MULTISTATE TAX COMMISSION

Report of the Hearing Officer Regarding Proposed Model Regulation for Apportionment of Income from the Sale of Telecommunications and Ancillary Services
April 2008

I. Procedural Summary

A. Development of the Proposal

In July, 2003, the Uniformity Committee of the Multistate Tax Commission re-commenced a project to develop a model special apportionment rule for income earned from the provision of telecommunication services.[1] Since the project's initiation, and until its completion by the Uniformity Committee in July, 2007, development of the proposal was discussed at every meeting of the Income & Franchise Tax Uniformity Subcommittee as well as numerous Income & Franchise Tax Uniformity Subcommittee teleconferences.

The Subcommittee organized the project around three main efforts 1) education, 2) policy development, and 3) drafting. The Subcommittee's educational effort included several presentations by industry experts[2], as well as a number of staff memoranda.[3] In addition, the level of public participation in general was high, and the Subcommittee received constructive comments at each of its meetings.[4].

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[1] The project had originally been commenced, but was then stayed, in the late 1990's.

[2] Deborah Bierbaum, AT&T, and Doug Hurst, Qwest, provided extensive helpful input to the Income & Franchise Tax Subcommittee, including three presentations on trends and current structure, operation and revenue outlook for the telecommunications industry. Kendal Houghton and Jeff Friedman, Southerland, Asbill and Brennan, gave a very informative presentation on the intersection and distinctions between telecommunication services and cable services; Walt Nagel, Sullivan & Worcester LLP, provided expert assistance to the Subcommittee as an un-paid technical consultant on the project.

[3] The Subcommittee received memoranda from MTC Staff member, Shirley Sicilian on the following topics: (1) *Estimated telecommunications and information service sector revenues by service type and by state, 1998 through 2004* – provided March, 2004 and updated July,2006, (2) *Compendium of existing definitions of "telecommunications,"* - provided March, 2005, (3) *Special Rule for Telecommunications Apportionment, including Options for Wholesale Service Sales Factor Assignment* – provided July, 2006, (4) *Survey of existing state treatment of outer-jurisdictional property for income tax and property tax purposes* – provided July, 2007.

[4] Deborah Bierbaum, AT&T; Doug Hurst, Qwest; Walt Nagel, Sullivan & Worcester LLP, Kristin Goodin and Margaret Wilson, Verizon; Kendal Houghton and Jeff Friedman, Southerland, Asbill & Brennan; Jamie Fenwick, Time Warner Cable; and others provided helpful participation and comments throughout the development process.

The Subcommittee began its policy development by approving a list of policy criteria for guiding the development of any model special apportionment regulation. It then compiled a checklist of key policy issues to be addressed in a model special regulation for apportionment of income from provision of telecommunications services.[5] During its March, 2005 meeting and at each meeting thereafter, the Subcommittee provided direction on these policy issues for staff to follow in preparing drafts of the model special rule. In doing so, the Subcommittee first addressed the question of whether there was a need for a special rule for this industry and, if so, what the scope of its application should be. The Subcommittee determined that, to the extent telecommunications companies are subject to UDITPA, the sales factor sourcing rules that apply under section 17 are not appropriate for the industry. Thus, to appropriately and uniformly apportion for both those providers that may be considered public utilities which are excluded from UDITPA, as well as those providers that are no longer considered public utilities and fall within section 17 of UDITPA, a special rule is necessary, and that the scope of the rule should encompass income arising from the sale of telecommunications and ancillary services.[6] The rule is not limited only to companies that are considered to be "telecommunications companies" -- any company that provides telecommunications or ancillary services would be required to source income from those services in accordance with the rule.

The next major policy decisions were focused on development of the special rule, in particular definitions and special sales and property factor provisions. The Subcommittee determined the model's definitions, and its sales factor numerator sourcing for retail services, should track as closely as possible with the sourcing rules laid out for sales and use tax purposes in the Streamlined Sales and Use Tax Agreement. Staff developed a draft of the model rule with annotations to the Streamlined Agreement definitions and rules. The Subcommittee then turned its attention to sales factor numerator sourcing for wholesale services, and after considering multitudes of possible options and information from staff interviews with personnel at the Federal Communications Commission, determined that the most reasonable approach on balance was to use, as a proxy, estimates compiled by the Federal Communications Commission.[7]

Finally, the Subcommittee determined outerjurisdictional property should not be included in the property factor denominator.[8]

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[5] In addition to MTC staff, Michael Brownell, California FTB, and Leonore Heavey, Louisiana, assisted with the development of the telecommunications apportionment policy checklist.

[6] The Subcommittee considered an alternative scope of application that would have included cable companies, internet service providers or other information services and determined that at this time the scope should be limited to telecommunications and services ancillary to telecommunications (ancillary services include services such as call forwarding, conference calling, call-waiting, etc.)

[7] MTC Staff consulted with Mr. Jim Land and Mr. Jim Eisner, economists responsible for estimating telecommunications industry information and compiling various FCC reports, including FCC table 15.6 using, in part, FCC form 499a.

[8] The Subcommittee considered a memorandum from MTC staff surveying various approaches to outer-jurisdictional property currently used in some states and in MTC model special apportionment rules for other industries.

A small drafting group of state volunteers and MTC staff worked to provide drafts for the Subcommittee in accordance with its policy direction.[9] At times, the drafting group was joined by industry representatives. At various stages of the draft's development, the Subcommittee received helpful written public comments, in addition to the oral public comments received during the meetings and teleconferences.[10]

On July 30, 2007, the Subcommittee recommended a final draft model regulation to the Uniformity Committee. The Uniformity Committee approved the draft and recommended it to the Executive Committee for public hearing.

B. Public Hearing

After more than 30 days notice to the public and interested parties, a Public Hearing was held on October 16, 2007 in Washington, DC.[11] Written public comments were submitted prior to hearing by the Committee on State Taxation (COST), Sutherland Asbill and Brennan, LLP (SA&B), and Elliott Dubin, Director of Policy Research, Multistate Tax Commission. At the hearing, oral comments were offered by the authors of the three written comments and by an attorney representing the Massachusetts Revenue Department. Following the hearing, the record was left open until November 16, 2007 for the submission of supplemental written comments, limited to the issues raised in the MTC Staff written public comments. All written comments are attached as Exhibits B through E:

Exhibit B: *Comments on the MTC's Proposed Model Regulation for Apportionment of Income from the Sale of Telecommunications and Ancillary Services* from Sutherland Asbill and Brennan, LLP.

Exhibit C: *Comments to the Multistate Tax Commission on the Issue of the Proposed Model Regulation for Apportionment of Income from the Sale of Telecommunications and Ancillary Services* by Todd A. Laird, Tax Counsel, Counsel on State Taxation (COST)

Exhibit D: *Written Comments on Proposed Model Regulation for Apportionment of Income from the Sale of Telecommunications and Ancillary Services* by Elliott Dubin,

[9] The small drafting group included Ben Miller, California FTB; Carl Joseph, California FTB; Michael Fatale, Massachusetts; Brenda Gilmer, Montana; and Charles Rhilinger, Ohio. Industry input to the drafting group during 2006 – 2007 included Deborah Bierbaum, AT&T, and Jamie Fenwick, Time Warner Cable.

[10] See *Industry Comments on Proposed Uniform Regulation for Apportionment of Income for Telecommunications and Other Industries* – received July, 2004; *Cable and Similar Service Providers' Comments on MTC Proposed Uniform Regulation for Apportionment of Income from the Sale of Telecommunications and Similar Services* – received July, 2005; and *Telecommunications Industry Comments on the MTC's Proposed Model Regulation for Apportionment of Income from the Sale of Telecommunications and Ancillary Services* - received July, 2007.

[11] A copy of the Notice of Public Hearing and proposed model regulation is attached hereto as Exhibit A.

Director of Policy Research, Multistate Tax Commission

Exhibit E: *Supplemental Comments on the MTC's Proposed Model Regulation for Apportionment of Income from the Sale of Telecommunications and Ancillary Services* from Sutherland Asbill and Brennan, LLP.

III. Summary of Substantive Provisions

A. Purpose of Proposed Model Regulation

The model regulation is intended to address changes in income tax reporting by telecommunication carriers as a result of the industry's evolution from a highly regulated environment to a deregulated business model. As regulated utilities, telecommunication carriers were excluded from UDITPA's coverage. This is, therefore, the first time the Commission has considered the adoption of an appropriate apportionment formula for income arising from the sale of telecommunications and ancillary services.

B. Operation of the Model Regulation

The regulation sets forth a series of rules to determine the sourcing of the sales factor for telecommunications and ancillary services. In addition, the regulation provides that outerjurisdictional property is excluded from the denominator of the property factor.

Summary of Proposed Model Regulation, by Section:

1. Section 1 provides that the regulation establishes rules with respect to the apportionment of income from the sale of telecommunications and ancillary services by a person that is taxable in at least two states.

2. Section 2 is a set of definitions applicable to the apportionment of income from the sale of telecommunications and ancillary services.

3. Section 3 first provides that outer jurisdictional property, as defined in Section 2, is excluded from the numerator and the denominator of the property factor. Section 3 then sets forth rules to determine when sales of telecommunications and ancillary services are in this state. Gross receipts from the sale of telecommunications services are in this state:

- When the call originates and terminates in this state or either originates or terminates and the service address is also located in this state, if the services are sold on a call-by-call basis.
- When the customer's place of primary use is in this state, if the services are sold on other than a call-by-call basis.
- When the customer's place of primary use is in this state pursuant to the Mobile Telecommunications Sourcing Act, if the gross receipts are from the sale of mobile telecommunications services other than air-to-ground radiotelephone service and

prepaid calling service.

- When the origination point of the telecommunications signal is first identified in this state by either of two stated methods, and the gross receipts are from the sale of post-paid calling service.

Section 3.ii.E provides that gross receipts from the sale of ancillary service, prepaid calling service or prepaid wireless calling service, as defined in Section 2, are in this state according to a series of rules that govern when the property is received by the purchaser at a business location of the seller in this state and when the property is not so received.

Section 3.ii.F provides that gross receipts from the sale of a private communication service, as defined in Section 2, are in this state according to a series of rules that depend upon the location of the customer channel termination points in this state and elsewhere, whether or not such service is for segments of a channel between two customer channel termination points located in different states, and whether or not such segments are separately billed.

Section 3.ii.G and H set forth detailed provisions that govern the apportionment of gross receipts from sales of telecommunication services to other telecommunication service providers for resale, and for bundled transactions.

Finally, Section 3.ii.I provides that gross receipts from the sales of telecommunication services which are not taxable in the State to which they would be apportioned pursuant to the regulation, shall be excluded from the denominator of the sales factor.

IV. Summary of Written and Oral Comments and Recommendations.

1. Ms. Kendall Houghton of SA&B submitted written comments and appeared at the hearing on behalf of AT& T Inc., Comcast Corporation, Sprint Nextel Corporation, Time Warner Cable and Verizon and Verizon Wireless. Ms. Houghton made a joint presentation with Ms. Deborah Bierbaum of AT&T. Todd Laird, Tax Counsel of the Council on State Taxation (COST) also made a presentation and submitted written testimony. Elliott Dubin, Director of Policy Research for the Multistate Tax Commission submitted written testimony and offered comments during the hearing. Michael Fatale, Chief, Bureau of Rulings and Regulations, Massachusetts Department of Revenue, also offered comments during the hearing.

The gravamen of Ms. Houghton and Ms. Bierbaum's testimony was that the telecommunications industry should not be singled out for the development of a special apportionment rule at the same time that the National Conference on Uniform State Laws, acting on the request of the MTC, is reviewing UDITPA, with specific focus on Section 17. In support of their position, Ms. Houghton and Ms. Bierbaum assert that any problems with cost of performance sourcing apply across the board to all services and service providers, and are not unique to the telecommunications industry. In addition,

they assert that the states have not identified any industry-specific practices that would justify a special rule for telecommunications at this time.

Specifically, Ms. Houghton and Ms. Bierbaum object to the MTC's treatment of wholesale sales of telecommunication services (carrier to carrier sales for resale of telecommunication services). In criticizing the proposed regulation's use of FCC Table 15.6 as a proxy for sourcing wholesale revenues by state, Ms. Houghton and Ms. Bierbaum point out that the data appearing on Table 15.6 represents aggregate industry revenue by state and is not necessarily representative of the revenue of any specific carrier. They maintain that use of this data could raise Commerce Clause issues under both the fair apportionment and fair relationship prongs of the Complete Auto test. Ms. Houghton and Ms. Bierbaum also object that the data on Table 15.6 is stale (three year lag).

Finally, Ms. Houghton and Ms. Bierbaum object to the use of throwout for both the property and sales factors, asserting that the use of throwout in this context could raise Commerce Clause issues under both the fair apportionment and fair relationship prongs of the Complete Auto test.

2. COST's written statement and testimony essentially tracked Ms. Houghton and Ms. Bierbaum's testimony regarding wholesale sales and throwout.

3. Mr. Dubin offered a response to industry objections to the use of FCC Table 15.6. In lieu of FCC Table 15.6, Mr. Dubin proposes amending the proposed rule to require taxpayers to apportion their wholesale service revenue using information reported by their affiliated groups to the FCC on line 315 of FCC Form 499a and population data. Affiliated groups of telecommunication carriers that do not have national retail sales are required to report total revenues from services provided for resale on line 315, for both interstate and international calls, on an annual basis. Mr. Dubin would multiply a taxpayer's interstate wholesale service revenues by a ratio, the numerator of which is the affiliated group's "carrier's carrier" revenues for the region of the apportioning state (listed by the group in Block 5 of FCC Form 499-A) and the denominator of which is the affiliated group's total "carrier's carrier" revenues. The result of this calculation is a proxy for the taxpayer's wholesale revenue for the region of the country that includes the apportioning state. To put the estimate on a state level, Mr. Dubin would then prorate the taxpayer's estimated wholesale regional revenues to the apportioning state using the most recent population estimates for that state compared to the sum of population estimates for all states in the region (as reported by the Census Bureau). Mr. Dubin would retain Table 15.6 as a proxy for determining wholesale receipts for those carriers who do not file Form 499-A.

4. Mr. Fatale testified that there is a present need for a special apportionment rule for telecommunications because that industry is increasingly shifting to non-market based apportionment as the industry evolves. Furthermore, Mr. Fatale offered the view that the proposed wholesale sale rule is fair in light of the fact that industry could not propose an alternative consensus approach, after being given ample opportunity to do so. Mr. Fatale

also offered suggestions for improving the bundling and business inputs provisions of the regulation.

5. In light of Mr. Dubin's testimony and written submission, the hearing officer held the record open until November 16, 2007 so that interested parties might offer comments in response. SA&B submitted supplemental written comments. SA&B objects to Mr. Dubin's alternative method for sourcing wholesale receipts from telecommunication services.

First, SA&B notes that to the extent the alternative method would still default to Table 15.6 for carriers that are not required to complete FCC Form 499a, the alternative "bears all the same infirmities" that the Proposed Model Regulation bears.

More fundamentally, SA&B objects that Form 499a is not filed on an entity-specific basis. As a result, individual company revenues are not broken out and the data reported on the form do not otherwise support apportionment of wholesale receipts on a separate income tax return. SA&B therefore contend that Form 499a is subject to the same constitutional infirmities as is Table 15.6. SA&B acknowledges that their constitutional concerns would be slightly reduced if Form 499a were to be used in lieu of Table 15.6, because of Form 499a's reliance on an affiliated group's aggregate data instead of an industry segment's aggregate data.

In addition, SA&B objects that the alternative method sources the regional data on Form 499a at the state level by apportioning the regional wholesale receipts to each state in the region in proportion to each state's most recent state population census data as a percentage of the region's population census data. SA&B objects that the use of population data results in a flat apportionment of receipts without regard to each carrier's actual business activity in any state.

Response to Witness Testimony

1. The hearing officer has considered SA&B's and COST's assertion that the MTC should defer consideration of an apportionment regulation for the telecommunications industry pending the completion of the current NCUSSL initiative to reform UDITPA. The hearing officer recommends that this Committee proceed with the current project because the course of the NCCUSSL initiative is uncertain and likely to be extremely time consuming. The history of the original UDITPA statute suggests that the NCUSSL process may take years.

The National Tax Association proposed a uniform apportionment law as early as 1928.[12] The modern drive to promulgate UDITPA began in 1953, when the Governors' Conference of the Council of State Governments adopted a resolution requesting that the

[12] Arthur D. Lyons, Jr., *The Uniform Division of Income for Tax Purposes Act,* 19 OHIO ST. L.J. 41, 42 (1958).

Council "study this problem [of nonuniform apportionment laws] with a view of attaining uniformity of statutory provisions relative to the apportionment of net income among the various states" and to report back to the Governors' Conference "as soon as possible."[13] NCUSSL completed its initial draft of a uniform apportionment statute in 1956.[14] The draft was considered by NCUSSL at its 1956 meeting and was referred back to the originating Committee for further study, reconsideration and resubmission to NCUSSL at its 1957 meeting.[15] NCCUSSL adopted UDITPA at its annual meeting on July 12 – 13, 1957 and the House of Delegates of the American Bar Association approved it during the following week.[16]

Measuring the commencement of the original NCUSSL UDITPA project from the Governors' Conference resolution calling for a uniform apportionment statute, it took four years (1953 – 1957) to bring that process to fruition.[17] Given the increased complexities of the modern service-based economy compared to the largely manufacturing based economy of the 1950's, it is reasonable to assume that it would take even longer for NCCUSSL to complete its work today. Indeed, Charles Trost, Chair of the NCCUSSL drafting committee for amending UDITPA, reported to the MTC Executive Committee at its January 2008 meeting in San Diego that the drafting committee will hold its first meeting in May 2008 and that the earliest NCCUSSL could vote on any proposed UDITPA changes would be the summer of 2009. Furthermore, COST has publicly announced its opposition to the NCUSSL UDITPA project, asserting that uniformity in apportionment should be achieved, if at all, through federal legislation.[18] For all these reasons, the hearing officer believes there is no sound reason to await the outcome of the NCUSSL process, if there is a current need for a special apportionment regulation for telecommunications.

2. The hearing officer does believe that there is a current need for a special regulation for telecommunications. As noted by the State of California;

> For many years, members of the telecommunications industry have assigned sales to California by constructing the numerator of the sales factor by adding together the total amount of interstate sales multiplied by the cost of equipment in California to total equipment everywhere and the intrastate sales. Recently, some members of the telecommunications industry have asserted claims that the numerator of the sales factor in California should be zero, even to the exclusion of intrastate calls, because the greatest cost of performance is located in another

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[13] Arthur D. Lyons, Jr., *Formula Apportionment of Corporate Income for State Tax Purposes: Natura Non Facit Saltum,* 18 OHIO ST. L.J. 84, 88 – 89 (1957).

[14] *Id.,* at 89.

[15] *Id.*

[16] Lyons, *The Uniform Division of Income for Tax Purposes Act,* 19 OHIO ST. L.J. at 41.

[17] For purposes of this report, the hearing officer has not considered the time necessary for the states that have enacted UDITPA to do so. Proposed MTC statutes and regulations also require implementation by the states. Therefore, the length of time required for the states to act on the ABA's original adoption of UDITPA is not germane to the objection raised by SA&B.

[18] Letter from Douglas L. Lindholm, Esq., COST President & Executive Director to Charles L. Trost, Esq., Chair, NCCUSSL UDITPA Drafting Committee, January 10, 2008.

state.[19]

Historically, the regulated telecommunications industry was not subject to UDITPA. As a result, the Commission has not previously addressed the question of whether a special apportionment rule is required for the formerly highly regulated telecommunications industry. The Commission has not hesitated to recommend industry-specific apportionment rules in the past when industries were deregulated.[20] The promulgation of a special rule for the apportionment of income by telecommunication carriers is neither unprecedented nor unique.

3. The Hearing Officer has considered SA&B's and COST's objection to the use of FCC Table 15.6 to apportion receipts from carrier wholesale telecommunication services. Their objections to the use of industry wide revenue in lieu of carrier-specific revenue are not without merit. But the industry has not been able to suggest a more appropriate general rule to apportion wholesales sales on a carrier-specific basis. In the absence of such information, Table 15.6 appears to be a reasonable proxy. Formulary apportionment, even when using taxpayer specific factors, is a "rough approximation." *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978); *Exxon Corp. v. Dep't. of Revenue*, 447 U.S. 207, 223 (1980). In the meantime, Section 18 of UDITPA allows for the use of alternative apportionment formulae in individual cases where the taxpayer shows application of the special rule results in distortion. The Commission and the member states can always modify the regulation in the future if experience under Section 18 suggests a better special apportionment rule for this industry.

4. The Hearing Officer considered Mr. Dubin's proposal to use FCC Form 499a in lieu of Table 15.6 to apportion receipts from carrier wholesale telecommunication services. Although Form 499a has certain potential advantages over Table 15.6, the Hearing Officer rejects Mr. Dubin's proposal. According to Jim Land, an FCC economist responsible for administering Form 499a, a carrier is only required to break down its wholesales sales on Form 499a if the carrier has had no retail sales direct to an end-user within a given FCC region. Since the larger telecommunications carriers almost always have retail end-user sales, they are subject to a minimum annual Universal Service Fee of $100 and don't generally report their regional wholesale sales. Form 499a is therefore not usable for state tax reporting.

5. The hearing officer has considered SA&B's Commerce Clause objection to the use of throwout. The proposed regulation provides for throwout in two contexts.

First, Section (3i) provides that outerjurisdictional property that is used by a taxpayer in providing a telecommunications or ancillary service shall be excluded from

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[19] Benjamin F. Miller, *Current Problems with UDITPA and Possible Solutions*, 38 STATE TAX NOTES 125, 2005 STT 190-3 (October 3, 2005).

[20] The MTC has promulgated special rules for the apportionment of income by construction contractors, airlines, railroads, trucking companies, television and radio broadcasters, financial institutions and publishers. MTC Reg. IV.18. (d) – (j). At least six of these industries – airlines, railroads, trucking companies, television and radio broadcasters and financial institutions – were formerly highly regulated and are now largely governed by the market.

the numerator and the denominator of the property factor. "Outerjurisdictional property" is defined in Section (2) (xxiii) to mean tangible personal property, such as orbiting satellites, undersea transmission cables and the like, that are owned or rented by the taxpayer and used in a telecommunications or similar service business, but that are not physically located in any particular state.

The hearing officer has serious doubts that the Commerce Clause has any applicability whatsoever when applied to outerjurisdictional property. Such property, while tangible, exists in no state – the property is either in outer space or under the ocean. Excluding this property entirely from the tax base of any state cannot in any way affect interstate commerce, because the property is not located in interstate commerce. On the other hand, it would clearly distort a carrier's apportioned income to include the property in the denominator when it can appear in no state's numerator. Doing so can only result in nowhere income. The Commerce Clause is designed to protect interstate commerce from state action that unreasonably burdens that commerce, for example, through multiple taxation. It is not intended to foster the creation of nowhere income by the use of property in outer space or under the ocean.

Next, Section (3)(ii)I provides that gross receipts from the sale of telecommunication services which are not taxable in the State to which they would be apportioned pursuant to section (ii)A through G, shall be excluded from the denominator of the sales factor.

Section (3)(ii)I is designed to address the problem of "nowhere income" that would result from a taxpayer's including receipts in the sales factor denominator that cannot be taxed in a State to which the receipts can be apportioned under section (ii)A through G. It is clearly reasonable under the due process clause for the states to exclude the receipts from the sales factor denominator when including them would result in nowhere income.

The hearing officer notes that no court has yet addressed the issue of the constitutionality of throwout under the Commerce Clause.[21] Conceptually, there would appear to be no sound reason to analyze throwout differently under the Commerce Clause than throwback would be analyzed. Throwback has been recognized for some forty years as an appropriate tool to achieve equitable apportionment of income and to avoid nowhere income.[22] With one exception, no court has ever held throwback to violate the

[21] SA&B states that "the throwout rule has been rejected by the Pennsylvania Supreme Court as being plainly in derogation of the intent to tax business activity "in this state." SA&B is apparently referring to *Paris Mfg. Co. v. Commonwealth of Pennsylvania,* 505 Pa. 15, 476 A.d 890 (PA 1984). In *Paris Mfg.,* the Pennsylvania Supreme Court ruled that the Pennsylvania Board of Finance and Revenue exceeded its statutory authority in applying throwout in cases where the taxpayer was not subject to income tax in another state. The Court found that applying throwout merely because another state did not impose an income tax violated the statutory requirement that alternative apportionment formulae be used only when the standard three factor apportionment formula did not fairly represent the extent of the taxpayer's business activity "in this state." No Commerce Clause issue was raised in the case.

[22] *Appeal of Joyce,* 1966 Cal. Tax Lexis, *Appeal of Finnigan Corp.,* 1988 Cal. Tax Lexis 28 (Finnigan I), 1990 Cal. Tax. Lexis 4 (Finnigan II), *Appeal of Huffy Corporation,* 1999 Cal. Tax Lexis 173.

Commerce Clause.[23] In the absence of such authority, there appears to be no reason to refrain from promulgating a throwout rule that, like the long-recognized throwback rule, is reasonably calculated to address the problem of nowhere income.

Hearing Officer Recommendations

The hearing officer recommends that the proposed model regulation be adopted, with the following proposed changes.

First, the definition of ""Outerjurisdictional property" in Section (2)(xxiii) should be modified to strike the word "similar" on line three, and replace it with "ancillary." The word "similar" is probably included by mistake from an earlier draft, when it was contemplated that the rule would encompass Internet access, data services, etc., in addition to telecommunications and services ancillary to telecommunications. Ancillary services are defined in the rule and include services such as call waiting, caller ID, conference calling, etc. As it is no longer contemplated that the rule will apply to services other than telecommunications and those ancillary to telecommunications, it is more accurate to use the term "ancillary" rather than "similar."

Next, the hearing officer recommends amending Section (3)(ii)F3 as follows:

> F. Gross receipts from the sale of a private communications service are in this state:
> …
> 3. if such service is for segments of a channel between two customer channel termination points located in different states and such segments of channel are separately charged, when ~~the customer channel termination points are in this state~~ **one of the customer channel termination points is** in this state, provide**d** however that only fifty percent of such gross receipts ~~are in~~ **shall be sourced to** this state;

The hearing officer recommends these changes for the following reasons.

As currently drafted, the first deletion ("the customer channel termination points

[23] *Home Interiors and Gifts, Inc. v. Strayhorn*, 2005 Tex. App. Lexis 5908 (3d Dist. Ct. App. 2005). The taxpayer in *Home Interiors* challenged the surplus throwback provision of the Texas franchise tax as failing the internal consistency prong of the Commerce Clause fair apportionment test. SA&B challenge the throwout provision in the proposed regulation on external consistency grounds, not internal consistency. In any event, the decision in *Home Interiors* turned on the unique structure of the Texas franchise tax, which imposed an alternative tax on a corporation's "net capital earned surplus" which was calculated by adding the tax on net taxable capital to the difference between the tax on net taxable earned surplus and the tax on net taxable capital. The Court held that if this tax structure were replicated in other states, there would be a possibility of double taxation. The proposed regulation would ordinarily apply to a conventional corporate income or franchise tax that does not involve the calculation of tax on alternative tax bases and so would not typically raise any issue of internal consistency under *Home Interiors.*

are in this state") appears to be a scrivener's error. As F.3 only applies in situations where there are two channel termination points located one each in two different states, the use of the plural is clearly inappropriate in this context. The hearing officer proposes changing the language to the singular, to reflect the intent of the working group.

The second deletion ("are in") and the proposed alternative ("shall be sourced to") clarify what the hearing officer believes to have been the intent of the working group. As currently drafted, the language can be construed to mean that none of the gross receipts shall be sourced to the state unless precisely fifty percent of such gross receipts "are in" this state. The hearing officer's suggestion is more consistent with the intent of the working group to deem 50% of the gross receipts to be in the state where there are two customer channel termination points located one each in different states.

The proposed changes are also closer to the language in Streamlined Section 314 C.2.c., as effective on and after January 1, 2008, upon which the working group based this section.

Respectfully submitted,

Sheldon H. Laskin
Hearing Officer