this section and the denominator of the apportionment fraction shall be equal to the sum of all the amounts required to be included in the denominator pursuant to the provisions of this section."

² Cal. Rev. & Tax Code §25120(f)(2)

³ Cal. Rev. & Tax Code §25120(f)(2)(K),(L)

⁴ Cal. Rev. & Tax Code §25120(f)(2)(L)

to reduce the exposure to risk caused by other business activities. The proposed MTC definition further provides that receipts from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities are *excluded* regardless of whether or not the events or transactions are engaged in for the purpose of hedging.

To the extent the transaction is not otherwise excluded, for California corporate income tax purposes receipts from the sale of intangible property are sourced to the state to the extent the property is used in the state. In the case of marketable securities, sales are in this state if the customer is in this state.⁵ Where the sale of intangible property is the sale of shares of stock in a corporation or the sale of an ownership interest in a pass-through entity, other than sales of marketable securities, California provides specific sourcing rules that look to the underlying assets of the corporation or partnership in which the stock or interest is being sold.⁶

Connecticut: Connecticut provides special industry sourcing rules for “securities brokerage services.” Corporations that provide “securities brokerage services” must apportion their net income derived from rendering such services using a single-factor formula measured by brokerage commissions and margin interest paid on brokerage accounts.⁷ [Please note that the recently enacted legislation revising the sourcing of receipts under SB 502 does not impact the sourcing rules for securities brokerage services.] “Security brokerage services” means services and activities including all aspects of the purchasing and selling of securities rendered by a broker, as defined in 15 USC 78c(a)(4) and registered under the provisions of 15 USC 78a to 78kk, inclusive, as from time to time amended, to effectuate transactions in securities for the account of others, and a dealer, as defined in 15 USC 78c(a)(5) and registered under the provisions of 15 USC 78a to 78kk, inclusive, as from time to time amended, to buy and sell securities, through a broker or otherwise.⁸ Security brokerage services shall not include services rendered by any person buying or selling securities for such person's own account, either individually or in some fiduciary capacity, but not as part of a regular business carried on by such person.⁹ “Brokerage commission” means all compensation received for effecting purchases and sales for the account or on order of others, whether in a principal or agency transaction, and whether charged explicitly or implicitly as a fee, commission, spread, mark-up or otherwise.¹⁰

New Jersey: For New Jersey corporate income tax purposes, the sales factor includes the receipts of the taxpayer, computed on the cash or accrual basis according to the method of accounting used in the computation of its net income for federal tax purposes, arising during such period from the following:

- sales of its tangible personal property located within this State at the time of the receipt of or appropriation to the orders where shipments are made to points within this State;

⁵ Cal. Rev. & Tax Code §25136(a)(2)

⁶ Cal. Code Reg. tit. 18, §25136-2(d)(1)(A)(1)

⁷ Conn. Gen. Stat. §12-218(g)(1).

⁸ Conn. Gen. Stat. §12-218(g)(3)(A)

⁹ Id.

¹⁰ Conn. Gen. Stat. §12-218(g)(3)(C)

- sales of tangible personal property located without the State at the time of the receipt of or appropriation to the orders where shipment is made to points within the State;
- services performed within the State;
- rentals from property situated, and royalties from the use of patents or copyrights, within the State; and
- all other business receipts (excluding dividends excluded from entire net income by paragraph (1) of subsection (k) of section 4 of P.L.1945, c.162 (C.54:10A-4) earned within the State.¹¹

New Jersey adopts special sourcing rules for certain industries including securities or commodities broker-dealers and asset management companies. Under N. J. Admin. Code §18:7-8.10(f), receipts from the services of a registered securities or commodities broker or dealer shall be sourced to New Jersey if the customer is located within the State. “Securities” and “commodities” have the same meaning as under IRC §475. Similarly, a New Jersey tax court found that securities bought and sold by a New Jersey market-maker in the over-the-counter securities market were integrated with the company's business carried on in other states and, therefore, receipts generated by the securities transactions were earned at the location of the company's customers.¹²

As it relates to asset management companies, New Jersey provides that the sales factor shall include receipts from asset management services and shall be sourced to the domicile of the customer.¹³ “Asset management services” means the rendering of investment advice, making determinations as to when sales and purchases are to be made, or the selling or purchasing of assets and related activities.¹⁴

Illinois: Illinois has also addressed taxpayers that primarily deal in securities transactions and has provided that the interest, net gains (but not less than zero) and other items of income from intangible personal property, shall be included in the numerator of the sales factor if the taxpayer is a dealer in the item of intangible personal property within the meaning of Section 475 of the Internal Revenue Code, and the income or gain is received from a customer in Illinois.¹⁵ Otherwise, such receipts are to be sourced based on where the income-producing activity is performed.¹⁶ We note that with the exception of this last provision, Illinois has adopted market-based sourcing rules.

In addition, Illinois has recently adopted regulations addressing hedging transactions. Under 86 Ill. Admin. Code 100.3380(c)(6)(B), Illinois now excludes any income, gain or loss from a transaction properly identified as a hedge under 26 USC 1221(b)(2)(A), 475(c)(3) or 1256(e)(2). A “hedging transaction,” as a transaction entered into by a taxpayer in the normal course of business primarily to manage interest rate risk or the risk of price or currency fluctuations (See 26 USC 475(c)(3), 1221(b)(2)(A) and 1256(e)(2)).¹⁷

¹¹ N.J. Rev. Stat. § 54:10A-6(B)

¹² See *Mayer & Schweitzer, Inc. v. Director, Div. of Taxation*, 20 N.J. Tax 217, 226 (Tax 2002)

¹³ N.J. Admin. Code §18:7-8.10(e)

¹⁴ N.J. Admin. Code §18:7-8.10(e)(4)(i)

¹⁵ 35 Ill. Comp. Stat. 5/304(a)(3)(C-5)(iii)

¹⁶ *Id.*

¹⁷ 86 Ill. Admin. Code 100.3380(c)(6)(A)

In its reasoning, the Illinois Department of Revenue provides in 86 Ill. Admin. Code 100.3380(c)(6)(A), that gains and losses on hedging transactions entered into to manage the risks associated with the acquisition of resources by a taxpayer (for example, price fluctuations in commodities consumed in the taxpayer's business) do not reflect the market for the taxpayer's goods and services and, therefore, should be excluded from the sales factor. However, gains and losses on hedging transactions entered into to manage risks associated with the gross income the taxpayer expects from its sales of goods and services (for example, the effect of foreign currency fluctuations on the dollar amount of gross income the taxpayer will receive from sales to a particular foreign country) are best accounted for in the sales factor as adjustments to the gross receipts from the transactions whose risks are being hedged. Gains and losses on hedging transactions that manage risks associated with both acquisitions and sales of the taxpayer (for example, electricity futures bought or sold by a taxpayer engaged in the business of buying and selling electrical power), or that otherwise cannot be associated with a particular transaction or class of transactions in the computation of the sales factor, should also be excluded from the sales factor. Taxpayers must refer to the federal income tax law for a framework for identifying gains and losses from hedging transactions to the transactions or class of transactions being hedged and for keeping records necessary to support the identifications.

Illinois provides instances in which hedging transactions are includible in gross receipts:

1. If the taxpayer's books and record clearly identify a hedging transaction as managing risk relating to a particular item or items of gross receipts, including anticipated items of gross receipts, that must be included in the sales factor;
2. If, for federal income tax purposes, the hedging transaction is integrated with the hedged item;
3. A transaction entered into by one member of a federal consolidated group identified as a hedge against a risk of another member if the two members are not members of the same unitary business group because the transaction is not hedging against a risk face by the taxpayer entering into the transaction; and
4. A transaction entered into by one member of a unitary business group with another member because the risk remains within the group.

Rhode Island: For purposes of computing the sales factor under the Rhode Island Corporate Income Tax, "gross receipts from sales" specifically includes net income from the sale or other disposition of securities or financial obligations.¹⁸ Rhode Island also adopts special industry apportionment and sourcing rules for taxpayers which provide "securities brokerage services," under which, at the election of the taxpayer, all net income derived directly or indirectly from the sale of securities brokerage services by a taxpayer shall be apportioned to Rhode Island only to the extent that securities brokerage

¹⁸ R.I. Gen. Laws §44-11-14(a)(2); R.I. Code R. 15-04.5

customers of the taxpayer are domiciled in Rhode Island. The portion of net income apportioned to Rhode Island shall be determined by multiplying the total net income from the sale of the services by a fraction: the numerator is the brokerage commissions and total margin interest paid in respect of brokerage accounts owned by customers domiciled in Rhode Island for the taxpayer's taxable year; and the denominator is the brokerage commissions and total margin interest paid in respect of brokerage accounts owned by all of the taxpayer's customers for the same taxable year.¹⁹

Florida: The Florida Department of Revenue has held in Technical Assistance Advisement No. 12C1-007 that gross receipts from three hedging transactions: (1) hedges on materials related to its inputs; (2) hedges related to the commodity it sells; and (3) hedges unrelated to items it purchases or sells; were never included in the sales factor, and net receipts from hedges on input materials used by the taxpayer and commodities unrelated to the taxpayer's business are also excluded. However, net receipts from hedging on commodities the taxpayer sells in its business are considered "sales" and included in the sales factor because the taxpayer is engaged in the sale of the underlying commodity.²⁰

¹⁹ R.I. Gen. Laws §44.11.14.2(b); R.I. Code R. 15-04.11(d)(2); R.I. Code R. 15-04.10(g)(2);

²⁰ Fl. Dept. of Rev., TAA, No. 12C1-007 May 25, 2011.