MULTISTATE TAX COMMISSION

MEMORANDUM

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

From: Bruce Fort, Counsel, Multistate Tax Commission

Date: 1/28/16

Re: Supplementary Information on Recommended Topics for Consideration by Section 18 Workgroup

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The Commission's Uniformity Committee has established a Compact Article IV (UDITPA) Section 18 Workgroup. The purpose of that workgroup is to address general Section 18 regulatory issues created by amendments to UDITPA that were adopted by the Commission in 2014 and 2015, and by proposed changes to the Commission's Model General Allocation and Apportionment Regulations made by Section 1 and Section 17 Workgroups. The Section 18 Workgroup had its initial telephonic meeting on January 19, 2016.

The group reviewed the list of topics identified by the Section 1 and Section 17 Workgroups as possibly needing to be addressed by the Section 18 group. The Section 18 group asked MTC staff to provide supplementary information and further explanation of those topics. This memo responds to that request.

In preparing this memo, staff referred to notes of discussions of the Section 1 and Section 17 workgroups and also to discussions held by the group that drafted the amendments to UDITPA. With respect to the Section 18 topics, however, the discussions were not extensive. Therefore, staff has attempted to infer the kinds of specific issues that these earlier groups anticipated would be addressed based on their general discussions. The workgroup should consider this when reviewing the supplementary information and explanations in this memo.[1]

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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. The Compact and model regulations speak for themselves.

The current model general regulation on allocation and apportionment of income is found here.[2] The version of that regulation with draft amendments (red line version) as approved by the Uniformity Committee in November of 2015 is found here.[3]

This memo is broken down between the six main topics identified. A seventh possible topic, identification of special industry regulations, is not addressed by this memo.

The six topics are:

(a) Address the possible distortion that could be caused by the exclusion of functional receipts from the definition of "receipts" for purposes of the receipts factor in certain circumstances.
(b) Consider exceptions to the definition of "receipts," which now excludes receipts from securities and hedging, where these receipts might represent "transactional" receipts for certain taxpayers (e.g. brokers) as well as how possible distortion might be avoided (e.g. churning of investments).
(c) Consider whether receipts from factoring of receivables should ever be included in the receipts factor.
(d) Address any situations where general population data, used under the draft Section 17 sourcing rules, might result in distortion and what methods might be used to address that distortion.
(e) Consider whether there needs to be a "*de minimis* rule" for sourcing of receipts in certain instances so that the taxpayer may use a proxy for sourcing, or possibly throw out those receipts from the factor.
(f) Address regulations that might be needed to interpret and implement the amendments to Article IV, Section 18 made by the Commission in 2015.

A. Possible Equitable Apportionment Regulation(s) Where the Receipts Factor Fails to Reflect a Taxpayer's "Business Presence" Within the State.

Previously, Article IV Section 1(g) used the phrase "sales" to describe the limits of what is now termed the receipts factor:

> 'Sales' means all gross receipts of the taxpayer not allocated under Sections 4 through 8 of this Act.

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2 http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/AllocaitonandApportionmentReg.pdf.

3 http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Section-1-Model-Definition-of-Receipts"-Regulation/Combined-Redline-Section-1-new-Section-17(SL-revision)-(4).pdf.aspx.

The definition of "receipts" in Multistate Tax Compact Article IV, Section 1 as amended in 2014 provides:

> (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.

The policy considerations leading up to this change are well-documented. The Uniformity Committee in its 2012-2014 deliberations on the new Article IV language agreed that the definition of "sales" was too inclusive, as it arguably included the gross amounts of short-term securities transactions, capital gains, dividends, hedging, factoring and other transactions which did not represent the "marketplace" for the taxpayer's goods and services. The new definition of "receipts" is based on what had become known as the "transactional test" of business income, that is, "transactions and activity in the regular course of business" for which the taxpayer presumably has customers in identifiable market places.

In addition, Article IV, Section 17, concerning the sales of services and receipts from the utilization of intangible property, has been completely re-written to require apportionment to the taxpayer's "market" for those activities. While receipts from licenses of intangible property are subject to apportionment and inclusion in the receipts factor, where the sale of intangible property is concerned, only a select type of intangible property is included in the receipts factor and all other receipts are excluded. Compact Article IV 17.(a)(4)(2) provides that receipts from only these types of sales of intangible property are included in the receipts factor:

> (A) a contract right, government license, or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area…;
>
> (B) receipts from intangible property sales that are contingent on the productivity, use, or disposition of the intangible property shall be treated as receipts from the rental, lease or licensing of such intangible property under subsection (a)(4)(i); and
>
> (C) all other receipts from a sale of intangible property shall be excluded from the numerator and denominator of the receipts factor.

The limitation of the receipts factor to so-called transactional test income should function well in the context of entities included in a combined report, since the "market" for goods and services of the combined group as a whole should reflect the location of the taxpayer's primary markets.

The working group should be aware that most "functional test" receipts, that is, income received from the disposition of property used in the taxpayer's trade or business, are treated as properly excluded from the receipts factor under the Commission's existing regulations which provided that where the location of income-producing activity for income from intangible property could be identified, it should be sourced to that location, but where the income-producing activity could not be identified, such receipts should be excluded. Additionally, the regulation provided that substantial capital gains, e.g., gains resulting from the sale of a factory, should be excluded from the receipts factor. Receipts from transaction in securities and several other types of activities were also excluded from the receipts factor in amendments to the Commission's regulations adopted in 2003.

But the Section 1 and Section 17 limitations of the receipts factor may not function well for taxation of certain corporate entities filing on a separate basis. Examples include so-called "special purpose" entities holding intangible property, or receiving taxable dividends, capital gains and interest, income that may have been generated by the taxpayer's unitary business conducted in multiple states. The potential for having apportionable income for which there is no means of apportionment under these rules is heightened by the exclusive reliance on the receipts factor in many states' apportionment formulas. Consider the following examples:

(a) Sticky's Food Co. operating fast food restaurants in thirty states establishes a captive insurance company in Vermont, Chicken Assurance, Inc. Sticky's transfers its ownership of various stocks and cash to the newly formed captive insurer. The stock generates $100 million annually. Chicken Assurance loans its excess income back to Sticky's at LIBOR rates, receiving interest payments of $50 million annually. It insures Sticky's restaurants from liability claims in five out of the thirty states, and receives premium payments of $40 million annually from Sticky's headquarters (in Delaware) for that service.

    Chicken Assurance is not subject to combined filing with Sticky's in most jurisdictions. Arguably, only the premium income derives from transactions in the ordinary course of business and meets the definition of "receipts."

(b) ABC Power Co. decides it will sell some of its coal-fired electric generating plants operating in five western states. After it finds an appropriate buyer, it transfers its plants to SaleCo, a newly-formed Delaware Corporation, which completes the sale and recognizes a $500 million capital gain for federal tax purposes. SaleCo. ceases to exist immediately after the sale, paying a liquidating dividend to ABC Power Co. SaleCo. made no sales of electricity during its one-day existence. Assuming the receipts from the sale are not included in the receipts factor, SaleCo's income may not be apportionable to any state even though deductions were previously taken for ABC Power Co. in those five states. .

(c) Same facts as above but one of SaleCo.'s power plants made sales into a single state on the day of the sale.

(d) Dynomo Corp. is the corporate parent of five foreign and five domestic subsidiaries, the latter five cumulatively operating in all fifty states. It receives:

    a. $1 billion in foreign dividends;
    b. $500 million in domestic-source interest payments;
    c. $500 million in foreign-source interest payments; and
    d. $5 million in inter-company service and management fees paid by one of its domestic subsidiaries operating in just two states.

Should the receipts factor of Dynomo Corp. be calculated entirely as a division between those two states?

B. Consider exceptions to the definition of "receipts," which now excludes receipts from securities and hedging, where these receipts might represent "transactional" receipts for certain taxpayers (e.g. brokers) as well as how possible distortion might be avoided (e.g. churning of investments).

Both the Section 1 and the Section 17 working groups had occasion to consider how to apportion receipts of those engaged in the business of selling securities. Transactions involving securities are explicitly excluded from the definition of receipts in Section 1(g). The issue is significant because many large business enterprises invest their working capital in short-term securities transactions (one common form of investment being Repurchase Agreements (REPOs)). While the resulting interest and capital gains from such investments is considered apportionable income[4], the inclusion of the gross amounts of such sales generally distorts the measure of the taxpayer's market for its goods and services.[5] Additionally, many business entities, including financial institutions, insurance companies and investment firms, engage in securities transactions as a regular part of their unitary business operations (including hedging activities) but also have other business operations involving the sale of goods and services to third parties. The combination of securities sales and transactional sales to customers would likely fail to reflect the location of taxpayer's market. Finally, there are some taxpayers engaged exclusively in trading securities for their customers and on their own account. The exclusion of securities trading income and losses from the definition of "receipts" would leave these taxpayers with no receipts factor by which to apportion their income.

The language of Article IV, Section 1 (and to a lesser extent, Section 17) strongly suggests that the Commission and its member states have already determined that the potential for distortion of the marketplace presented by inclusion of securities in the receipts factor outweighs the countering concern that exclusion of such receipts would result in a failure to reflect the taxpayers' "business presence" within the taxing states. The 2003 amendment to the Commission's regulations provides that securities are excluded from the "sales factor," except for "sales of securities by securities dealers." See Reg. IV.2.(a)(5). California's definition of "receipts" similarly excludes securities but includes a statutory exception for securities dealers. The Uniformity Committee debated including that type of exception in Section 1's definition of receipts but rejected the idea because of concerns that multi-operational taxpayers who also held "securities dealer" licenses could attempt to distort their market-based sourcing.

One possible alternative would be to adopt a special industry regulation for securities dealers, limited to those who meet a certain threshold percentage of trading on behalf of third parties. California has promulgated an extensive securities dealer regulation, attached to this memo

[4] *See Allied-Signal v Director, Division of Taxation*, 504 U.S. 768 (1992).
[5] *See, e.g. Microsoft Corp. v. Franchise Tax Board*, 139 P.3d 1169 (Ca. 2006); *Sherwin-Williams Co. v. Johnson,* 989 S.W.2d 710 (Tenn. App. 1999).

as Appendix A. That regulation sources receipts from trading activities on behalf of third parties to the "marketplace" for those services. The regulation also allows a "look-through" to the ultimate customer's location for services performed for mutual funds and similar entities. Under this approach, receipts from securities trading on the taxpayer's own account (and perhaps trading on behalf of related entities) would not be included in the receipts factor.

C. Consider whether receipts from factoring of receivables should ever be included in the receipts factor.

In the course of its deliberations, the Section 1 working group considered whether to adopt a list of income sources which would not constitute "receipts", as the 2003 amendments had done See Reg.IV.2.(a). The Uniformity Committee decided against adoption of such a list but it did consider whether receipts from factoring of account receivables should be addressed separately since factoring was not explicitly addressed in the current definition of "receipts." The working group's concern was that for some cash basis taxpayers, only the amounts received as a consequence of factoring their accounts would be considered receipts. But simply allowing cash basis taxpayers to include receipts from factoring without specifying where those receipts should be sourced was not seen sadequately addressing the problem. Conversely, a rule that simply allows receipts from factoring receivables to be included in the receipts factor would allow accrual basis taxpayers to double-count those receipts, and source those factoring receipts to the location of the factoring company, not to the location of the taxpayer's market.[6] The factoring companies themselves might be subject to the Financial Institutions Apportionment Regulation,[7] or might require consideration under a separate special industry regulation.

D. Address any situations where general population data, used under the draft Section 17 sourcing rules, might result in distortion and what methods might be used to address that distortion.

The Section 17 workgroup devoted a great amount of time to considering whether allowing taxpayers to use population data in some cases as a reasonable method of approximating the market for receipts from sales of services or intangibles might result in distortion. In particular, the working group expressed concern that a taxpayer with a primarily-domestic marketplace might be able to use a "world-wide" population base for purposes of reasonably approximating its market, when in fact the taxpayer has only insignificant amounts of overseas customers or audiences.

A second issue discussed by the working group was whether use of general population data was appropriate for reasonable approximation where a taxpayer's market was primarily regional, or where the rates of internet usage or product markets differed among regions. The Section 17 working group rejected use of internet usage data in favor of population statistics maintained by

[6] *See Union Pacific Corp v. Idaho State Tax Commission*, 83 P.3d 116 (Id. 2006).
[7] http://www.mtc.gov/getattachment/Uniformity/Adopted-Uniformity-Recommendations/Financial-Institutions-Apportionment-Rule-Amended-2015.pdf.aspx.

the U.S. Census Bureau, and this recommendation was adopted by the Uniformity Committee as a whole.

The draft Section 17 regulation approved by the Uniformity Committee does include certain safeguards designed to protect against over-statement of the receipts factor denominator. First, the regulation provides that when using secondary methods of reasonable approximation:

> "…the relevant specific geographic area [of delivery] include only the areas where the service was substantially and materially delivered or resold. Unless the taxpayer demonstrates the contrary, it will be presumed that the area where the service was substantially and materially delivered or resold does not include areas outside the United States."

A similar provision is included in Reg.IV.17.(e)(2) relating to marketing intangibles. Additionally, Article IV, Section 17 contains a "throw-out" provision where the taxpayer is not subject to tax in the market where its services are delivered or property is used.

E. Consider whether there needs to be a "de minimis rule" for sourcing of receipts in certain instances so that the taxpayer may use a proxy for sourcing, or possibly throw out those receipts from the factor.

The Commission's existing *Model General Allocation and Apportionment Regulation* includes a provision allowing for the exclusion of certain receipts from occasional or incidental sales, so long as the exclusion did not materially affect the taxpayer's apportionment in a state. See Reg. IV.18.(c). That provision was removed by the Section 1 workgroup as it re-worked the model regulation in part because the example used referenced a "functional test" transaction. Reg.IV.18.(c) provides in part:

> (2) Insubstantial amounts of gross receipts arising from incidental or occasional transactions or activities may be excluded from the sales factor unless their exclusion would materially affect the amount of income apportioned to this state. For example, the taxpayer ordinarily may include in or exclude from the sales factor gross receipts from transactions such as the sale of office furniture, business automobiles, etc.

During the Section 17 working group meetings, some lengthy discussions were held as to whether a "*de minimis*" provision was appropriate for the Section 17 sourcing regulations, given that the regulation included numerous provisions for reasonable approximation. Concerns were also raised as to how to determine whether an amount was immaterial and whether it could affect factor-based nexus determinations, for instance. On the other hand, some voiced the opinion that failure to include a *de minimis* standard could result in excessive compliance and administrative costs.

Currently, the new proposed model regulations under consideration by the Commission do not include any *de minimis* exclusion standard, for sales of tangible property, intangible property transactions or the sale of services.

F. Address regulations that might be needed to interpret and implement the amendments to Article IV, Section 18 made by the Commission in 2015.

In July of 2015 the Commission approved several changes to Compact Article IV, Section 18. Section 18 now provides:

(a) If the allocation and apportionment provisions of this Article 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.

(b)(1) If the allocation and apportionment provisions of this Article do not fairly represent the extent of business activity in this State of taxpayers engaged in a particular industry or in a particular transaction or activity, the tax administrator may, in addition to the authority provided in section (a), establish appropriate rules or regulations for determining alternative allocation and apportionment methods for such taxpayers.

(2) A regulation adopted pursuant to this section shall be applied uniformly, except that with respect to any taxpayer to whom such regulation applies, the taxpayer may petition for, or the tax administrator may require, adjustment pursuant to Section 18(a).

(c) The party petitioning for, or the [tax administrator] requiring, the use of any method to effectuate an equitable allocation and apportionment of the taxpayer's income pursuant to subsection (a) must prove by [Drafter's note: insert standard of proof here]:

(1) that the allocation and apportionment provisions of this Article do not fairly represent the extent of the taxpayer's business activity in this State; and

(2) that the alternative to such provisions is reasonable. The same burden of proof shall apply whether the taxpayer is petitioning for, or the [tax administrator] is requiring, the use of any reasonable method to effectuate an equitable allocation and apportionment of the taxpayer's income. Notwithstanding the previous sentence, if the tax administrator can show that in any two of the prior five tax years, the taxpayer had used an allocation or apportionment method at variance with its allocation or apportionment method or methods used for such other tax years, then the tax administrator shall not bear the burden of proof in imposing a different method pursuant to (a).

(d) If the [tax administrator] requires any method to effectuate an equitable allocation and apportionment of the taxpayer's income, the [tax administrator] cannot impose any civil or criminal penalty with reference to the tax due that is attributable to the taxpayer's reasonable reliance solely on the allocation and apportionment provisions of this Article.

The changes to Article IV, Section 18 establish both substantive and procedural rules for the taxing agency's use of equitable apportionment authority and the discretionary grant of authority to adopt a different methodology by petition. These changes may require additional regulatory guidance to promote appropriate implementation by adopting states and uniformity in practice to the extent such uniformity can be achieved given existing state administrative regulations and practices.

APPENDIX

California Securities Dealers Apportionment Regulation

25136-2(g). Receipts from sales of marketable securities and other activities pertaining to marketable securities are assigned to this state to the extent that the taxpayer's customer who is responsible for paying such receipts is located in this state. 25136-2(g)(1). For purposes of this section (g), the term "marketable securities" shall have the meaning assigned to the term "security" by Section 475(c)(2), Internal Revenue Code, and shall include instruments described by Sections 475(e)(2)(B), (C), and (D) of that code. 25136-2(g)(2). Sales of Marketable Securities

25136-2(g)(2)(A). Except for sales related to treasury functions as provided by California Revenue and Taxation Code Section 25120(f)(2)(K), the location of the customer for receipts from the sale of marketable securities, including any accrued interest or dividends, shall be the billing address in the records of the taxpayer of the customer who is responsible for paying such receipts. 25136-2(g)(2)(B). Subparagraph (A) shall not apply to an entity that apportions income under Regulation Section 25137-4.2 25136-2(g)(3). Other activities pertaining to Marketable Securities. 25136-2(g)(3)(A). The location of the customer for receipts constituting brokerage commissions derived from the execution of marketable securities purchase or sales orders for the accounts of customers shall be the billing address in the records of the taxpayer of the customer who is responsible for paying such commissions. 25136-2(g)(3)(B). The location of the customer for receipts constituting margin interest earned with respect to a brokerage account containing marketable securities shall be the billing address in the records of the taxpayer of the customer who is responsible for paying such margin interest. 25136-2(g)(3)(C). The location of the customer for receipts constituting fees earned by the taxpayer for advisory services to a customer in connection with the underwriting of marketable securities for such customer (such customer being the entity which is contemplating issuing or is issuing marketable securities) or fees earned by the taxpayer for managing or participating in an underwriting of marketable securities shall be the billing address in the records of the taxpayer of such customer who is contemplating issuing or is issuing marketable securities. 25136-2(g)(3)(D). The location of the customer for receipts constituting account maintenance or asset based account fees attributable to an account containing marketable securities shall be the billing address in the records of the taxpayer of the customer who is responsible for paying such account maintenance or asset based account fees. 25136-2(g)(3)(E). The location of the customer for receipts constituting fees for advisory services in relation to merger or acquisition activities shall be the billing address in the records of the taxpayer of the customer who is responsible for paying such fees. 25136-2(g)(3)(F). The location of the customer for receipts constituting fees for administration, distribution and management services related to marketable securities shall be determined in the same manner as asset management services pursuant to the provisions of Regulation 25137-14(b)(1)(B). For purposes of this paragraph, administration, distribution and management services shall mean services similar to those described in Regulation Section 25137-14(a)(7), but not provided by a mutual fund service provider as defined in Regulation Section 25137-14(a)(5) or in connection with a regulated investment company. 25136-2(g)(3)(G). The location of the customer for receipts constituting interest income related to lending which is collateralized by marketable securities (such customer being the borrower) shall be the billing address in the records of the taxpayer of such customer who is responsible for paying such interest. 25136-2(g)(3)(H) If the taxpayer receives any receipt enumerated in subparagraphs (A) to (G), inclusive, from a contractual relationship with a corporation or other business entity acting as an intermediary securities broker-dealer between the taxpayer and the customer of the intermediary securities broker-dealer, the location of such receipt received by the taxpayer shall be the billing address of such customer of the intermediary securities broker-dealer. The amount of such receipt shall exclude the amount the taxpayer is required to pay to the intermediary securities broker-dealer for such contractual relationship. 25136-2(g)(4).) If the location of the customer cannot be determined from the billing address in the records of the taxpayer, then the location of the customer shall be reasonably approximated as defined in subsection (b)(5) above.