Idaho Amended response to MTC's Issue List dated November 7, 2014.
(Significant changes highlighted in grayscale)

1. **Research existing MTC regs to see if any can be adopted/adapted for use in implementing the definition of receipts under the model**.

Idaho Response: FYI - Idaho's current definition of gross receipts (adopted in 2002) is found in Idaho Income Tax Administrative Rule 325.07 which is nearly identical to that found in the MTC's Reg. IV.2.(a)(5). Rule 325.07 states:

> **07. Gross Receipts**.
>
> a. Gross receipts are 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 or loss is recognized (or would be recognized if the transaction were in the United States) under the Internal Revenue Code. Amounts realized on the sale or exchange of property are not reduced for the cost of goods sold or the basis of property sold. Gross receipts, even if business income, do not include such items as, for example:
>
> i. Repayment, maturity, or redemption of the principal of a loan, bond, or mutual fund or certificate of deposit or similar marketable instrument;
>
> ii. The principal amount received under a repurchase agreement or other transaction properly characterized as a loan;
>
> iii. Proceeds from issuance of the taxpayer's own stock or from sale of treasury stock;
>
> iv. Damages and other amounts received as the result of litigation;
>
> v. Property acquired by an agent on behalf of another;
>
> vi. Tax refunds and other tax benefit recoveries;
>
> vii. Pension reversions;
>
> viii. Contributions to capital;
>
> ix. Income from forgiveness of indebtedness; or
>
> x. Amounts realized from exchanges of inventory that are not recognized by the Internal Revenue Code.
>
> b. Exclusion of an item from the definition of gross receipts is not determinative of its character as business or nonbusiness income. Nothing in this definition shall be construed to modify, impair or supersede any provision of Rules 560 through 595 of these rules.

Over the years the Commission published a few decisions holding that certain transactions were not "sales"

- Docket 21626 (08/17/2012), receipts related to commodity inventory exchange transactions are not "gross receipts". http://tax.idaho.gov/decisions/1221626.pdf. However, see Docket 20731 (10/20/2009), proceeds from crude oil trading constitute "sales" for apportionment purposes. https://tax.idaho.gov/decisions/0920731.pdf.

- Docket 22696 (12/27/2011), the sum of money and the fair market value of the property or services received (i.e. the actual cash received in the transaction) was included within the Idaho sales factor rather than the full contract price of the forward energy contract trades since no additional money or other property or services were received as part of the transaction. https://tax.idaho.gov/decisions/1122696.pdf.

- Docket 15696 (09/16/2002), (1) a repurchase agreement or repo is essentially a borrowing transaction, typically involving a security issued by the U.S. government or a U.S. agency(with a domestic lender as a counterpart) is not a sale, (2) a sell/buyback (SBB) involving a Canadian or other foreign security and a foreign counterparty is not a sale and (3) a buy/sellback (BSB), usually involving a foreign security and foreign counterparty, is not a sale. Basically, a transaction structured as an SBB or repo is in substance a secured loan, in which the initial "sale" leg is simply the obtaining of loan proceeds by the borrower. The same is true in the case of BSBs and reverse repos, where the first "purchase" leg is the funding of the loan by the lender. Neither the first leg of an SBB/repo or the second leg of a BSB/reverse repo should be treated as "sales" for purposes of the sales factor. http://tax.idaho.gov/search-decisions.cfm.

- Docket 12131 (4/13/1998), a manufacturing company bought and sold "auction preferred stock" (APS) and municipal securities, comprising about 27% to 38% of total receipts. The APS in substance was found to be a sophisticated debt instrument that generated deductible dividends for income tax purposes. Among its transactions in municipal securities, the company repeatedly bought $5 million to $10 million of certain municipal bonds and resold them the following day, generating receipts of $170 million from those particular securities in a single month. The Tax Commission held that the APS and municipal securities were in substance loans to the issuers, with the claimed receipts being repayments of such loans with interest. Hence the returns of capital did not belong in the sales factor.

- Docket 12155 (2/9/1998), a manufacturing company invested working capital in short-term time deposits with an average maturity of 2.7 days and an average size of $10.2 million, generating 446 maturities in a typical year, for gross receipts of $4.5 billion. It also invested lesser sums in other interest bearing investments, all held to maturity, for total receipts of $5.3 billion (including the $4.5 billion just mentioned). Net profit on this activity was $2.4 million in the year analyzed. In contrast, annual Idaho sales were in the $9-$12 million range, and sales of merchandise were about $3 billion per year. The Tax Commission held that the intangible receipts, to the extent they represented returns of capital, were not "sales" and so did not belong in the sales factor.

- Docket 7798 (11/3/1994), Because the purpose of the sales factor is to represent the extent of a taxpayer's market in a specific state, and because the safe harbor lease transactions were merely paper transactions, the sales factor should be computed without regard to the lease income reported as a result of the safe harbor leases.

2. Do state statutes/regulations/judicial and administrative decisions provide guidance as to the definition of the terms "maturity", "redemption", "sale", "exchange," "loan" or "other disposition?"

Idaho Response:

> Sale: A sale is defined as a transaction in which title passes from the seller to the buyer, or when possession and the burdens and benefits of ownership are transferred to the buyer. A sale may have occurred even if the buyer does not have the right to possession until he partially or fully satisfies the terms of the contract. Idaho Income Tax Administrative Rule 010.06.
>
> Loan: For purposes of the Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions, loan is defined within Section 2(j) as follows:
>
> (j) "Loan" means any extension of credit resulting from direct negotiations between the taxpayer and its customer, and/or the purchase, in whole or in part, of such extension of credit from another. Loans include participations, syndications, and leases treated as loans for federal income tax purposes. Loans shall not include: properties treated as loans under Section 595 of the Federal Internal Revenue Code; futures or forward contracts; options; notional principal contracts such as swaps; credit card receivables, including purchased credit card relationships; non-interest bearing balances due from depository institutions; cash items in the process of collection; federal funds sold; securities purchased under agreements to resell; assets held in a trading account; securities; interests in a REMIC, or other mortgage-backed or asset-backed security; and other similar items.

Maturity, redemption, exchange, and "other disposition" not explicitly defined within the Idaho Income Tax Act or the corresponding Idaho Income Tax Administrative Rules. It is possible that other non-income tax Idaho statutes or the Internal Revenue Code may define some of these terms.

Also, do they provide guidance as to how the collection or selling of accounts receivable should be treated under Section 1?

Idaho Response: No specific guidance within the Idaho income tax statutes or corresponding Income Tax Administrative Rules. However, see attached Idaho Supreme Court Decisions involving Union Pacific and the double counting of receipts within the sales factor from the sale of accounts receivable. Please note the court's discussion in the 2001 ruling as follows:

> The district court initially ruled that the sale of the accounts receivable was nothing more than collateralized borrowing and that it did not constitute "sales" for the purpose of apportioning business income under Idaho Code § 63-3027(i). Union Pacific Corporation then moved for reconsideration, pointing out answers by the Tax Commission to three requests for admission in which the Tax Commission admitted: (1) "that Plaintiff's proceeds from its sales of accounts receivable were business income;" (2) "that Plaintiff sold its accounts receivable in transactions that qualify as a 'sale'

> pursuant to I.C. § 63-3027(a)(5);" and (3) "that Plaintiff's sales of its accounts receivable were not loans against a receivable accounts [sic]." Based upon the Tax Commission's answers to these requests for admissions, the district court granted summary judgment to Union Pacific.

Finally, can they provide guidance as to how receipts should be treated in a combined reporting state if the combined group engages in multiple lines of business, when the receipts for each line are realized at varying periods of regularity?

Idaho Response: No specific guidance found within Idaho Income Tax Administrative Rules.

3. **As Section 1 is based on the transactional test alone, do state statutes/regulations/judicial and administrative decisions provide any guidance as to the treatment of receipts that would fall exclusively under the functional test?**

Idaho Response: Basically Idaho's income tax administrative rules list the same examples as found under the MTC's Reg. IV.1.(a)(5)(B) (the attached Union Pacific court case did deal with a situation not falling within the transactional test). Idaho Income Tax Administrative Rule 333.04 states:

> 04. Examples of Business Income Under the Functional Test. 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. 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.

Are rules needed to govern when receipts would be regarded as exclusively realized under the functional test?

Idaho Response: No response at this time. Would like to hear what other think on this question.

4. **What issues should the work group identify as falling within Section 18 rather than Section 1? For example, receipts from the sale of securities in the ordinary course of business. Should special industry regulations be promulgated for such cases?**

Idaho Response: No response at this time. Would like to hear what other think on this question.

5. **Does California (or other states) have rules governing the treatment of receipts from the sale of securities in the ordinary course of business?**

Idaho Response: No response.

6. **By the next meeting, I will research the MTC regs in relation to item 1 above. I will also address item 5 and begin to survey state law in relation to the remaining items. Steve Wynn is to research Idaho law/practice regarding item 3. I would appreciate any state materials you have regarding any of these items. Plus, please give some thought to item 4. Finally, if you think of additional issues we should address under Section 1, please let me know.**

   Idaho Response: During the initial meeting I had raised a question if the removal from the sales factor receipts that were strictly related to the functional test would cause an issue for those states with a single sales factor similar to the concern that was being discussed over the removal of the receipts from the sale of securities. After reading the e-mail sent by Sheldon during the initial working group teleconference, I believe that my question is basically the same as what was raised in that e-mail which contained the following:

> **Helen, Bruce and I have been discussing the following:**
>
> **"the one area I (Bruce) hope you will consider is a regulation for separate-entity states in a sales factor only environment, when the only income is from non-inventory sales, for instance, a holding company with no employees or property receiving capital gain income or taxable REIT/foreign dividends. We need some explicit regulation to cover that issue—a look through to the sales factor of the payor corporation, for instance. Here's an example: Paper company decides it wants to sell one of its paper mills. It drops the stock ownership (not the actual physical assets) into SaleCo. SaleCo nets a $400 million capital gain, pays a non-taxable domestic dividend back to paper company. No factors anywhere for Sale Co. We need the sales factor to reflect where that SaleCo's income originated…**
>
> **Ben Miller wanted a special Section 18 regulation to cover that. I think the regulation should be under the sales factor definition—there is nothing "unusual" or "incongruous" about the fact scenarios described above."**
>
> **If we go this route, I tend to think that Section 18 may be the more appropriate vehicle. The new model Section 1 excludes receipts from the sale of securities from the definition of receipts.**

In looking at the statutory language defining "receipts," as approved by the executive committee, my initial reaction is that the receipts discussed in the e-mail are probably the types of receipts that the executive committee approved as falling outside of the definition of receipts since the receipts do not fall within the "transactional test" and basically are not a customer (marketplace) receipt. With respect to the gain on the sale of the paper mill, it probably does not matter if the receipt was generated by the sale of the paper mill, generated by the sale of stock, or generated by the sale of stock that is treated as a sale of the assets under the Internal Revenue Code (IRC sec. 338 provisions).

In 2012, Idaho amended its “Gross Receipts for Intangibles” provision found in Income Tax Administrative Rule 570 Special Rules Sales Factor to address the receipts from the sale of an ownership interest in another entity that was transacting business within Idaho as follows:

> b. Notwithstanding Rule 550 of these rules, gross receipts from the sale of an ownership interest in another entity are included in the sales factor numerator based on the proportion of the entity’s operational assets located in Idaho. The amount included is determined by multiplying the gross receipts received by the percentage of the entity’s total real and tangible personal property located in Idaho at the time of the sale.

Rule 570 is part of the Commission’s alternative apportionment provisions. Prior to the adoption of that provision, in 2009, Idaho issued an administrative decision involving the sale of stock the resulted in the partial sale of a business. In Docket 20731, the Commission invoked alternative apportionment as follows:

> The Petitioner sold a controlling interest in a business which included a beef plant located in Idaho. The Petitioner concedes that the income realized from the sale is business income, but maintains the gain was realized from the sale of intangible property (stock). Pursuant to Idaho Code § 63-3027(r), if a sale of intangible property occurs both in Idaho and outside Idaho, the sale is assigned to the state where the greater cost of performance occurred. The Petitioner states that greater cost of performance associated with the sale (such as negotiations and drafting stock transfers and agreements) occurred at its place of commercial domicile. Accordingly, the Petitioner assigned the sale to its state of commercial domicile for sales factor purposes. The Petitioner did not include any of the sale proceeds in the Idaho numerator of the sales factor. Additionally, the Petitioner assigned the interest income on the finance notes received in the sale to its state of commercial domicile.
>
> The Division disagreed with the Petitioner’s characterization of the sale. Through the stock sale, the Petitioner effectively sold a controlling interest in the business and the underlying assets of the business to unrelated parties. This was not a sale of passive stocks unrelated to the Petitioner’s primary business. Rather, this was a sale of an operational part of the Petitioner’s business which included the physical [Redacted] plant located in Idaho.
>
> Idaho Income Tax Rule 570.02.a. provides that if the income producing activity in respect to business income from intangible personal property can be readily identified, the income is included in the denominator of the sales factor, and if the income producing activity occurs in Idaho, in the Idaho numerator of the sales factor as well. The Division reasoned that at least part of the business income generated by the sale of stock was attributable to the operational assets of the business. Accordingly, the Division included a pro rata share of the sales proceed in the Idaho sales numerator to account for the proceeds attributable to the Idaho [Redacted] plant.

> The Tax Commission agrees with the Division. As discussed above, Income Tax Rule 570 set forth alternatives for the apportionment of business income under the authority of Idaho Code § 63-3027(s).
>
> In this specific instance, the Tax Commission finds that the alternative apportionment provision relied upon by the Division is reasonable. First, the division of income fairly represents the Petitioner's business activity in Idaho and, if applied uniformly, would result in taxation of no more or no less than 100 percent of the Petitioner's income. The Division prorated the income in relation to the property present in Idaho. If every UDITPA state followed suit, then no more or less than 100 percent of the Petitioner's income would be subject to state income taxes.
>
> Second, the division of income does not create or foster lack of uniformity among UDITPA jurisdictions. As stated by the Idaho Supreme Court, the purpose of the UDITPA apportionment provisions is for each state to tax the income generated by the business activity occurring in that particular state. Union Pacific, supra. Because the standard apportionment provisions of UDITPA does not always accomplish this purpose, UDITPA provides for alternative apportionment relief, which is nearly identical to the relief found in Idaho Code § 63-3027(s). The relief provisions may be invoked by either the taxpayer or the state taxing authority. In this case, the standard apportionment provisions relied upon by the Petitioner does not fairly reflect the Petitioner's business in the various states in which the Petitioner conducts its business, including the state of Idaho. Under the Petitioner's argument, if all of the stock had been sold to an unrelated party and the Petitioner had effectively divested itself of the business and assets, then all of the proceeds would be assigned to the Petitioner's state of commercial domicile. Such an assignment would ignore that the operational business had been transferred, including assets of the business located in Idaho.
>
> Third, the proposed alternative apportionment reflects the economic reality of the business activity engaged in by the Petitioner in the taxing state. It is the transfer of a controlling interest in the operational business that generates income, not simply the transfer of unrelated stock in the abstract. In this particular stock exchange, new owners gained control of the operational business.

That decision can be found at https://tax.idaho.gov/decisions/0920731.pdf.

In the October 25, 2013, Report of the Hearing Officer, Professor Pomp, made a number of observations, including:

> Hearing Officer's Report pages 97-98: The Report's (referring to Shirley Sicilian's, report to Cory Fong, Chair of the Executive Committee, on May 10, 2012) strongest argument for including the gross receipts from only the transactional definition is that it is "generally agreed that the purpose of the sales factor is to reflect the taxpayer's market activity, not its production activity. If that is the case, then the type of receipts that are included in the sales factor should be those that reflect the contribution of the

taxpayer's market to the earning of income. It is unnecessary, and may be counter-productive, to include receipts from transactions involving the taxpayer's production property—such as plant, machinery, and equipment—in the sales factor. Including receipts from these types of assets would not reflect the market for the taxpayer's product and could essentially double count the property factor.

Hearing Officer's Report pages 101-102: Consider, for example, a corporation that at the beginning of January sold a trivial amount of inventory and shortly thereafter sold the plant in State A that manufactured that inventory and ceased operations. Assume the gain on the sale reflected increases in the value of the real property in State A, and that the inventory was delivered outside of State A. If State A used a single-sales factor, and the receipts from the sale of the plant were excluded as the Draft proposes, none of the gain would be apportioned to State A, which has a strong claim to tax such gain. If all the destination states also used a single sales factor and excluded the receipts from the sale of the plant, the gain would be apportioned based entirely on the receipts from the inventory. In this case, a very tiny tail would wag a very large dog, perhaps violating the external consistency doctrine or triggering Section 18 relief.

One could describe the above problem as being caused not by the exclusion of the receipts but rather by the adoption of a single sales factor. As a matter of logic, the problem is caused by *both* the exclusion of gross receipts and the adoption of the single sales factor. But one teaching of *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978) is that the Supreme Court is not likely to mandate particular types of apportionment formulas; accordingly, in litigation the formula will probably be accepted as the starting point. The framework of analysis is likely to be on whether as applied the formula is fair and reflects a reasonable sense of how income is generated if the gross receipts from the sale of the plant are excluded from the sales factor.

Hearing Officer's Report pages 106 and 107: Either including the gross receipts generated by income satisfying the functional test as the Act does, or excluding such receipts as the Draft does, can raise external consistency and Section 18 issues, and it is not clear that there is a systemic bias one way or the other. The Hearing Officer has seen situations that triggered Section 18 issues where the gross receipts were included and ones where they were excluded. Generalizations are simply not very useful given the wide range of transactions that can occur.

Excluding the gross receipts from transactions satisfying the functional test, however, has one advantage not set forth in the Report. If a business is sold as a stock sale, the sale of a partnership or membership interest, Draft Art. IV.17(a)(4)(ii)(C) would throw out the receipts. If a business is sold as an asset sale, the receipts from tangible assets would be assigned under Art. IV.16 using the destination principle. By excluding such receipts from the sales factor, the Draft would conform stock sales, partnership sales, and membership interests in an LLC with asset sales.

The Hearing Officer, on page 98 of his report, did include the following observation:

"In a three-factor apportionment formula, the sales factor is intended to balance the property and payroll factors, and it should be defined to offset

rather than amplify the contributions of the production states. If the Executive Committee were to adopt a single sales factor, then this analysis may be different. In that case, it may be reasonable to provide for some reflection of the contributions of production states, even if that is accomplished through the sales factor." Report, p. 16 (referring to Shirley Sicilian's, report to Cory Fong, Chair of the Executive Committee, on May 10, 2012).

Underlying added. In summary, given the language of the approved statute, can the working group include these scenarios in regulations as constituting a receipt? I would be interested in hearing from those that believe these types of transactions fall under the new definition of receipts. Hopefully others will provide a response once they have had time to digest the concept contained with the e-mail.

The Hearing Officer also pointed out of couple of other possible issues. I am not sure if the working group wants to discuss these issues raised at some point or not.

Hearing Officer's Report page 99 (in part): A taxpayer wishing to include (or exclude) the receipts from a transaction would have an incentive to characterize an activity as falling within (or without) the transactional test, creating the potential for litigation . . ..

A taxpayer seeking to include receipts in the sales factor would want to avoid the functional test and would have an incentive to characterize a transaction as a service rather than as property. Services are outside the functional test but could satisfy the transactional test. Conversely, a taxpayer seeking to exclude the receipts would have an incentive to characterize a transaction as property rather than a service and then argue the functional test rather than the transactional test was satisfied. Especially in a digital world, the line between property and services can be blurry (as well as the line between tangible and intangible property) . . ..

Hearing Officer's Report pages 99-100 (in part): The . . .incorporation of the Act's definition of the transactional test with its reliance on the concept of "regular" is inconsistent with the Hearing Officer's proposed draft of apportionable income. . . . The Hearing Officer fears that the definition of "regular," with all of its ambiguities, will become the focus of future litigation . . .

The aforementioned Idaho Income Tax Administrative Rules can be found at http://adminrules.idaho.gov/rules/current/35/0101.pdf.

The aforementioned MTC regulations can be found at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/AllocaitonandApportionmentReg.pdf

The aforementioned Hearing Officer Report dated October 25, 2013, can be found at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Pomp%20final%20final3.pdf.