

## Hearing Officers' Recommended Proposal

### for the Amendment of Reg.IV.18.(c) to Include Net Gains from the Sale of Certain Intangibles in the Sales Factor of the Apportionment Formula

(Exhibit A of Final Report of Hearing Officers dated April 1997)

**Reg.IV.18.(c).(4).(A).** Where gains and losses on the sale of liquid assets are not excluded from the sales factor by other provisions under Reg.IV.18.(c), such gains or losses shall be treated as provided in this subsection. This subsection does not provide rules relating to the treatment of other receipts produced from holding or managing such assets. If a taxpayer holds liquid assets in connection with one or more treasury functions of the taxpayer, and the liquid assets produce business income when sold, exchanged or otherwise disposed, the overall net gain or loss from those transactions for each treasury function for the tax period is included in the sales factor. For purposes of this subsection, each treasury function will be considered separately.

**(B).** For purposes of this subsection, a liquid asset is an asset (other than functional currency or funds held in bank accounts) held to provide a relatively immediate source of funds to satisfy the liquidity needs of the trade or business. Liquid assets include foreign currency (and trading positions therein) other than functional currency used in the regular course of the taxpayer's trade or business; marketable instruments (including stocks, bonds, debentures, options, warrants, futures contracts, etc.); and mutual funds which hold such liquid assets. An instrument is considered marketable if it is traded in an established stock or securities market and is regularly quoted by brokers or dealers in making a market. Stock in a corporation which is unitary with the taxpayer, or which has a substantial business relationship with the taxpayer is not considered marketable stock.

**(C).** For purposes of this subsection, a treasury function is the pooling and management of liquid assets for the purpose of satisfying the cash flow needs of the trade or business, such as providing liquidity for a taxpayer's business cycle, providing a reserve for business contingencies, business acquisitions, etc. A taxpayer principally engaged in the trade or business of purchasing and selling liquid assets in the normal course of its trade or business is not performing a treasury function with respect to income so produced.

**(D).** Overall net gain refers to the total net gain from all transactions incurred at each treasury function for the entire tax period, not the net gain from a specific transaction.

**(E).** Examples.

Example 1. A taxpayer manufactures various gift items. Because of seasonal variations, the taxpayer must keep liquid assets available for later inventory acquisitions. Because the manufacturer wants to obtain a return on available funds, the manufacturer acquires liquid assets, which are held and managed in State A. The net gain resulting from all gains and losses on the sale of the liquid assets for the tax year will be reflected in the denominator of the sales factor and in the numerator of State A.

Example 2. A stockbroker acts as a dealer or trader for its own account in its ordinary course of business. Some of the instruments sold are liquid assets. This subsection does not operate to classify those sales as attributable to a treasury function.

## Hearing Officers' Recommended Proposal

### for the Amendment of Reg.IV.18.(c) to Include Net Gains from the Sale of Certain Intangibles in the Sales Factor of the Apportionment Formula

**(Underline/strikeout to Exhibit A of Final Report of Hearing Officers dated April 1997 indicating technical corrections recommended by Hearing Officers subsequent to issuance of their Final Report and accepted by MTC Executive Committee on May 2, 1997)**

**Reg.IV.18.(c).(4).(A).** Where gains and losses on the sale of liquid assets are not excluded from the sales factor by other provisions under Reg.IV.18.(c), such gains or losses shall be treated as provided in this subsection. This subsection does not provide rules relating to the treatment of other receipts produced from holding or managing such assets. If a taxpayer holds liquid assets in connection with one or more treasury functions of the taxpayer, and the liquid assets produce business income when sold, exchanged or otherwise disposed, the overall net gain ~~or loss~~ from those transactions for each treasury function for the tax period is included in the sales factor. For purposes of this subsection, each treasury function will be considered separately.

(B). For purposes of this subsection, a liquid asset is an asset (other than functional currency or funds held in bank accounts) held to provide a relatively immediate source of funds to satisfy the liquidity needs of the trade or business. Liquid assets include foreign currency (and trading positions therein) other than functional currency used in the regular course of the taxpayer's trade or business; marketable instruments (including stocks, bonds, debentures, options, warrants, futures contracts, etc.); and mutual funds which hold such liquid assets. An instrument is considered marketable if it is traded in an established stock or securities market and is regularly quoted by brokers or dealers in making a market. Stock in a corporation which is unitary with the taxpayer, or which has a substantial business relationship with the taxpayer is not considered marketable stock.

(C). For purposes of this subsection, a treasury function is the pooling and management of liquid assets for the purpose of satisfying the cash flow needs of the trade or business, such as providing liquidity for a taxpayer's business cycle, providing a reserve for business contingencies, business acquisitions, etc. A taxpayer principally engaged in the trade or business of purchasing and selling instruments or other items included in the definition of liquid assets set forth herein ~~in the normal course of its trade or business~~ is not performing a treasury function with respect to income so produced.

(D). Overall net gain refers to the total net gain from all transactions incurred at each treasury function for the entire tax period, not the net gain from a specific transaction.

(E). Examples.

Example 1. A taxpayer manufactures various gift items. Because of seasonal variations, the taxpayer must keep liquid assets available for later inventory acquisitions. Because the manufacturer wants to obtain a return on available funds, the manufacturer acquires liquid assets, which are held and managed in State A. The net gain resulting from all gains and losses on the sale of the liquid assets for the tax year will be reflected in the denominator of the sales factor and in the numerator of State A.

Example 2. A stockbroker acts as a dealer or trader for its own account in its ordinary course of business. Some of the instruments sold are liquid assets. This subsection does not operate to classify those sales as attributable to a treasury function.

## **Hearing Officers' Recommended Proposal**

### **for the Amendment of Reg.IV.18.(c) to Include Net Gains from the Sale of Certain Intangibles in the Sales Factor of the Apportionment Formula**

**(Incorporating technical corrections to Exhibit A of Final Report of Hearing Officers dated April 1997 recommended by Hearing Officers subsequent to issuance of their Final Report and accepted by MTC Executive Committee on May 2, 1997. This version of the proposal may be scheduled for a vote of the Multistate Tax Commission on August 8, 1997).**

**Reg.IV.18.(c).(4).(A).** Where gains and losses on the sale of liquid assets are not excluded from the sales factor by other provisions under Reg.IV.18.(c), such gains or losses shall be treated as provided in this subsection. This subsection does not provide rules relating to the treatment of other receipts produced from holding or managing such assets. If a taxpayer holds liquid assets in connection with one or more treasury functions of the taxpayer, and the liquid assets produce business income when sold, exchanged or otherwise disposed, the overall net gain from those transactions for each treasury function for the tax period is included in the sales factor. For purposes of this subsection, each treasury function will be considered separately.

**(B).** For purposes of this subsection, a liquid asset is an asset (other than functional currency or funds held in bank accounts) held to provide a relatively immediate source of funds to satisfy the liquidity needs of the trade or business. Liquid assets include foreign currency (and trading positions therein) other than functional currency used in the regular course of the taxpayer's trade or business; marketable instruments (including stocks, bonds, debentures, options, warrants, futures contracts, etc.); and mutual funds which hold such liquid assets. An instrument is considered marketable if it is traded in an established stock or securities market and is regularly quoted by brokers or dealers in making a market. Stock in a corporation which is unitary with the taxpayer, or which has a substantial business relationship with the taxpayer is not considered marketable stock.

**(C).** For purposes of this subsection, a treasury function is the pooling and management of liquid assets for the purpose of satisfying the cash flow needs of the trade or business, such as providing liquidity for a taxpayer's business cycle, providing a reserve for business contingencies, business acquisitions, etc. A taxpayer principally engaged in the trade or business of purchasing and selling instruments or other items included in the definition of liquid assets set forth herein is not performing a treasury function with respect to income so produced.

**(D).** Overall net gain refers to the total net gain from all transactions incurred at each treasury function for the entire tax period, not the net gain from a specific transaction.

**(E).** Examples.

Example 1. A taxpayer manufactures various gift items. Because of seasonal variations, the taxpayer must keep liquid assets available for later inventory acquisitions. Because the manufacturer wants to obtain a return on available funds, the manufacturer acquires liquid assets, which are held and managed in State A. The net gain resulting from all gains and losses on the sale of the liquid assets for the tax year will be reflected in the denominator of the sales factor and in the numerator of State A.

Example 2. A stockbroker acts as a dealer or trader for its own account in its ordinary course of business. Some of the instruments sold are liquid assets. This subsection does not operate to classify those sales as attributable to a treasury function.

*Multistate Tax Commission*



**RESOLUTION OF THE EXECUTIVE COMMITTEE PURSUANT TO  
BYLAW 7 REGARDING PROPOSED AMENDMENT OF REG.IV.18.(c)  
TO INCLUDE NET GAINS FROM SALE OF CERTAIN INTANGIBLES**

WHEREAS, the Hearing Officers, René Y. Blocker and Alan H. Friedman, after public hearings held pursuant to Article VII(2) of the Multistate Tax Compact and Bylaw 7(a) of the Multistate Tax Commission, has submitted their "Final Report of Hearing Officers regarding the proposed Amendment of Reg.IV.18.(c) to Include the Net Gains from the Sale of Certain Intangibles in the Sales Factor of the Income Apportionment Formula" dated April 1997; and

WHEREAS, the Hearing Officers have recommended, among other things, the adoption by the interested States of the Multistate Tax Commission and any other State wishing to do so, of the provision set forth in Exhibit A to the above-mentioned Final Report; and

WHEREAS, Bylaw 7(g) requires such a recommendation be circulated to the affected members of the Multistate Tax Commission to determine if they will consider the recommendation for adoption within their respective jurisdictions,

NOW, THEREFORE, IT IS RESOLVED THAT the Executive Director is directed to survey the affected Multistate Tax Commission Member States pursuant to Bylaw 7(g) and to report the results thereof to the Chair of the Executive Committee as soon as practicable, but no later than July 15, 1997; and

IT IS FURTHER RESOLVED THAT the recommendation so surveyed shall be either that attached as Exhibit A to the above-mentioned Final Report or one containing any technical changes that may be thereon.

Entered this \_\_\_\_ day of May 1997 by the Executive Committee of the Multistate Tax Commission.

Attest:

\_\_\_\_\_  
Dan R. Bucks  
Executive Director

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*Multistate Tax Commission*



April 16, 1997

Mr. Val Oveson, Chair  
Multistate Tax Commission  
c/o Utah State Tax Commission  
210 North 1950 West  
Salt Lake City, UT 84134

Re: Final Report of Hearing Officers regarding the proposed Amendment of  
Reg.IV.18.(c) to Include the Net Gains from the Sale of Certain Intangibles in the  
Sales Factor of the Income Apportionment Formula.

Dear Chairman Oveson:

Enclosed please find the Hearing Officers' Final Report regarding the proposed Amendment of Reg.IV.18.(c) to Include the Net Gains from the Sale of Intangibles in the Sales Factor of the Income Apportionment Formula" submitted for your review. A copy of this Final Report has been distributed to the remainder of the Commission's Executive Committee, other Member State representatives and to members of the public who have requested a copy of the Report. The Hearing Officers recommend that the Executive Committee consider adoption of the recommended amendment and take all action appropriate under the Multistate Tax Compact and the Multistate Tax Commission's bylaws.

The subject matter of the Final Report arises out of the MTC Uniformity Committee's proposal to amend the MTC's existing regulations to provide for the inclusion in the sales factor of net gains from transactions involving certain intangibles. This Report sets forth the full text of the regulation recommended for the Executive Committee's consideration. It includes a summary of the comments received during the additional public hearing session on this matter and a discussion of the proposal and related issues. The written comments provided by State and business representatives during the second hearing session accompany the Report.

Thank you.

Respectfully submitted,

René Y. Blocker  
Hearing Officer

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*Multistate Tax Commission*



**FINAL REPORT OF HEARING OFFICERS**

*regarding the proposed*

**Amendment of Reg. IV.18.(c). to Include Net Gains from the Sale of  
Certain Intangibles in the Sales Factor of the Apportionment Formula.**

Submitted by:

René Y. Blocker  
and  
Alan H. Friedman  
Hearing Officers  
April 1997

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# FINAL REPORT OF THE HEARING OFFICERS

regarding the proposed

## Amendment of Reg.IV.18.(c). to Include Net Gains from the Sale of Certain Intangibles in the Sales Factor of the Apportionment Formula

### I. Overview of Final Report.

This Final Report contains the Hearing Officers' recommendations regarding the Uniformity Committee's proposal to amend Multistate Tax Commission Regulation IV.18.(c). to provide for the inclusion in the apportionment formula's sales factor of only net gains from the sale or other disposition of certain intangible property. In accordance with the requirements of the Multistate Tax Commission's hearing process set forth in Article VII of the Multistate Tax Compact<sup>1</sup> and Bylaw No. 7 of the Multistate Tax Commission ("MTC" or "Commission"), the Hearing Officers submit, for the consideration of the Executive Committee, this report containing a synopsis of the hearing proceedings and a detailed recommendation for Commission action. Pursuant to Bylaw 7, the report must be submitted to the Executive Committee prior to the conduct of a survey of the Member States of the Commission that will determine whether a majority of them would consider the adoption of the proposal as an MTC recommendation.

The Executive Committee may accept, reject or modify the Hearing Officers' recommendations or it may take any other action which it deems appropriate, including authorizing another hearing session. In any event, before referring any uniformity recommendation to the full Commission, a Bylaw 7 survey of the MTC States will be conducted. If a majority of the interested Member States agree to consider the proposal for adoption, then, at its next meeting after the survey, the full Commission will vote on whether to adopt the proposal as a recommendation by the MTC to the States. If it is adopted by the Commission, there is no requirement that the States adopt the recommended provision. The States individually choose whether or not they will adopt the proposal through their individual administrative or legislative process. As required in the hearing process, the Hearing Officers' Final Report sets forth the full text of the proposed regulation and includes an explanation of the proposal and the related issues. [The full text of the proposed regulation is attached to this Final Report as *Exhibit A.*]

By way of background, in November 1994, the MTC Executive Committee directed that a public hearing be held on a proposal developed to amend the MTC's regulations setting forth the special rules for the apportionment formula sales factor, Reg.IV.18.(c). Special Rules: Sales Factor. The proposed amendment was drafted to add a new paragraph to subsection (c) of

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<sup>1</sup>The Multistate Tax Compact is the authorizing and governing statute of the Multistate Tax Commission.

Reg.IV.18. explicitly providing for the inclusion in the sales factor of only *net gains* realized from transactions involving certain intangibles. The MTC's Uniformity Committee drafted the proposal with the intention of formalizing a uniform method for the treatment of gains received from generally short term investment and reinvestment of certain intangible assets, a method that the majority of MTC States indicated was already in use in their States. The original language recommended by the Uniformity Committee and referred to public hearing by the Executive Committee reads:

Where the taxpayer realizes gains or losses from the sale or other disposition of intangible property held as part of the taxpayer's operational investments, e.g., working capital, only the net gain from such sales or dispositions reported as taxable will be included in the sales factor.

The Uniformity Committee considered the proposal to be a discrete, narrow amendment that merely would reflect the approach most MTC Member States indicated they already utilized in treating gains from the generally short term investment and reinvestment of intangible assets or the "trading" of intangibles activity.<sup>2</sup>

Several alternatives to the original language were proposed over the course of the initial hearing session. This Final Report recommends the adoption of a revised version of the alternative proposed by the Staff of the California Franchise Tax Board ("CA-FTB"). The CA-FTB Staff suggestion, also known as Alternative II, is one of two alternatives suggested in the Hearing Officers' Interim Report to replace the language originally drafted for this amendment. [*Exhibit B* to this Final Report includes a side-by-side view of the original proposal, and of both Alternative I and Alternative II (without examples) and a copy of the full text of Alternative II, with examples. *Exhibit A*, the recommended proposal, reflects the revisions made to Alternative II.]

The Hearing Officers recommend adoption by the Commission of the proposed rule as an amendment to Reg.IV.18.(c). under the authority of the Multistate Tax Compact, Article IV, Section 18. Although as with any rule there are exceptions, the Hearing Officers find that in general, the inclusion in the sales factor of the gross receipts from short term investment and reinvestment of funds in liquid assets would distort the income-producing activity reflected by such use of the taxpayer's funds in this manner. One exception set forth in the recommended rule is an exception for dealers and traders in securities.

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<sup>2</sup>The term "churning" of intangibles was used in the Hearing Officers' Interim Report to describe the activity of investing and reinvesting, generally on a short-term basis, certain intangible assets. A hearing participant has objected to the use of the term "churning" because of the apparently negative connotation associated with this term in the context of securities trading. In lieu of the term "churning", this Final Report will refer to the activity at issue as "trading" of intangibles.



The recommended amendment creates a new paragraph (4) to subsection (c) of Reg. IV.18. The recommended regulation reads as follows:

Reg. IV.18.(c).(4).(A). Where gains and losses on the sale of liquid assets are not excluded from the sales factor by other provisions under Reg. IV.18.(c)., such gains or losses shall be treated as provided in this subsection. This subsection does not provide rules relating to the treatment of other receipts produced from holding or managing such assets. If a taxpayer holds liquid assets in connection with one or more treasury functions of the taxpayer, and the liquid assets produce business income when sold, exchanged or otherwise disposed, the overall net gain or loss from those transactions for each treasury function for the tax period is included in the sales factor. For purposes of this subsection, each treasury function will be considered separately.

(B). For purposes of this subsection, a liquid asset is an asset (other than functional currency or funds held in bank accounts) held to provide a relatively immediate source of funds to satisfy the liquidity needs of the trade or business. Liquid assets include foreign currency (and trading positions therein) other than functional currency used in the regular course of the taxpayer's trade or business; marketable instruments (including stocks, bonds, debentures, options, warrants, futures contracts, etc.); and mutual funds which hold such liquid assets. An instrument is considered marketable if it is traded in an established stock or securities market and is regularly quoted by brokers or dealers in making a market. Stock in a corporation which is unitary with the taxpayer, or which has a substantial business relationship with the taxpayer is not considered marketable stock.

(C). For purposes of this subsection, a treasury function is the pooling and management of liquid assets for the purpose of satisfying the cash flow needs of the trade or business, such as providing liquidity for a taxpayer's business cycle, providing a reserve for business contingencies, business acquisitions, etc. A taxpayer principally engaged in the trade or business of purchasing and selling liquid assets in the normal course of its trade or business is not performing a treasury function with respect to income so produced.

(D). Overall net gain refers to the total net gain from all transactions incurred at each treasury function for the entire tax period, not the net gain from a specific transaction.

(E). Examples.

Example 1. A taxpayer manufactures various gift items. Because of seasonal variations, the taxpayer must keep liquid assets available for later inventory acquisitions. Because the manufacturer wants to obtain a return on available funds, the manufacturer acquires liquid assets, which are held and managed in State A. The net gain resulting from all gains and losses on the sale of the liquid

assets for the tax year will be reflected in the denominator of the sales factor and in the numerator of State A.

**Example 2.** A stockbroker acts as a dealer or trader for its own account in its ordinary course of business. Some of the instruments sold are liquid assets. This subsection does not operate to classify those sales as attributable to a treasury function.

The foregoing recommended provision enumerates the specific types of intangibles at issue, provides a basis for calculating net gains from different types of transactions and establishes an exception for dealers and traders in securities. It also includes language to clarify that the proposal is not to be read to suggest that receipts from the sale of intangibles are includible in the sales factor in all instances.

Section II of this Final Report sets forth the background of the proposal and summarizes the oral and written comments submitted by participants during the second hearing session. Section III provides an explanation of some key aspects of the proposal and addresses several significant issues raised by a number of contributors to the hearing sessions.

## II. Summary of Hearing Sessions.

Many of the participants during the initial hearing session in this matter expressed dissatisfaction with the language as originally proposed. A consensus developed among responding State and industry representatives that the original language:

- 1) was too broad to capture only the trading activity at which it was aimed;
- 2) contained unclear and undefined terminology; and
- 3) did not address several important issues, such as the treatment of dealers and traders in securities.

Two alternatives to the original language were developed, one presenting simply a re-draft of the original to resolve the problems of over-breadth and lack of clarity and a second alternative, submitted by Staff of the California Franchise Tax Board ("CA-FTB"), introducing a much more comprehensive approach to the treatment of gains from the "trading" of intangibles. The suggestions have been labeled Alternative I and Alternative II. [See *Exhibit B.*]

The Hearing Officers' Interim Report, submitted December 28, 1995, did not recommend adoption of the originally proposed language but instead recommended that the Executive Committee consider adopting one of the two alternatives and approve an additional hearing session for the purpose of

gathering public comment on Alternatives I and II. It became clear that the purportedly discrete proposal would implicate broader issues than expected. [Refer to the Interim Report for a description of the comments received and an explanation of issues arising out of the initial hearing session on this matter.]

Following the Executive Committee's approval of an additional hearing, a second hearing session was held on Friday, May 3, 1996, in Washington, D.C. [The Notice of Hearing for this session is attached as *Exhibit C*.] The public comment period was extended to June 3, 1996, to allow for the submission of additional written comments. The Notice of Hearing for the second session requested responses to the following specific questions, in addition to seeking general public comment:

1. Do the alternatives achieve the aim of clarifying the scope of the "churning" activity sought to be reached?
2. With respect to Alternative I, are the terms "operational function" and "net gains" appropriately defined?
3. With respect to Alternative II, are terms such as "liquid assets" and "treasury function" clear?
4. Is the approach adopted under Alternative II preferable? Specifically, is an explicit enumeration of the types of intangible property to be included appropriate? Should an exception be made for dealers in securities?
5. Should some or all of the language of the two alternatives be combined? Would such a combination establish a clearer solution to the treatment of income from "churning" activity?
6. What revisions are suggested for either or both of these alternatives?

The discussion during the June 3rd hearing session focused almost exclusively on the question of whether the proposed amendment properly may be adopted as a regulatory provision under the Section 18 distortion-relief regulations or whether a statutory change would be necessary. Several industry representatives objected to using a regulatory approach under Section 18 to effectuate the inclusion of only net gains from the "trading" of intangibles. These representatives maintain that the proposal reads as a general rule, and as such, cannot be adopted as an amendment of the Section 18 regulations. They suggest that a statutory change in the definition of "sales" which refers only to "gross receipts" is necessary for the proper adoption of the proposal.<sup>3</sup> They also expressed concern over whether the

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<sup>3</sup> Under the Multistate Tax Compact, Article IV, Section 1.(g), "sales" is defined to mean "all gross receipts of the taxpayer not allocated under paragraphs of this Article." The term "gross receipts" is not defined in the Compact. The Hearing Officers understand that the Uniformity Committee recently started working on a project to draft a definition of "gross receipts." That project is in the initial stages of development.

proposal, if adopted, would be retroactively or prospectively applied, suggesting that a only prospective application would be proper.<sup>4</sup>

The only other major issue raised during the second hearing session came from a California attorney who commented generally in favor of Alternative II, the CA-FTB Staff draft, but suggested specific changes to the language referring to dealers or traders in securities. He proposed the following change to the last sentence of section (C) of Alternative II:

A taxpayer whose principal trade or business includes the principally engaged in the business of purchasing and selling liquid assets in the normal course of its trade or business is not performing a treasury function with respect to income so produced.

Additionally, he suggested revising Example 4 under section (E) of Alternative II to read:

Example 4. A stockbroker acts as a dealer or trader for ~~conducts trading activity on~~ its own account in its ordinary course of business. Some of the instruments sold are liquid assets. This regulation does not operate to classify those sales as attributable to a treasury function. [This has become Example 2 of the recommended regulation, *Exhibit A.*]

Written comments were submitted by eight respondents representing State and industry interests during the second hearing session. [See Exhibits D through K.] A summary of each of the comments is provided below.

The State of Arizona expressed a preference for Alternative II as a more explicit and therefore, more helpful approach to treating gains from trading of intangibles. [See *Exhibit D.*] Arizona noted its concern, however, that Alternative II does not provide a clear definition of the activity, *i.e.*, the short term investment and reinvestment of intangibles that are to be used in the business in the future.

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<sup>4</sup>Morrison & Foerster, the representatives referred to above, also submitted correspondence setting forth some of the comments made during the hearing session. [See *Exhibit J.*] In their correspondence, the representatives imply that the Hearing Officers inappropriately omit several cases (*U.S. Steel Corp. v. Wisconsin Dep't of Revenue*, No. 16578 (Wisc. Tax App. Comm'n May 9, 1985) and *Illinois Tool Works, Inc. v. Lindley*, 436 N.E.2d 220 (1982) (Ohio Supreme Court)) from the Interim Report to show that the provision merely is declaratory of existing law. The Interim Report actually indicates that the decisions are cited simply to "provide some insight into judicial/tribunal response to the issue the proposal is intended to reach." (Interim Report at page 15.) *U.S. Steel Corp. v. Wisconsin Dep't of Revenue*, which held that inclusion of gross proceeds was required by the State's statute in effect at the time, clearly is cited at page 12 of the Interim Report with an explanation that the Wisconsin legislature adopted a statute that appeared to reverse the decision shortly after it was entered. The other decision, *Illinois Tool Works, Inc. v. Lindley*, involved only the question of whether the income from the sales of discounted U.S. Treasury bills was required to be included in the sales factor at all. Making no mention of the more specific issue of whether the sales factor should include the gross receipts or only the net gain from the sale of intangible personal property, the Ohio Supreme Court in *Illinois Tool Works* held that the Board of Tax Appeals' decision to include the income in the sales factor was not unreasonable.

Preferring Alternative I, Utah suggested changes designed to narrow the language of this alternative. [See *Exhibit E*, p. 2.] Utah believes that it is inappropriate to reflect net losses as a positive value, as provided for in Alternative II. Also, the State was concerned that Alternative II does not include a statement to allow for the possible exclusion of any gain from the sales factor, if appropriate under other paragraphs of MTC Reg.IV.18.(c). Neither alternative, in Utah's estimation, satisfactorily describes the precise activity of short term investment and reinvestment of intangibles.

Like Utah, Kentucky objected to reflecting net losses as a positive value as proposed in Alternative II. Kentucky preferred the simplicity of Alternative I, while acknowledging that a blending of the two alternatives might produce a satisfactory provision. [See *Exhibit F*, pp. 3-4 for the combined language suggested by Kentucky.]

The State of Oregon supports Alternative II primarily because it is more comprehensive than Alternative I, particularly in enumerating intangibles not covered by the proposal and in providing an exception for dealers in securities. Oregon also suggested combining some of the language of both Alternative I and Alternative II. [See *Exhibit G*, pp. 2-3.]

Staff members of the CA-FTB submitted a letter confirming their support of Alternative II. While they agreed that Alternative I is an improvement over the originally proposed language, they also noted that Alternative I does not deal with several important issues that Alternative II is designed to resolve, such as the treatment of traders and dealers in securities and the identification of the types of intangibles in question. [See *Exhibit H*.]

From the industry side, Morrison & Foerster submitted correspondence objecting to adoption of the proposal as a regulation under MTC Reg.IV.18. [See *Exhibit I*.] All of the other comments of these representatives addressed procedural issues about the adoption of the proposal.

ARCO also submitted comments, [see *Exhibit J*], maintaining its opposition to any proposal to include net gains instead of gross receipts in the sales factor. ARCO's tax counsel commented, however, that a State's decision to adopt this proposal should not include a decision to reflect net losses as a positive value.

Another industry representative from McDermott, Will & Emery, lodged an objection to the notion that "the inclusion of gross receipts from the management of working capital inherently distorts the sales factor." [See letter at *Exhibit K*.] He maintains that the treatment of funds invested and reinvested in intangibles should be no different than the treatment of funds invested and reinvested in inventory, stating:

The process of investing and reinvesting working capital follows and is part of the same process of investing and reinvesting in inventory for sale. Both processes generate income for the business. In both cases, the underlying business activity is properly measured by the gross receipts generated, not by the income generated.

He concludes that there is no inherent distortion in including in the sales factor gross receipts from management of working capital and thus, it is inappropriate to adopt a *per se* rule that would include only net gains from "trading" of intangibles.

### III. Hearing Officers' Recommendations.

The Hearing Officers recommend adoption of a revised version of the CA-FTB Staff proposal, Alternative II. The recommendation does not adopt the approach of reflecting losses as a positive value as proposed by the CA-FTB Staff. Additionally, the proposed regulation includes a statement that the rule would apply only in instances where gains would not otherwise be excluded from the sales factor by operation of other subsections of Reg. IV.18.(c). [See *Exhibit A* for the full text of the proposed regulation.] The recommended revised version of Alternative II establishes a comprehensive approach to treating gains from the "trading" of intangibles that the Hearing Officers believe resolves several issues not addressed by either the originally drafted proposal or the suggested Alternative I (a re-draft of the original language). The Hearing Officers find it reasonable to recommend a comprehensive proposal that will resolve foreseeable issues and help to minimize the need to revise the amendment in the future.

#### *A. Recommended as a Section 18 rule.*

The proposal to amend Section 18 of the MTC's regulations has alarmed several respondents who argue that a *per se* rule can be effectuated only through a statutory change and not by means of an administrative or regulatory modification. The use of Section 18 distortion-relief provisions should be limited, they contend, to unusual, non-recurring circumstances. However, these concerns seem to discount the full scope of rule-making authority under the Multistate Tax Compact's Article IV, Section 18 provision.

The Multistate Tax Compact ("Compact") adopts and incorporates, with a few exceptions, the language governing the division of income contained in the Uniform Division of Income for Tax Purposes Act ("UDITPA"). Under Article IV.18 of the Compact, special rules may be established for calculating the apportionment factors where special circumstances exist. Article IV.18 provides:

If the allocation and apportionment provisions of Article IV do not fairly represent the extent of the taxpayer's business activity in this State, the taxpayer may petition for or the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (1) separate accounting;
- (2) the exclusion of any one or more of the factors;
- (3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
- (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

The language of this statute does not prohibit the adoption of a rule of general application under circumstances where it has been found that the normal allocation and apportionment rules do not fairly represent the extent of taxpayers' business activity.

In the Hearing Officers' view, the inclusion in the sales factor of gross receipts from the generally short term investment and reinvestment of certain intangibles (generally idle cash) held for the future operation of a taxpayer's business, inherently produces incongruous results. Although there may be occasions on which the inclusion of gross receipts from the "trading" of intangibles is not distortive, in most cases, the inclusion of gross receipts is not a fair reflection of a taxpayer's business activity in a State. To illustrate, where a taxpayer uses \$10,000,000 in idle cash to reinvest in 30-day Treasury notes over the course of one year, the inclusion of the gross receipts in the sales factor defies economic realities. To represent that investing and reinvesting the same \$10,000,000 twelve times in one year fairly represents business activity sufficient to produce \$120 million dollars plus a relatively small amount of interest, distorts the apportionment formula by artificially increasing the denominator of the sales factor. Without applying a method to include only net gains from such "trading" of intangibles, the taxpayer doing business in a State where this distortive investment activity does not take place would include the \$120 million in receipts in the sales factor denominator but would include none of the receipts in the numerator because the intangibles income in most cases would be sourced to the taxpayer's State of commercial domicile or to the State where the investment activity took place. The Hearing Officers find that this investment activity, by its very nature, does not produce the type of gross receipts contemplated by the drafters of UDITPA and the Compact to be included in the sales factor of the apportionment formula. It should be noted here that the drafters of both UDITPA and the Compact explicitly permitted some reasonable amount of flexibility in their construction. The introduction to Article IV of each document states that "[u]nless the context otherwise requires", certain terms, including the term "Sales", are to have a prescribed meaning. The Hearing

Officers find that the generally short term investment and reinvestment of certain intangible assets constitutes a different context than that contemplated under Article IV.(1)(g) of the Compact defining "Sales" as "all gross receipts of the taxpayer not allocated...".

Several hearing participants have compared the investment and reinvestment of idle cash in intangibles to the investment and reinvestment of working capital in inventory. In the judgment of the Hearing Officers, the "trading" of intangibles activity cannot be viewed in the same manner as the investment and reinvestment of capital in inventory. Funds utilized in the "trading" of intangibles activity are generally being invested and reinvested during an interim period as they are available for use directly in the operation of the business. The purchase of inventory with the same idle cash represents a direct use of the funds in the business operation. Sales of inventory produce the quintessential gross receipts that the Compact and UDITPA contemplate for apportioning income of a multistate business. Gross receipts from the sales of the inventory will be reflected both in the sales factor denominator and in the sales factor numerator of the various States in which taxable sales activity occurs. Gross receipts from investment and reinvestment of funds in inventory in the sales factor do not artificially impact the sales factor the way that inclusion of unadjusted gross receipts from investment and reinvestment in intangibles would. The absence or presence of artificiality results from the difference in the nature of the two types of investments. For example, large sums may be invested and reinvested in overnight securities that return, each time, the original investment plus a very small amount of interest. Over the course of a year, the unadjusted gross receipts from this continuous activity will be entirely disproportional to the income that has been earned from the use of funds invested. In addition, attributing the gross receipts to the location of the "trading" activity is distortive by virtue of the fact that the interest or other compensation received for the use of the invested funds is derived not only from the "trading" activity, but also from the use of the invested funds themselves. Netting gross receipts lessens the inherent distortive impact of recognizing the location of the trading activity for purposes of determining the sales factor numerator. This trading activity sourcing does not recognize the income producing activity of the entire business that produces the very funds that are traded in intangibles. Large sums invested directly in the business in inventory, *generally*, will result in a return of original investment plus profit occurring over a comparatively longer period of time and representing the results of the direct operation of the business.<sup>5</sup>

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<sup>5</sup>The Hearing Officers acknowledge that there could be or are circumstances under which a taxpayer invests and reinvests its idle cash in inventory over a short period of time and that the activity may be similar to the "trading" of intangibles at issue here. Perhaps as a project separate from the proposal under consideration here, the treatment of gross receipts from "trading of inventory" activity should be evaluated if there is a reasonable argument that including those gross receipts in the sales factor generally does not fairly reflect business activity of the taxpayer.



Moreover, the comparison of "trading" of intangibles activity with investment and reinvestment of funds in inventory does not seem take into account the differentiation inherent in UDITPA between tangible property and intangible property and the consequent differentiation of treatment of the receipts from transactions involving the two types of property. Essentially, the net gains from "trading" of intangibles may be viewed much like interest income received from intangibles. As illustrated in Example (v) of MTC Reg. IV.1.(c).3., only the interest income from intangibles and not the original capital used to invest in the intangible, would be considered business income includible in the apportionment formula:

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

There appears to be little significant difference between the activity in Example (v) above and the "trading" of intangibles activity, except perhaps, the transaction involved in the "trading" activity may be structured as a sale and purchase instead of as an investment transaction. The form of the transaction does not warrant different treatment of similar types of income.

The Hearing Officers find that the inclusion of gross receipts from the limited and specific activity of "trading" of intangibles is inherently distortive of the sales factor of the apportionment formula. The Hearing Officers further find that the adoption of the proposed amendment would provide a reasonable approach for addressing an accounting method that, in general, results in the apportionment of income that unfairly reflects certain taxpayers' business activities in States that apportion under UDITPA, the Compact or similar laws.<sup>6</sup> Having made this finding, the question remains whether the proposal to remedy this distortive effect may be promulgated as a regulation.

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<sup>6</sup> As noted in the Interim Report, a number of State courts have recognized the distortive effect of including gross receipts from "trading" of intangibles and have allowed the inclusion of only net gains. See *Appeals of Pacific Telephone and Telegraph Company*, Cal. St. Bd. of Equal., May 4, 1978 [SBE-XXIII-375, 78-SBE-028]; *American Telephone & Telegraph Co. v. State Tax Appeal Board*, 787 P.2d 754 (Mont. 1990); *American Telephone and Telegraph Company v. Director, Division of Taxation*, 4 N.J. Tax 638 (Tax Ct. 1982), aff'd and modified, 194 N.J. Super. 168 (App. Div., cert. denied 97 N.J. 627 (1984)). A more detailed explanation of these three cases may be found in the Interim Report at pages 13-16. A recent Indiana Tax Court decision upheld the inclusion in the sales factor of only net gains from the taxpayer's activity of regularly investing its working capital in a variety of securities. *Sherwin Williams Co. v. Dept. of State Revenue*, No. 49T10-9412-TA-00273, Dec. 2, 1996. Citing the New Jersey AT&T case as instructive, the Indiana Tax Court found that under Indiana law, "gross receipts" for the purpose of the sales factor includes only the interest income, and not the rolled over capital or return of principal, realized from the sale of investment securities."

Art.IV.18 of the Compact allows deviation from the normal allocation and apportionment rules when these rules do not fairly reflect the taxpayer's income-producing activities in the State. This statutory provision particularly allows "the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." *Art.IV.18.(d)*. The statute does not require an *ad hoc* approach to every taxpayer in that situation. Indeed, one of the core principles of the Compact and of UDITPA is to achieve tax uniformity among the many States and to interpret this language to prohibit the adoption of a common standard defeats the uniformity goal.

The proposed method of including only net gains properly may be adopted as a regulation under the authority of Section 18 of the Compact as a rule generally applicable to the special circumstances of a taxpayer that has derived receipts from the "trading" of intangibles activity. The Compact contemplates that the Commission will formalize a standard for the treatment of circumstances that give rise to a distortive apportionment result. Of course, the taxpayer retains the right to prove that the inclusion of gross receipts is not distortive of its apportionment formula.<sup>7</sup>

Some hearing participants have focused on the Section 18 provisions of the MTC's regulations in taking the position that the proposal at issue here may not be adopted administratively. Specifically, hearing respondents have pointed to MTC's Reg.IV.18.(a)., Special Rules: In General, which restates the language contained in the Compact and adds the following:

Article IV.18. permits a departure from the allocation and apportionment provisions of Article IV only in limited and specific cases. Article IV.18. may be invoked only in specific cases where unusual fact situations (which ordinarily will be unique and non-recurring) produce incongruous results under the apportionment and allocation provisions contained in Article IV.

In the case of certain industries such as air transportation, rail transportation, ship transportation, trucking, television, radio, motion pictures, various types of professional athletics, and so forth. the foregoing regulations in respect to the apportionment formula do not set forth appropriate procedures for determining the apportionment factors. Nothing in Article IV.18. or in this Regulation IV.18. shall preclude [the tax administrator] from establishing appropriate procedures under Article IV.10. to 17. for determining the apportionment factors for each such industry, but such procedures shall be applied uniformly.

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<sup>7</sup>Practically, it is difficult to understand why a taxpayer would object to the use of net gains under these circumstances if the difference is insignificant. It is only when the difference between including gross receipts and including net gains is significant that the issue becomes troublesome. A taxpayer contesting the inclusion of only net gains has, in effect, made the case that there is a significance to including gross receipts. Aside from instances where a taxpayer may contest the approach proposed herein on grounds of principle, such a challenge generally will not be very cost effective for most taxpayers.

Reliance on the regulatory language may be displaced, however. The above excerpt should not be read to limit the rule-making authority granted by the Compact. It indicates that Article IV.18 of the Compact may be invoked only in limited and specific cases involving unusual circumstances. This language does not indicate that Article IV.18 may be invoked only on a case-by-case basis. The regulation simply states that the Article "permits a departure" from the normal rules and that departure certainly may take the form of a uniform method to address a limited and specific situation.

It is the opinion of the Hearing Officers, that the arguments being made against the adoption of a *per se* rule for the treatment of net gains from "trading" intangibles reflect an overly-restrictive interpretation of the phrase, "only in specific cases where unusual fact situations (which ordinarily will be unique and non-recurring) produce incongruous results under the apportionment and allocation provisions contained in Article IV." The proposal under consideration here addresses the treatment of receipts from the very limited and specific factual situation of a taxpayer engaging in "trading" of intangibles activity. This proposal establishes, then, a uniform method for treating similarly situated taxpayers. Nothing in the MTC's regulations or in the Compact prevents the adoption of general rule that may be applied to any number of taxpayers who present a unique, non-recurring fact situation.

Additionally, this proposal recognizes one type of taxpayer that engages in the "trading" of intangibles activity for whom the net gains treatment would not be appropriate. Dealers and traders in securities engage in "trading" of intangibles in the normal course of business, thus their factual situations normally would not present the kind of unique, non-recurring situation to which the proposed regulation is intended to apply. There may be other exceptions and those taxpayers would have the right to demonstrate that inclusion of gross receipts would not distort its apportionment formula.

Finally, the Hearing Officers' recommendation must always be filtered through the laws of each adopting State. The States must determine under their respective laws whether the State may properly adopt the proposal as a regulation under Article IV., Section 18 of the Compact; as a regulation defining "sales" or "gross receipts" under Article IV. (1)(g) or "sales" under Article IV.15 and 17; or whether statutory amendment is required. The input above, along with the submissions provided through this public hearing process should provide a good starting point for that analysis.

#### *B. Describing the "trading" activity.*

The proposed amendment is intended to apply to gains from the generally short term investment and reinvestment of intangibles (generally purchased

with idle cash) being held for future use in the operation of the taxpayer's business. The originally proposed language described the activity as the "sale or other disposition of intangible property held as part of the taxpayer's operational investments, e.g., working capital...". The term "working capital" seemed to be too broad because it may include more than just intangibles being held for future business use, and thus, the term was eliminated because of the difficulty in defining its scope with acceptable precision. Additionally, the term "operational investments" seemed to confuse the distinction between "operational function" and "investment function" made by the United States Supreme Court in *Allied-Signal v. Dir., Div. of Taxation*, 504 U.S. 768 (1992).

The combined definitions of the "treasury function" concept and the "liquid asset" concept introduced in Alternative II seems to provide a fair and administrable description of the "trading" of intangibles activity. Under the proposal, a taxpayer that pools and manages assets (like marketable instruments and mutual funds) being held to provide a relatively immediate source of funds has engaged in the "trading" intangibles activity. Liquid assets are defined specifically enough to identify both the kinds intangible of assets at issue and to identify the finite period of time, at issue, that is, the point between the acquisition of funds that will be used in the business and the actual use of the funds in the business. Pooling and managing these liquid assets conveys the kind of control exercised over the intangibles as they are invested and reinvested.

*C. Losses not reflected as a positive value.*

Alternative II as drafted by the CA-FTB Staff provided for the reflection of net losses from the "trading" of intangibles as a positive value in the sales factor. CA-FTB Staff drafted Alternative II to include losses to account for all activity in a State, even if that activity produced a net loss. [See Interim Report, *Exhibit L* (CA-FTB Staff letter).] Several State and industry respondents expressed objections to reflecting losses as a positive value on the grounds, primarily, that there is no precedent for doing so.

The Hearing Officers recommend that losses not be reflected in the sales factor as a positive value under these circumstances. The Hearing Officers view the approach of including losses as having theoretical merit—an activity that happens to result in a loss or negative value, also reflects the extent of the taxpayer's business activity that is being conducted. However, in order to achieve as much uniformity as possible, and in light of several objections from State and industry participants, it is recommended that losses not be included. Consequently, the recommended amendment does not include references to "net loss" and removes the original Examples 2 and 3 contained in Alternative II that illustrated the treatment of losses.

*D. Other revisions to the language of Alternative II and issues raised.*

1. No effect on preceding paragraphs of Reg.IV.18.(c).

The recommended regulation includes language intended to clarify that the amendment of the new paragraph (4) does not operate to supersede the application of other paragraphs under subsection (c) of Reg.IV.18. Thus, the recommended regulation begins with the following sentence: "Where gains and losses on the sale of liquid assets are not excluded from the sales factor by other provisions under Reg.IV.18.(c), such gains or losses shall be treated as provided in this subsection. Receipts from the sale of certain intangibles may not be includible in the sales factor in all instances. Notably, paragraph (3) of Reg.IV.18.(c) excludes from the sales factor income from intangibles that is not readily attributable to any particular income producing activity of the taxpayer. The operation of other paragraphs of subsection (c) under appropriate circumstances should not be affected by the proposed amendment.

2. Identifying traders and dealers in securities.

A hearing participant suggested that the language used to identify dealers and traders in securities to whom the proposal would not be applied, should be modified to read, "a taxpayer *whose principal trade or business includes* the business of purchasing and selling liquid assets..." instead of, "a taxpayer *principally engaged in* the business of purchasing and selling liquid assets." [See *Exhibit A*, subparagraph (C).] The Hearing Officers believe that the latter phrasing is more precise and therefore, recommends that the "principally engaged" language remain. The Hearing Officers have included in Example 2 of the recommended regulation the suggested language, "acts as a dealer or trader." [See *Exhibit A*, subparagraph (E).]

3. Prospective or retroactive application.

The Hearing Officers' recommendations do not include a statement regarding the retroactive or prospective application of the proposed amendment. The proposal is not intended as a change in State law, but if in a particular State it is interpreted to be a change, the State must determine whether the proposal is to be applied retroactively or prospectively.

4. Examples as part of recommended proposal.

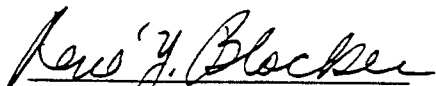
The Hearing Officers have included two examples in the recommended regulation: one to illustrate the general operation of the proposal and the other to illustrate the treatment of "trading" of intangibles activity by securities dealers or traders under the proposal. Several commentators

indicated that they thought the examples were helpful. The Hearing Officers recognize that some States may be unable or may not desire to adopt examples. Although the Hearing Officers recommend inclusion of the examples, States must make their own determinations regarding whether or not the examples will be included if the State chooses to adopt the proposal.

#### IV. Conclusion.

For the reasons set forth herein, the Hearing Officers recommend that the Executive Committee consider adoption of the revised version of Alternative II, for the amendment of Reg.IV.18.(c). This amendment would create a new paragraph (4) providing for the inclusion in the sales factor of the apportionment formula of only net gains from the sale or disposition of certain intangibles.

Respectfully submitted,



René V. Blocker  
Hearing Officer