To: Wood Miller, Chair, Uniformity Committee
Chis Coffman, Chair, Section 18 Regulatory Working Group

From: Bruce Fort, Counsel, Multistate Tax Commission

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Memorandum
Considerations for Special Allocation and Apportionment of Income Under Article IV
Where Taxpayer Has No or Minimal "Transactional" Receipts

The Uniformity Committee's "Section 18" working group has asked staff to prepare a memo outlining some possible approaches the states could adopt under Compact Article IV, Section 18 to the problem of a taxpayer having taxable income but no "receipts" as defined under Article IV, Section 1(g). The potential for uncertainty in apportioning income of "special purpose" entities and non-operational taxpayers is especially acute for states utilizing separate-entity reporting and single sales ("receipts") factor apportionment.[1]

This memorandum outlines two possible approaches to the task of establishing a regulatory framework for implementation of Section 18's grant of authority to tax administrators to adopt rules ensuring the equitable apportionment of income earned in multiple jurisdictions. The first approach is to broadly recognize the existence of the problem while leaving possible resolutions to be developed on an *ad hoc* basis. The second approach could include a detailed set of rules describing instances which would not result in appropriate outcomes and would attempt to establish sourcing rules for particular types of income. (This memorandum does not address possible sourcing rules for dividends and partnership distributions pending further study and input from the working group.)

Article IV defines receipts as follows:

> (g) "Receipts" means all gross receipts of the taxpayer that are not allocated under paragraphs of this article, and that are received from transactions and activity in the regular course of the taxpayer's trade or business; except that receipts of a taxpayer from hedging transactions and from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities, shall be excluded.

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[1] This memorandum is intended to be educational and explanatory in nature and does not represent the Commission's legal interpretation of Article IV of the Compact, proposed or existing model regulations, or committee discussions and deliberations. Additionally, this memorandum is intended to offer drafting suggestions for the working group's consideration and does not constitute a recommendation by the Commission or its staff as to the advisability of any suggestion, idea or proposal.

A. Adopt a Broad Regulation Recognizing Existence of Problem But Leaving Solution Open:

Some Suggested Language:

> In some cases, application of the definition of "receipts" and the sourcing rules contained in Article IV, section 17 may fail to reflect the business presence of the taxpayer in this state, because, for instance, the taxpayer has no receipts arising from transactions and activity in the regular course of the taxpayer's trade or business. In that event, the taxpayer's income shall be apportioned to this state in a manner which reflects (a) the extent to which the taxpayer's income was derived from this state in comparison to other states; (b) the extent to which apportioning receipts pursuant to this section to this state would result in the taxpayer's income being subject to tax in multiple states; (c) the extent to which such income would not otherwise be subject to tax in any state; and (d) the application of other such other factors as the [tax commissioner] deems appropriate.

B. Adopt More Specific Guidance:

Considerations and Issue Check-List:

1. Define Trigger for Application of Section 18 Special Apportionment:

a. "No receipts from transactions and activities in regular course of business";
b. "Predominant Source" of gross/net income did not arise from transactions and activities in the regular course of business;
c. "Predominant Source of gross/net income did not arise from transactions in the regular course of business <u>and</u> sourcing for receipts arising from transactions and activities in regular course <u>fails to reflect</u> extent of taxpayer's business activity in the state;
d. At least [75%] of gross/net income did not arise from transactions and activities in the regular course of business;
e. At least [75%] of gross/net income did not arise from transactions and activities in the regular course of <u>and</u> sourcing for receipts arising from transactions and activities in regular course <u>fails to reflect</u> extent of taxpayer's business activity in the state;
f. It is presumed (rebuttable presumption) that where [predominant non-transactional or [75%] scenarios] that the taxpayer's apportionment formula will fail to represent the extent of the taxpayer's business presence in the state, necessitating use of a special formula…
g. Distinguish "operational" entity from non-operational entity, e.g., holding company, and use that definition as a component of trigger;

2. **Other Factors to Consider for Trigger Mechanism:**

    a. Different Rules/Presumptions for Single-Factor and Three/Four Factor Apportionment States?

    b. Different Rules for Taxation as Separate Entity Versus Taxation as Member of Combined/Consolidated Group Including Operational Taxpayers?

3. **Identify and Source Common Types of Income Arising From Activities Not In Regular Course of Business:**

Capital Gains from Sale of Business or Business Segment:

a. Source income to state(s) where taxpayer did business prior to sale, as measured by
    i. Property and Payroll for all states, regardless of apportionment formula currently used by the state
    ii. Receipts (for Receipts-Factor only states)
    iii. Property, Payroll and Receipts for all states, regardless of apportionment formula currently used by the states;
    iv. Use current apportionment methodology.
b. Source income according to whether real property/TPP predominate under tax accounting (California approach), using current year factors if 6+ month return or past year factors for short year (6 months or less);
    i. If value of real and tangible personal property exceed 50% of sale value, use property and payroll percentages;
    ii. If goodwill predominates, use receipts factor;
    iii. Special rule for 338(H)(10) deemed asset sales? [not in California rules]

c. Source Income to commercial domicile of:
    i. Taxpayer;
    ii. Business or business segment being sold (incl. target corp. under 338 election).

d. Source income according to "pro-forma" in-state apportionment percentages of combined/consolidated group;

Capital Gains Arising From Other Dispositions of Property, Including Stocks and Securities:

a. Source income according to apportionment factors of securities and stock issuers (New York approach).

b. Source Income to commercial domicile of:
    1. Taxpayer;
    2. Securities and stock issuer.

c. Source income according to "pro-forma" in-state apportionment percentages of combined/consolidated group;

Interest Income from Entity Not Considered a Financial institution

California adopts the approach that such income should be sourced according to its rules applicable to financial institutions. Adopting that approach based on the MTC's Model Apportionment Rules for Financial Institutions, interest would be sourced as follows:

1. The numerator of the receipts factor includes interest, fees, and penalties imposed in connection with loans secured by real property if the property is located within this state. If the property is located both within this state and one or more other states, the receipts described in this subsection are included in the numerator of the receipts factor if more than fifty percent of the fair market value of the real property is located within this state. If more than fifty percent of the fair market value of the real property is not located within any one state, then the receipts described in this subsection shall be included in the numerator of the receipts factor if the borrower is located in this state.

2. The numerator of the receipts factor includes interest, fees, and penalties imposed in connection with loans not secured by real property if the borrower is located in this state. In the case of an unrelated business, the borrower's location is its commercial domicile. In the case of a related business, the borrower is located in this state to the extent it has property and payroll in this state.

Deferred: Dividends and Partnership Distributions