



MULTISTATE TAX COMMISSION

To: Holly Coon, Chair, Uniformity Committee's Section 18 Model Regulation Working Group;
Uniformity Committee

From: Bruce Fort, Counsel, Multistate Tax Commission

Date: February 7, 2017

Re: **Staff Comment Regarding Operation of Proposed "Throw-out" Rule in Section 18 Model Regulation for Apportionment of Income for Taxpayers with No "Receipts"**

A discussion was held during last week's call regarding the operation of the proposed "throw-out rule" for receipts which would be assigned to a jurisdiction in which a taxpayer is not taxable. *Proposed Model Regulation Section 4.*¹ In particular, concerns were raised as to whether the "taxable" standard would apply to actual taxation imposed by states, and second, whether the taxable standard would apply to related entities (where those entities are used as a "proxy" for creating a receipts factor for the actual taxpayer) would be subject to this regulation's throw-out rule. The working group expressed concern that the regulation is insufficiently clear on these matters and may be unworkable.

For the reasons set forth below, I believe the proposed model regulation's "throw-out" rule is workable, although it could benefit from additional clarity.

Compact Article IV, Section 3 defines "taxable" within a state as having two principal components. First, does the taxpayer have a sufficient connection with the state to enable the state to impose an excise tax on the privilege of doing business measured by income under constitutional standards? Second, could the state impose an income-based tax without violating P.L. 86-272? If both standards are met, the taxpayer is deemed to be "taxable" within the state.

Based on the reference to this Compact test, I believe the proposed throw-out rule in Section 4 need not consider whether the taxpayer is actually taxed (or not taxed) in a state to which income would otherwise be assigned under application of the Section 18 is regulation. And, if the taxpayer has actual receipts under other provisions of the Compact (Article IV, Sections 16 or 17), presumably this Section 18 regulation would not apply at all. That is, the test in Section 4 is a hypothetical one, and one which

¹ 4) [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] shall be eliminated from the receipts factor.

assumes every state adopted this regulation. The hypothetical nature of the test could be clarified in the body of Section 4.

Second, I believe that, by its terms, the relevant test for “taxability” and throw-out applies not to the “proxy” entity (or year of operations for the proxy entity) used to create a receipts factor in some instances, but only to the separate-entity “Section 18” taxpayer. This treatment is appropriate since the purpose of the throw-out provision is to avoid “nowhere” apportionable income. Whether the “proxy entity” was taxable in particular states should not be a factor, since its income is not being apportioned.

I hope the following proposed examples (in yellow) make those points clear, while I am sure there are additional suggestions to make the operation of the proposed throw-out provision less opaque.

Examples:

1. Taxpayer CB Holdings, Inc. is a Nevada corporation with one employee and one office in Reno, Nevada. During the tax year it earned 100% of its gross income from dividends paid from CB REIT, Inc., which was engaged exclusively in leasing retail stores, directly and indirectly, to Crazy Bob Auto Parts, Inc. CB REIT, Inc. has one employee and one office, also in Reno, Nevada. All three corporations are related parties. 20% of CB REIT’s leased stores are in this state, with the remainder of the store leases equally distributed in States A, B, C, and D. Although all of the taxpayer’s dividend income is derived from CB REIT, under Section 1(a)(iii), 20% of the taxpayer’s receipts are assigned to this state.

1a. Same facts, except that CB Holdings, Inc. is not taxable in the remaining states in which CB REIT indirectly leases property. Under Section 4, those receipts are eliminated from the receipts factor numerator and denominator, resulting in 100% of the receipts factor attributable to CB Holdings, Inc.’s leasing activities being assigned to this state.

1.b. In the following year, CB Holdings, Inc. decides lend its excess capital to Crazy Bob Auto Parts, Inc., located in State Y. As a result of that loan, CB Holdings, Inc. reports \$40 million of interest income in addition to \$160 million of lease income. Although CB Holdings, Inc. does not meet this state’s definition of a financial institution, the receipts from lending activity (\$40 million) will be included in the receipts factor pursuant to 1(c) and assigned to State Y as the location of the borrower. Because CB Holdings, Inc. is not taxable in four of the five states in which it receives a dividend attributable to CB REIT’s leasing activity, \$128 million of the dividend income is eliminated from the receipts factor denominator, with the remaining \$32 million included in the receipts factor numerator and denominator for this state. The \$40 million of loan income will also be included in the receipts factor denominator of CB Holdings, Inc., resulting in a receipts factor in this state of 32/72, and 40/72 in State Y.

1c. CB Holdings, Inc. is only taxable in this state as its loans to Crazy Bob Auto Parts Inc. in State Y are insufficient to establish a taxable nexus in that state. CB Holdings, Inc.’s receipts factor is apportioned 100% to this state (\$32 million/\$32 million.)

2. Taxpayer Quick Sale Co. is a Delaware corporation formed exclusively to facilitate the disposition of three identical power plants in three separate states, which formerly belonged to Ten States

Nuclear Corp. The sale is expected to generate a capital gain of \$100 million on the plant located in this state and a capital loss of \$25 million on each the two plants located elsewhere. In the year preceding the sale, 10% of Ten States Nuclear Corp's apportionment factors were in this state. One day after its formation, the taxpayer's stock is sold to Risky Investments for \$500 million in cash. Because 10% of Ten State Nuclear Corp's apportionment factors in the year preceding the sale were in this state, ~~fail to reflect the location of Quick Sale Co.'s assets, 33%~~ 10% of Quick Sale's capital gain (\$50 million) is assigned to this state.

2a. Same facts, but the sale is structured as a IRC Sec. 338(h)(10) election and is deemed to be a sale of assets, not stock, under this state's income tax conformity rules. Even though the plant located in this state accounted for the only capital disposition generating a gain, the taxpayer's receipts (\$50 million) are assigned to [all ten] ~~three~~ states based on the taxpayer's apportionment factors in the year preceding the sale. ~~the location of the assets.~~

2b. Quick Sale Corp. is only taxable in this state in the year of disposition, despite the fact that Ten states Nuclear Corp. conducted business in all ten states in the year prior to the disposition. Because Quick Sale Corp. is not taxable in the other nine states, and its only "receipt" is from the capital disposition, its receipts factor in this state under Section 4 would be 100%.