



To: Holly Coon, Chair, Uniformity Committee

From: Bruce Fort, Counsel, Multistate Tax Commission

Date: March 5, 2017

Subject: Model Apportionment Regulation Draft for Taxpayers Lacking “Receipts”

The Uniformity Committee’s “Section 18” working group¹ has been meeting telephonically on a weekly basis since our in-person meeting in July 2016 to draft a proposed model regulation for apportioning the income of entities that lack “receipts” derived from transactions and activities in the regular course of business.² Because many states have eliminated the property and payroll factors from their apportionment formulas, it is possible that a non-operational subsidiary could have apportionable base income, but no apportionment factors.

The working group believes the draft is nearing completion. The goals of the drafting project are still to: (a) provide a predictable means of apportionment; (b) use market-based sourcing concepts where possible; (c) avoid “nowhere assignment” or double assignment of receipts; and (d) retain flexibility for unanticipated circumstances. Additional information on the working group’s activities and prior drafts may be found on the group’s MTC web page, <http://www.mtc.gov/Uniformity/Project-Teams/Section-18-Regulatory-Project>.

A. Throw-Out of Gross Receipts Which Would Otherwise be Assigned to Non-Nexus Jurisdictions

The working group’s efforts were aided (and complicated) by a suggestion from the full Uniformity Committee at its in-person meeting on December 12, 2016, that the committee consider using a provision similar to that found in Article IV, Section 17, for “throwing out” gross receipts in situations where the regulation would otherwise assign those receipts to a jurisdiction in which the taxpayer is not “taxable.” Under Compact Article IV, Section 1, and related model regulations, to be

¹ The working group is chaired by Holly Coon of Alabama and includes Matt Peyerl, North Dakota, Phil Skinner and Nate Nielson, Idaho, Jason Larimer and Katie Lolley, Oregon, and David Hesford, Washington, Michael Fatale, Massachusetts, Jennifer Hays, Kentucky Legislature, and Scott Fryer, Arkansas, with additional and valuable participation from other state officials and practitioners. Once again, we wish to extend particular thanks to Karen Boucher for her insightful comments.

² Article IV, Section 1(g) defines receipts as:

“...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.”

“taxable” means the taxpayer has sufficient nexus with the state to be subject to taxes on its business earnings as measured by income under the U.S. Constitution and not protected under the immunity provisions of P.L. 86-272. A taxpayer may still be considered “taxable” in a state even if the state chooses not to impose an income-based tax.

The working group decided early on that “throw-back” would be unmanageable, but has come to believe that a “throw-out” rule may be manageable, although it does present complications.

To that end, the working group would like to discuss some of those complications with the full Uniformity Committee and solicit advice as to whether the throw-out effort should be continued, limited or abandoned.

B. Summary of the Proposed Model Regulation’s Structure

The working group concluded that the proposed regulation should provide guidance for apportioning the various types of “functional” income receipts a special purpose entity might receive, rather than try to classify particular entity types.³

The opening paragraph provides that the regulation is only applicable to taxpayers with “receipts” totaling 3.33% or less of apportionable gross receipts.

The first section then establishes rules for dividends, capital gains, financial-institution type activities (including lending); factoring accounts receivable, and investment activities.

The second through fourth sections provide that income types amounts not subject to apportionment in Section 1 should be apportioned by: (i) using property and payroll to create a receipts factor; (ii) using the combined/consolidated group’s receipts factor if the taxpayer is filing using methods; or (iii) using a percentage based on the taxpayer’s federal consolidated income everywhere compared to federal consolidated income otherwise apportioned to that state. We anticipate these sections will rarely be applied.

The fifth section contains the throw-out provision discussed above.

³ As discussed in our previous memorandum to the Committee, some recent cases cast light on what some of these entities might look like:

In *Blue Bell Creameries, LLP v. Roberts*, 333 S.W.3d 59 (Tenn. 2011), the taxpayer created a special purpose entity with no employees or property, and which sold no products or services. The entity’s only function was to facilitate the reorganization of BBC USA, Inc. from a C corporation to a Subchapter S corporation, recognizing a \$142 million capital gain from the reorganization. The taxpayer argued that the entity was not operationally unitary with the underlying business activity of BBC USA, Inc., which was making ice cream products. The Tennessee Supreme Court disagreed, and allowed Tennessee to impose its apportioned franchise tax on the special purpose entity using the apportionment factors of the underlying business.

In *First Marblehead Corp v. Commissioner of Revenue*, 56 N.E.3d 132 (Mass. S.J.Ct. 2016), the taxpayer, Gate Holdings, Inc., was a holding company which held securitized student loan portfolios on behalf of 16 separate trusts, receiving interest income from loan repayments and guarantees. The underlying loans were originated by its parent First Marblehead and securitized for sale on the financial markets. Gate’s status as a financial institution was contested by the parties. Gate had no operations, no employees, no tangible property, and no sales of property or services.

In *Harley-Davidson, Inc. v. Franchise Tax Board*, 237 Cal. App. 4th 194 (Ct. App. 4th Dist. 2015), the taxpayer was a Nevada corporation which received income from accounts receivable transferred to it from related parties but was not subject to combination with those entities. The taxpayer claimed it lacked nexus in California.

The sixth section contains a safety-valve allowing either the taxpayer or the tax agency to seek to use an alternative equitable method of apportionment.

Finally, the proposed model includes examples of how the regulation might be applied. Many of the examples are complicated, but the complication is necessary to cover all the variables that might confront a tax administrator.

C. Looking Forward

We await suggestions on other areas where a special purpose regulation addressed to changes to Sections 1 or 17 of Article I of the Compact is desired.



Discussion Draft
Proposed Special Apportionment Regulation ~~Latest Discussion Draft~~
For Taxpayers Lacking “Receipts”
(Updated 2/213/3/17):

Where the taxpayer’s receipts, as defined by [Compact Article IV.1.g] are less than 3.33% of the taxpayer’s gross receipts [as defined by Model Allocation and Apportionment Regulation IV.2.(a)(5),] the rules set forth herein shall be applied in calculating the taxpayer’s receipts factor. These rules for calculating the receipts factor may also apply, in the discretion of the tax commissioner, in other circumstances in which the apportionment formula does not fairly represent the extent of the taxpayer’s business activity in the state.

1) In the case of any taxpayer with non-de minimis gross receipts consisting of dividends from related parties, interest, investment income, or proceeds from the disposition of a business or business segment, those gross receipts, to the extent included in apportionable income, shall be assigned as follows:

(a) Dividends paid by a related party [as defined in Sec. 17 or other state law], shall be included in the receipts factor denominator and shall be included in the receipts factor numerator ~~effor~~ this state (i) where it can be reasonably determined that the dividends were paid from earnings generated by the dividend payor in particular years, by using the dividend payor’s apportionment factors for those years; (ii) where the years in which the earnings were generated by the dividend payor cannot be reasonably determined, by using the average of the apportionment factors of the dividend payor for the current and preceding year; and (iii) where the dividend income was generated from activities or earnings of one or more related parties to the dividend payor, by using the apportionment factors of those related parties in the years in which those activities occurred or earnings were generated;

(b) Capital gains (but not capital losses) deriving from the disposition of the stock or other intangible property rights representing at least a 20% ownership interest in a business entity which is or was ~~functionally connected to a part of~~ the taxpayer’s unitary business ~~activities~~ shall be included in the receipts factor denominator and shall be included in the receipts factor numerator ~~in [for this state]~~ to the same extent as that business entity’s average apportionment factors were ~~assigned to in~~ this state in the year preceding the disposition, unless use of the business entity’s apportionment factors in a different year is necessary to fairly reflect the location of the income-generating activity of that entity. Capital gains (but not capital losses) deriving from the disposition of the tangible assets of a business or business segment shall be included in the receipts factor denominator and shall be included in the receipts factor

numerator ~~in [for this state]~~ to the same extent as that business's apportionment factors were in this state in the year preceding the disposition, unless use of the business's apportionment factors in a different year is necessary to fairly reflect the location of the income-generating activity of that business.

(c) Receipts arising from those activities described in Sections 3(d) through 3(j) of the MTC's Formula for the Apportionment and Allocation of the Net Income of Financial Institutions Model Statute ~~(as adopted July 29, 2015)~~ [or this state's financial institution receipts factor rules] shall be included the receipts factor denominator and shall be included in the receipts factor numerator for this state to the extent those receipts would be assigned to this state under ~~[this state's financial institution receipts factor rules]~~ or [under the MTC's Formula for the Apportionment and Allocation of the Net Income of Financial Institutions Model Statute (as adopted July 29, 2015)] or [this state's financial institution receipts factor rules].

(d) Gross receipts derived from accounts receivable previously sold to or otherwise transferred to the taxpayer, to the extent they cannot be assigned under Subsection (1)(c), shall be included in the denominator of the receipts factor and shall be included in the numerator of the receipts factor for this state to the same extent that those amounts are collected from borrowers in this state;

(e) The net amount [but not less than zero] of receipts not assigned under ~~Sections (Subsections (1)(b-) through (1)(d))~~ arising from investment activities, including the holding of, or the maturity, redemption, sale, exchange or other disposition of ~~[marketable securities or cash,~~ shall be included in the sales factor denominator and shall be included in the sales factor numerator ~~of the receipts factor~~ for this state to the same extent as the investment activities would be assigned to this state under [this state's financial institution receipts factor rules] or [under the MTC's Formula for the Apportionment and Allocation of the Net Income of Financial Institutions Model Statute (as adopted July 29, 2015), Section 3(n), if this state has not adopted a special apportionment rule or statute for financial institutions]; all other receipts from investment activities shall be assigned to the state in which such investments are managed.

2) If the taxpayer has gross receipts that are not included in the receipts factor pursuant to Section (1), and the state requires the use of multiple factor apportionment formulas, those gross receipts shall be included in the denominator of the receipts factor and shall be included in the numerator of the receipts factor ~~effor~~ this state by using the remaining apportionment factors and percentages applicable to that taxpayer, where those factors are non-*de minimis*.

3) If the taxpayer has gross receipts that ~~are not~~cannot be apportioned pursuant to Sections (1) and (2) ~~of this regulation, and the taxpayer's income and factors are included on a combined or consolidated return filed in this state,~~ those gross receipts shall be included in the denominator of the receipts factor and shall be included in the numerator of the receipts factor ~~effor~~ this state into the same ratio~~extent~~ as the receipts factor ~~of numerators for~~ the remainder of the combined or consolidated group ~~if the taxpayer's income and factors are included on a combined or consolidated report or return filed~~are in this state; ~~or.~~

4) ~~(b) If the taxpayer is filing as a separate entity in~~ has gross receipts that cannot be apportioned pursuant to Sections (1), (2) or (3) of this state regulation, those gross receipts shall be included in the denominator of the receipts factor and shall be included in the numerator of the receipts factor

for this state by ~~taking~~applying the ratio of the federal taxable income of ~~new~~those entities which was apportioned to this state versus the federal taxable income apportioned to this state of the federal consolidated group of which the taxpayer is~~was~~ a member ~~which was apportioned to this state.~~

- 5) ~~3) [NEW MATERIAL]~~ Receipts which are or would be assigned under this regulation to a jurisdiction in which taxpayer is not taxable [as defined in Article IV, Section 3] in the current tax year shall be eliminated from the receipts factor numerator and denominator.
- 6) ~~4)~~ To the extent application of the preceding subsections fails to result in an equitable apportionment of the taxpayer's gross receipts, the taxpayer may petition for, or the [tax commissioner~~administrator]~~ may require the use of an alternative calculation of its receipts factor to more clearly reflect the extent of the taxpayer's business activity in this state as provided for in Article IV, Section 18.