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Report of The Hearing Officer: Multistate Tax Compact Article IV [UDITPA] Proposed Amendments

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MULTISTATE TAX COMMISSION

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Proposed Amendments

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Table of Contents

I. Introduction

In December, 2012, the Multistate Tax Commission (MTC) Executive Committee approved a public hearing for proposed model amendments to Article IV of the Multistate Tax Compact (Compact). The Hearing Officer held a public hearing and received nine sets of written comments. Numerous comments, many oral, were received after the hearing. This report provides a background to the amendments, a summary of the proposals' substantive features, a review of the public testimony, and the Hearing Officer's comments and recommendations, including in some cases, his proposals for a redrafted statute.

II. Background

A. Procedural Background

In 1957, after decades of attempts by various organizations to draft model state corporate income tax apportionment rules, the Uniform Law Commission (ULC) succeeded in promulgating its model Uniform Division of Income for Tax Purposes Act (UDITPA). UDITPA provides a model law for assigning the total taxable income of a multistate corporation among the states in which it does business. Article IV of the Compact incorporates UDITPA nearly verbatim. Most, but not all, enacted versions of the Compact also do.

A number of important provisions are significantly outdated. States have begun to revise these provisions unilaterally. In response to these developments, the MTC formally recommended to the ULC in September of 2006 that it initiate a project to revise UDITPA. In particular, the MTC recommended that the following five provisions be the focus of review:

1. Sales factor numerator sourcing for services and intangibles (market-based sourcing) (Compact Art. IV.17)
2. Sales Definition (Compact Art. IV.1(g))
3. Factor Weighting (Compact Art. IV.9)
4. Business Income Definition (Compact Art. IV.1(a))
5. Equitable Apportionment (Compact Art. IV.18)

In August 2007, after receiving the MTC's recommendations and additional input from the Federation of Tax Administrators, the Council on State Taxation, and others, the ULC determined that it would review and "revise UDITPA in its entirety." A UDITPA committee was formed and two reporters were appointed,[1] one of whom (Pomp) is the author of this Hearing Report. The reporters held meetings to receive additional public comment. At these meetings and in writing, the MTC explained that a revised model would help maintain a reasonable level of uniformity by giving state legislatures something to draw on as they modernize their apportionment statutes. Some taxpayer representatives and others opposed the effort. In June 2009, after considerable public comment and controversy, the ULC discharged its UDITPA committee and explained that no further work would be undertaken, with the understanding that it might re-open the effort at a later time.

The MTC suspended its efforts at reforming UDITPA while the ULC project was underway. This was reasonable because UDITPA is the ULC's model law. The MTC did not want to be seen as pre-empting or

[1] The other reporter was Prentiss Willson, Of Counsel to Sutherland Asbill & Brennan LLP.

interfering with the ULC project. But as a result time was lost on issues that were advancing rapidly, such as market-based sourcing. In retrospect, the aborted ULC project delayed the MTC's efforts to take a leadership role on fast-developing issues as evidenced by California having adopted a "benefits received" approach to market-based sourcing whereas the Uniformity Committee adopted a "delivery of service" approach.

In July 2009, the MTC Executive Committee directed that "revisions to Article IV of the compact—specifically, the five areas suggested as the focus for the Uniform Law Commission's revision project—be referred to the Uniformity Committee and that [the Uniformity Committee] come back to the Executive Committee if the Uniformity Committee recommends the scope of issues be changed." The Uniformity Committee completed its work in March 2012, and in December 2012 the Executive Committee approved the proposed model for public hearing.

B. Summary of the Uniformity Committee Proposals

The Uniformity Committee's proposals would replace the terms "business income" and "non-business income" with "apportionable income" and "non-apportionable income." Both categories would be broadened, and more generally, business income would include all income subject to apportionment under the Constitution.

The apportionment formula would be redefined in three ways: (1) the factor weighting would be left to each state, although double-weighted sales is recommended, (2) the sales factor would be limited to receipts from transactions and activity in the regular course of the taxpayer's trade or business, and (3) receipts from transactions other than sales of tangible personal property would be sourced, like those from sales of tangible personal property, to the market state.

More specifically, receipts from sales of services would be sourced to the location where the service was delivered, receipts from sale or lease of intangibles would generally be sourced to where the intangible was used, and receipts from lease of tangible personal property and the sale or lease of real property would be sourced to where the property was located.

Finally, the alternative apportionment provisions would be clarified to allow states to adopt regulations, in addition to the existing power to make ad hoc adjustments.

C. Public Hearing[2]

The public hearing was held March 28, 2013, in Washington D.C. following more than 30 days' notice. The hearing was well attended, both in-person and by telephone, with approximately 35 people identifying themselves. Oral comments were received regarding amendments to each of the five provisions. In addition, nine sets of written comments were received and are available on the MTC website at http://www.mtc.gov/Uniformity.aspx?id=5777.

D. Nomenclature and Style

Throughout this Hearing Report, "Act" is used to refer to UDITPA. References to the Act by state tax lawyers deviate from the citation used by the Compact. For example, Act Art. IV.18, the provision on

[2] All of the public comments were summarized herein by Lila D. Disque of the MTC.

alternative apportionment, is known to everyone in the field as "Section 18." The Hearing Officer follows this more common usage. The other Articles discussed in this report tend to be known by their subject matter, such as the "apportionment formula," and the "sales factor," rather than by their more formal Compact citation.

"Draft" is used to refer to the proposed changes by the Uniformity Committee. "Report" refers to a document prepared by Shirley Sicilian, MTC General Counsel, to Cory Fong, Chair of the Executive Committee, of May 10, 2012. Although the Hearing Officer quibbles with portions of this Report, it is a remarkable document that is quoted at length at various places below; the full document is worth careful study.

The Hearing Officer does not intend that this report read like a law review article, or that it reinvent the wheel. We have a shared tax culture and heritage, which means a statute like P.L. 86-272 or a U.S. Supreme Court case like *Quill* can be mentioned without any elaboration or explanation. Most readers are also familiar with the state tax literature. The intent is not to get mucked up in the weeds, or rely on a particular state's experience, statutes, or case law. To do so only invites distraction and cavils. Consequently, there are only limited citations and footnotes because descriptions of state law or cases are meant to be only illustrative of different approaches. Nor is there any reason to challenge or deconstruct Supreme Court opinions. All of that can wait for a different forum. The goal of the Hearing Officer was to fly at less than 30,000 feet but not crash land in the swamp. Any of the discussion below can be expanded and elaborated upon in future documents.

The Hearing Officer was given a broader mandate (actually no mandate at all) than has been traditional for this role. He thanks Joe Huddleston, Executive Director of the MTC, for this vote of confidence (and hopes he does not regret it).

E. Organization of the Report

Many of the issues raised by the Draft are interdependent. For example, under the Draft the sales factor includes only receipts from transactions satisfying the transactional test, which is the subject of other amendments. The Hearing Officer suggests a different definition of the transactional test than does the Draft and that suggestion has obvious implications for the sales factor. Consequently, a discussion of the transactional test best precedes a discussion of the sales factor.

As another example of interdependency, the Draft excludes from the sales factor the receipts from the treasury function and from hedging. These same receipts are also thrown out under the Draft's rule in Art. IV.17 for receipts from the sale of intangibles. Because the Hearing Officer argues that the treasury function and hedging are best dealt with under Draft Art. IV.17 and not as part of the sales factor, the former is addressed before the latter.

The Draft's revisions of equitable apportionment provide a backdrop to many of the other proposed amendments and for that reason is best discussed early on. Similarly, whether a state has a single sales factor apportionment formula rather than one incorporating property and payroll is likely to influence the evaluation of a proposed amendment. Hence there is value to discussing the Draft's proposals for the apportionment formula before more specific amendments are addressed.

Consequently, to provide a more manageable presentation, the Draft amendments are discussed in the following order: factor weighting, equitable apportionment, business income, market-based sourcing, and the receipts factor.

F. Acknowledgements

Following the Hearing, many of the luminaries in the field provided invaluable support. The exchange of views and reactions continued to nearly the date on this Hearing Report. Although time consuming, the process was invaluable.

The state tax field may be the depository of the greatest intellectual firepower in the tax profession. Generous with their time, able to put on their tax policy hats, and willing to share a wealth of experiences and observations, the following friends and colleagues happily helped educate the Hearing Officer: Mary Benton, Dan Bucks, Bruce Ely, Peter Faber, Michael Fatale, Craig Fields, Karl Friedan, Jeff Friedman, Cara Griffith, Rick Handel, Helen Hecht, Ferdinand Hogroian, Holly Hyans, Bruce Johnson, Rick Kay, Todd Lard, Doug Lindholm, Jane May, Ben Miller, Mitch Newmark, Richard Parker, Art Rosen, Ted Spangler, Kirk Stark, John Swain, Phil Tatarowicz, and Marilyn Wethekam.

Many of the views expressed below had their roots in discussions with Prentiss Willson when he served with the Hearing Officer as a co-reporter for the ULC's project on revising UDITPA. Prentiss is the proverbial "lawyer's scholar" and "scholar's lawyer." He bridges both

camps effortlessly and is a font of wisdom, experience, and sound judgment.

Lila Disque, Elliot Dubin, and Bruce Fort of the MTC's staff performed herculean assistance. Shirley Sicilian was a wonderful sounding board, intellectual provocateur, and reality check. One of the fun things about this project was getting to brainstorm with Shirley. Her charm and grace, combined with analytical rigor, made her a delight to work with.

III. Public Comment and Recommendations

A. Factor Weighting

The Uniformity Committee recommended that the apportionment formula be changed to a double-weighted sales factor.

> Art. IV.9 All business income shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus two times the sales factor, and the denominator of which is ~~three~~four.
>
> The Executive Committee changed the proposal as follows:
>
> Art. IV.9 All business income shall be apportioned to this State by multiplying the income by a fraction, [State should define its factor weighting fraction here. Recommended definition: "the numerator of which is the property factor plus the payroll factor plus two times the sales factor, and the denominator of which is ~~three~~four].

1. Reasons for Change

Most states have moved away from the Act's evenly-weighted, three-factor formula, replacing it with approaches that more heavily weight the sales factor. Today, only a small number of states unconditionally follow the Act's formula. Most either double weight the sales factor or use it exclusively.

As the Report explains, the Uniformity Committee considered five options: "(1) retain the current, three-factor equal weighting, (2) double weight the sales factor, (3) use only a single sales factor, (4) indicate that the weighting is each state's choice (this approach lacks a uniformity focus, but would acknowledge states' differing tax policies and the point that states are, in fact, moving in a uniform direction), and (5) allow taxpayers to elect a weighting which will allow it to file uniformly in all or some threshold percentage of states (unlike the taxpayer apportionment election that exists now in Compact Article III.1, this election would be limited to factor weighting and would require a consistent election in some number of other states) . . . [T]he Uniformity Committee determined that the double-weighted sales formula had the most support among the states." Report, p. 11.

The Uniformity Committee recommended a double-weighted sales factor; the Executive Committee voted to allow each state to "define its [own] factor weighting fraction," but recommended the double-weighted sales factor.

2. Public Comment

Commenters viewed this proposed amendment as an imperfect solution. Benjamin Miller, appearing on his own behalf, stated he prioritizes uniformity, and if this goal is achieved the overall result may be acceptable. Dan Bucks, who also appeared on his own behalf, objected to any attempt to move states toward a common formula in the current policy environment. Sutherland Asbill & Brennan LLP advocated a "menu of options" for states to choose from as far as factor-weighting fractions.

3. Comments by the Hearing Officer

i. A Brief History of Formulary Apportionment

At the risk of elevating brevity over precision, a brief history of apportionment follows:

Initially, separate accounting was used more frequently than formulary apportionment. Besides its conceptual weaknesses, separate accounting was expensive for taxpayers to implement because it was not the way they normally kept their books and records. Apportionment formulas started to replace separate accounting as the preferred method. Cases like *Underwood*, *Bass*, and *Hans Rees'* show that some of the early formulas consisted of one factor: property. Other states, including Massachusetts, used what came to be the UDITPA evenly-weighted, three-factor formula utilizing property, payroll, and sales. As these two approaches suggest, in the early part of the 20th century apportionment formulas differed widely among the states.

The growth of interstate mercantile and manufacturing activities was accompanied by calls for uniformity in state taxation. Well before the adoption of UDITPA, the National Tax Association (NTA) proposed an evenly-weighted, three-factor formula. The NTA did not claim that the formula was based on any economic principle or theory, or that it was better than other formulas at measuring where income was generated. To the contrary, the NTA recognized that all formulas were arbitrary. The most important thing was uniformity and that meant a formula on which the states could agree. The property and payroll factors were attractive to the manufacturing states (the origin states) and the sales factor was attractive to the market or destination states. By recommending the evenly-weighted, three-factor formula (the so-called Massachusetts formula), a formula that reflected what many states were already doing, and one that was attractive to both the origin and destination states, the NTA opted for political expediency and ease of adoption.

The NTA recommended the destination principle for the sales factor. At the time, destination was only one of the approaches used for assigning sales. Two other approaches were origin based: the state from which the goods were shipped, or the state in which the sales office was located. If the purpose of the sales factor is to recognize the contribution by the market state, a destination principle made more sense than the origin-based rules.

Despite the political attractiveness of the evenly-weighted, three factor formula, a Nobel Prize winning economist described the formula as: "[t]his simple but arbitrary and capricious formula has all the earmarks of having been concocted by a committee of lawyers who had forgotten anything they ever were taught about statistics or economics." William Vickrey, *The Corporate Income Tax in the U.S. Tax System*, 73 Tax Notes 597, 602 (1996). (Vickrey also thought a sales factor had no role to play in an apportionment formula, a common opinion among economists when UDITPA was being debated and one shared by the Willis Committee, which recommended only property and payroll factors.) This criticism ignored a major virtue of the formula: it divides something that cannot be easily assigned geographically–income–using factors that can be located geographically–property, payroll, and sales. But as the discussion of Art. IV.17 suggests, *see* Sections III.D(5)-(10) below, the sales factor might be less able to deal with the receipts from services and intangibles than the receipts from tangible property.

Because of the lack of any scientific or economic model upon which the evenly-weighted, three-factors were based, the formula could not resist attempts by states, at the urging of business, to use it to encourage economic development. Around the 1970's, a few states started to double weight the sales factor with many more doing so over the next few decades.

Compared with an evenly-weighted three-factor formula, a double-weighted sales factor results in increased tax on some corporations and decreased tax on others, and has no effect on corporations that conduct all of their activities in the state. The effect depends on the mathematical relationship between the sales factor and the property and payroll factors. More specifically, corporations whose sales factors are less than the average of their property and payroll factors benefit from a double-weighted sales factor; other interstate corporations are disadvantaged. The former describes, for example, corporations with the bulk of their manufacturing and payroll in a state that sell outside that state.

Double weighting (or using only a sales factor) results in increased tax on corporations that manufacture outside the state and sell in the state without the protection of P.L. 86-272. But for an out-of-state corporation protected by P.L. 86-272, a double-weighted sales factor will be more of a disincentive for the corporation to engage in nexus-creating activities in that state than would an evenly-weighted factor. The disincentive effects are even greater under a single-factor sales formula.

Legislators typically view the shift from an evenly-weighted to a double-weighted sales factor (or sales only) as an incentive for in-state corporations to expand their operations in the state and for out-of-state corporations to locate in the state. States have emphasized the incentive effects of the shift over the disincentive effects.

A state that finds double weighting attractive will be drawn to using only a sales factor. Mathematically, this is equivalent to placing an infinite weight on the sales factor in any formula using a property or payroll factor. A single sales factor provides the greatest benefit to corporations that are primarily producing inside the taxing state and selling outside that state, and provides the greatest detriment to those primarily producing outside the state and selling in the state. Many commentators challenge the benefits of using a single sales factor (or double-weighted sales factor) to influence economic development. Even if there are benefits, they will be neutralized as other states adopt similar measures.

From a tax policy perspective, the single sales factor is virtually indefensible. It is hard to think of situations where an interstate taxpayer generates income without the use of capital or labor. Moreover, under the right fact pattern, a single sales factor might produce results that violate the external consistency prong of the fair apportionment requirement under the Commerce Clause, results raising the possibility of alternative apportionment. In addition, using only sales to apportion income places a great burden on the rules used for assigning receipts to a state. As the discussion of Art. IV.17 suggests, *see* Section III.D, below, the Hearing Officer is concerned whether the various existing state rules or those proposed in the Draft can meaningfully bear that burden (at least for interstate business-to-business transactions).

Politically, corporations prefer a tax reduction implemented by changes to the apportionment formula, as opposed to a visible reduction in the tax rate or an increase in grants or credits. Compared to these other ways of benefitting corporate investment and activities, a change in the apportionment formula is more opaque and non-transparent, and more likely to escape notice and debate.

ii. Double Weighting As a Fair Compromise

There is no science, economic theory, or model that determines the normative weighting of the factors, or for that matter, what the factors should even be. At the least, a double-weighted sales factor has the advantage of sharing the tax base equally between the origin (or production states) and the destination (or market states), assuming sales are assigned to the latter. There are no strong normative reasons for favoring the origin states over the destination states or vice versa so that double-weighting is a reasonable and fair compromise. If the payroll and property factors are viewed as double-weighting the origin states, that is balanced by double-weighting the sales factor.

The states did not adopt a double-weighted sales factor, however, because they thought it was a fair compromise. The overriding reason was economic development—the same reason motivating the movement to a single sales factor.

iii. The Recommendation of Double Weighting is Unlikely to Have any Significant Effect

The Executive Committee's proposal to allow states to define the factor weighting fraction is a concession to reality. The states have long deviated from the Act's three-factor, evenly-weighted formula. The proposal merely reflects the current state of affairs.

The recommendation of double weighting is unlikely to have much effect. A substantial number of states currently double weight; the only effect of the recommendation will be if it discourages some of them from moving in the direction of a single sales factor. States that have already made that change are hardly going to abandon it because of the Draft, unless they are unhappy with a single sales factor for other reasons, perhaps because a loss in tax revenue is not offset by increased economic activity. The group that might be affected will be the small number of states currently conforming to the Act. The Draft will release them from the obligation of using a three-factor, evenly-weighted formula, although some of these states may move directly to using only sales and skip double weighting entirely.

The Act's evenly-weighted, three-factor formula did little to stop the movement to double weighting or to the single sales factor. Double weighting may be sound tax policy, but considerations of economic development will typically prevail.

iv. The Effect on Uniformity

The recommendation that states can do what they want with the formula will probably be criticized by some as a major setback for uniformity. When the Hearing Officer was a co-reporter for the ULC project, he was often told that if no agreement could be reached on the formula, there was no reason to continue with the project.

The Hearing Officer dismisses this view. Even back in 1957, when UDITPA was proposed, uniformity never quite existed. Long before the evenly-weighted, three-factor formula emerged as the consensus approach, specialized formulas were used for specialized industries—and these were often quite different from the three-factor formula. (The Hearing Officer has not attempted to determine whether the states used *similar* industry-specific formulas; some similarity no doubt existed.) These specialized formulas co-exist today with the Act's formula. The MTC, which has labored mightily to develop industry-specific formulas, has not been criticized (nor should it have been) on the grounds that these efforts have thwarted uniformity. To the contrary, one of the reasons the corporate income tax has proven to be so resilient in light of the considerable structural changes in the economy has been the development of these alternative formulas.

In 1957, the Act's evenly-weighted, three-factor formula applied primarily to manufacturing and mercantile activities, which at that time represented a significant percentage of the country's gross domestic product (GDP). With the rise of interstate activities subject to specialized formulas, which do not incorporate an evenly-weighted, three-factor formula, such as those covering financial services, telecommunications, broadcasting, and advertising, combined with the country's loss in manufacturing, the Act's apportionment formula has come to cover less of the country's GDP. This suggests that the movement away from the 1957 formula was less a threat to uniformity than is sometimes asserted. Furthermore, given the specialized formulas that always existed, the uniformity in the apportionment formulas that prevailed in 1957 is probably overstated. Finally, the MTC industry-specific regulations that do not adopt the evenly-weighted, three-factor formula cover major sectors of the service economy. The Act's formula has simply come to cover a less significant percentage of GDP.

More fundamentally, perhaps uniformity should be viewed on an industry basis, rather than on a more general level. The lack of criticism of the MTC industry regulations as undercutting uniformity may be an implicit endorsement of this view. If so, the MTC's regulations covering the apportionment of specialized industries such as financial institutions, telecommunications, airlines, railroads, trucking companies, and television and radio broadcasting have done more to promote uniformity than the movement away from the three-factor formula has done to undercut uniformity.

Even these detailed industry-specific regulations cannot respond to what some might argue the concept of uniformity requires: identical tax rules on taxable income and nexus; identical interpretation of terms and concepts; and identical rates. To take those goals seriously, however, would paralyze legitimate efforts at harmonizing the rules on apportionment.

v. Concluding Observation

The Hearing Officer endorses the Executive Committee’s Proposal. Notwithstanding the recommendation for double weighting, the march to a single sales factor can still be expected to continue. The Hearing Officer believes that the most useful role for the MTC is to continue its cooperative efforts with the private sector to formulate industry-specific rules of apportionment. The MTC has a track record in being able to bring interested parties together in a spirit of cooperation and formulating workable model regulations.

B. Equitable Apportionment

The Uniformity Committee recommends adding a new paragraph to the existing language in Article IV.18.

Article IV.18.

(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).

1. Reasons for Change

Art. IV.18, commonly known as "Section 18," or alternative or equitable apportionment, recognizes that one size does not fit all. That is, the apportionment provisions (and less commonly, the allocation provisions) cannot work well in every possible situation. Section 18 acts as a safety valve, allowing tax administrators and taxpayers to smooth the rough edges of the apportionment and allocation provisions when applied to a particular transaction.

Some doubt exists whether the existing language of Article IV.18 authorizes the promulgation of regulations–hence the proposed new paragraph. The Act's references to the *taxpayer's* business, using the singular, rather than the plural–*taxpayers' businesses*–and the reference to the *taxpayer's* activity rather than *taxpayers' activities*, raise the possibility that Section 18 does not authorize industry-wide regulations. Despite this doubt, many states have nonetheless issued regulations under Section 18. Many times these regulations were formulated in cooperation with the affected industries, which have no reason to challenge them as unauthorized by the Act.

Neither the Proceedings of the Uniform Commissioners nor the official Comment accompanying Section 18 address whether its language was intended to authorize the promulgation of regulations. The single Comment states: "Section 18 is intended as a broad authority, within the principle of apportioning business income fairly among the states which have contact with the income, to the tax administrator to vary the apportionment formula and to vary the system of allocation where the provisions of the Act do not fairly represent the extent of the taxpayer's business activity in the state," which does not explicitly refer to regulations. Commentary by participants in the drafting of UDITPA, however, suggests that regulations were anticipated. Certainly the states, with the support of the MTC, have long relied on Section 18 as their basis to issue industry-specific regulations. Indeed, part of MTC Reg. IV.18(a) provides that "[i]n 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 may 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." (The Regulation does not address the use of separate accounting.)

The Report states that the MTC has interpreted Section 18 as its authority to adopt model special apportionment rules. Report, p. 25. But these rules are hortatory and have no binding effect so that the MTC needs no authorization for their adoption. In any event, Art. VI.3 of the Compact provides the MTC with the power to "recommend proposals for an increase in uniformity or compatibility of State and local tax laws with a view toward encouraging the simplification and improvement of State and local tax law and administration." If the MTC needs any authority to issue non-binding regulations, this provision should provide it.

The purpose of the Draft is to conform the statute with the longstanding position of the MTC and of tax administrators by granting the power to establish rules or regulations, provided they are applied uniformly. The Draft preserves the right of taxpayers to request, or tax administrators to apply, alternative apportionment independent of any regulations.

A second part of the current MTC Regulation cited above addresses more limited applications of Section 18. That part provides that "Article

IV.18. permits a departure from the allocation and apportionment provisions of Article IV only in limited and specific cases where the apportionment and allocation provisions contained in Article IV produce incongruous results . . ." Prior to 2010, this part of the regulation provided that "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." Former MTC Reg. IV.18(a).

The Hearing Officer understands that the language "unusual fact situations (which ordinarily will be unique and non-recurring)" was removed in 2010 to facilitate responses to the so-called treasury function cases that were being litigated across the country. *See* Hearing Officer's Report: Recommendation Concerning Proposed Amendment to Multistate Tax Commission's Model Allocation and Apportionment Regulation IV.18.(a): Equitable Adjustment of Standard Allocation and Apportionment Rule, dated March 29, 2010, *available at* http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Committees/Executive_Committee/Scheduled_Events/Section18hearingofficerrepfinal.pdf (last visited Oct. 13, 2013). The change was intended to avoid the argument that Section 18 should be applied *only* in the case of unusual, unique and nonrecurring situations, which would not describe the commonplace treasury function. The change also eliminates the argument that "nonrecurring" means occurring "only once" in the life of the taxpayer.

The Draft, by authorizing regulations, also puts to rest what some had viewed as a tension between the two parts of MTC Reg. IV.18(a)(both the former and current versions). This view suggested that the admonition that Section 18 should be used sparingly was inconsistent with the promulgation of industry-wide regulations. Moreover, efforts at uniformity would be undermined if alternative apportionment moved away from being seen as a narrow exception to the more general provisions in the Act.

Whether alternative apportionment should address only limited situations rather than industry-wide transactions reveals a deeper conflict between the appropriate roles of the legislative and executive branches. Under Section 18, an executive branch employee—a tax administrator—is given the power to deviate from (and thus functionally replace) the detailed and specific apportionment and allocation rules promulgated by the legislative branch in order to implement the legislative goal of more "fairly represent[ing] the extent of the taxpayer's business activity in this State." This is a broad delegation of power to the executive branch, which when exercised at the initiative of a tax administrator, can undercut the reliance interests of taxpayers that filed returns based on the Act. Even when a taxpayer is granted the right to use equitable apportionment at its request, the even-handed treatment of any similarly situated taxpayers can be jeopardized. These considerations suggest a narrow application of alternative apportionment. (These considerations also suggest that any regulations issued under Section 18 should be prospective only.)

The power to deal with narrow situations and the power to issue regulations represent two very different conceptions of the relationship between the legislative and executive branches. The Draft would grant executive branch employees the power to promulgate industry-wide regulations, granting a tax administrator discretion to set aside the statutory apportionment and allocation rules and substitute an alternative of broad application, not specifically endorsed by the legislature (although one the legislature could overrule if it disagreed with the tax department).

In other areas of non-tax law, it is common to set forth legislative goals in very broad terms, such as “just and reasonable rates,” or “public convenience and necessity,” with a broad delegation to an executive agency to implement those goals. Typically, the actions of the agency implementing these broad goals are public, transparent, and highly visible, which would likely be true of regulations under Section 18. By contrast, ad hoc actions under alternative apportionment are typically confidential.

2. Public Comment

Mr. Miller, Peter L. Faber, and Sutherland all noted in their comments that Art. IV.18 should make explicit which party carries the burden of showing the need for variation. Sutherland suggested the MTC look at options to limit the application of Section 18 to be consistent with its intent. It also suggested clarifying that the section applies only to alternative apportionment and not alternative tax base calculation.

3. Comments by the Hearing Officer

i. Regulation versus Statute

As a policy matter, the granting of power to tax administrators to adopt alternative apportionment through regulations might be opposed on the grounds that Section 18 should be used sparingly and that the adoption of regulations is far removed from the provision's roots. Regulations that a tax department might adopt should be adopted by a legislature.

The Hearing Officer appreciates this view but also acknowledges the widespread existing reliance by tax administrators on Section 18 as the authority for the promulgation of regulations; that reliance is unlikely to be reversed. Also, there is some support for the view that Section 18 was meant to authorize such regulations. The Hearing Officer believes that industry-wide guidance is desirable—the issue is whether that goal is best achieved through regulations or by statutes and that choice cannot be resolved in the abstract.

Whether the legislature should adopt a statute or the tax department should adopt a regulation is difficult to decide as an a priori matter. In any given state, the allocation of responsibilities for tax drafting probably reflects well-entrenched political traditions. But contrary to one asserted advantage, the legislative process does not necessarily guarantee taxpayers more procedural protections than does the regulatory process. Most (if not all) states have administrative procedures acts that are consistent with the federal Administrative Procedures Act (APA) or the Model State Administrative Procedures Act. These procedures allow taxpayers to participate in various capacities throughout the regulatory process. The protections under these Acts might equal or exceed whatever rights a taxpayer has to participate in the legislative process. Ultimately, however, taxpayers unhappy with regulations can always appeal to a legislature to overturn them. In that sense, the legislature is the final arbiter.

While the Hearing Officer endorses the Draft's delegation of regulatory authority to tax administrators, the preference of the Hearing Officer is to have the MTC continue its leadership role in promulgating industry-wide regulations. The MTC already has a successful record at dealing with the financial institutions, telecommunications, airlines, railroads, trucking companies, and television and radio broadcasting. The MTC with its sophisticated expertise, depth of experience, and transparent procedures should continue its efforts at drafting industry-specific regulations. Whether an MTC regulation is adopted in whole or in part by a tax department or a legislature, the quality of decision making at the state level is dramatically enhanced by the efforts of the MTC in conjunction with the private sector. The MTC can marshal resources at the national level that would be beyond the capabilities of most states.

Finally, nothing in the Draft or the discussion above would affect a tax department's normal procedures of issuing non-binding guidance on how it will treat certain transactions or industries. A department should be free to explore various preliminary approaches as it gathers experience and sharpens its understanding of taxpayers and their business practices, and to provide early guidance to the public. Rather, the issue is whether once a tax department has enough knowledge about a particular problem area to apply its position uniformly to that industry or transaction, it can take the next step and issue binding regulations rather than asking the legislature to intervene. On balance, the Hearing Officer finds no compelling reason why a department should be deprived of the power to issue regulations. If the custom and tradition of a state favors statutory rather than regulatory intervention, a tax department can always invite the legislature to become involved.

ii. The Burden of Proof Should be on the Party Invoking Alternative Apportionment

One written comment submitted at the Hearing made several suggestions, including a recommendation that the Draft should address which party—the taxpayer or the tax administrator—has the burden of proof when invoking equitable apportionment.

The Hearing Officer concludes that the broad consensus among the states is that whichever party is seeking alternative apportionment has the burden of proof. It seems obvious to many courts that the burden should be placed on the party invoking alternative apportionment because that party is asking permission to deviate from the general rules on apportionment and allocation. On the other hand, there is a presumption of correctness that accompanies a department's assessment. If that applies in the context of alternative apportionment the taxpayer would *always* have the burden of proof.

The Hearing Officer concludes that the view that the party invoking alternative apportionment has the burden of proof reflects general principles of American jurisprudence, although these are rarely articulated in the cases dealing with Section 18. These principles are suggestive rather than determinative and in isolation none is definitive. Taken as a whole, however, and applied in the context of Section 18, they support the consensus view that the party invoking alternative apportionment should have the burden of proof.

First, the party that pleads a fact generally has the burden of proof. That would be whichever party–the tax department or the taxpayer–invoked alternative apportionment.

Second, the burden of proof commonly falls on the party that seeks to change the existing, general state of affairs. In the case of Section 18, the existing, general state of affairs is represented by the Act's general apportionment and allocation rules. Those represent the legislative norm. The party seeking to deviate from the norm is the party invoking alternative apportionment. Put differently, the person who claims the benefit of an exception to a general rule typically has the burden of proof.

Third, the general jurisprudential principle of handicapping or discouraging a disfavored contention would place the burden of proof on the party seeking alternative apportionment. Section 18 is meant to apply sparingly (other than industry-wide regulations). Those ad hoc situations should be kept to a minimum. Consequently, the party seeking alternative apportionment should have the burden of proof.

Fourth, the party with access to particular facts should have the burden of proof. If, for example, a tax department has access to particular facts that justify its invocation of alternative apportionment, such as metrics gleaned from others in the industry that filed returns, it ought to have the burden of proof.

Finally, the burden of proof is usually placed on the party that contends the more unusual event has occurred. As applied in the context of

Section 18, that would be the party seeking a narrow deviation from the more general and specific rules on apportionment and allocation.

For a further discussion of the above principles, see McCormick on Evidence, Sec. 337, (5th ed. 1999); Sutherland Statutes and Statutory Construction, Sec. 47:11 (7th ed. 2007).

The Hearing Officer recommends to the Executive Committee that Section 18 contain an explicit provision stating that the party invoking alternative apportionment should have the burden of proving that the statutory conditions are satisfied, and that the burden should be the same for either the taxpayer or the tax administrator. The state's normal rules on the applicable level or standard of proof would apply.

The Hearing Officer recognizes that the burden of proof can be described as a procedural issue and not an apportionment or allocation issue. Procedural issues have traditionally been viewed as outside the scope of the Act. But uniform procedural issues can encourage uniform outcomes and thus further the goals of the Act.

iii. No Penalties for Following the Act

The written comments presented at the Hearing also suggested that Section 18 should prohibit the imposition of penalties if a taxpayer files a return consistent with the Act, but the tax administrator successfully invokes alternative apportionment. The Hearing Officer agrees (and in the interest of disclosure, was involved in a case raising this issue). Normally, a taxpayer cannot be expected to anticipate that a tax administrator will successfully displace the statutory provisions on apportionment with an alternative method. A taxpayer that has followed the apportionment and allocation provisions in the Act should not be punished unless that reliance is unreasonable.

From a tax policy perspective, penalties are useful for punishing and discouraging willful and purposeful conduct, which in turn should encourage voluntary compliance. A taxpayer filing a return that is consistent with a statute (and its interpretation) is not acting in any manner that should be punished. Imposing a penalty under those circumstances is equivalent to penalizing a driver for exceeding a speed limit known only to the police.

This approach is not intended to prevent a tax department from imposing penalties in tax avoidance situations. A tax department can continue to argue a transaction is a sham, lacks economic substance, does not reflect arm's length pricing, violates the step transaction doctrine, and the like. A state may also have adopted special penalty statutes dealing with tax avoidance. The Hearing Officer does not intend that violations of these statutes or anti-abuse doctrines would be precluded. Such situations and the concomitant penalties are outside the Act. The Hearing Officer is concerned with non-abusive situations where a tax department might impose a method that a taxpayer could not have reasonably expected, or perhaps was even unavailable to the taxpayer as a filing method. The Hearing Officer finds the imposition of penalties in this situation to be unreasonable.

The Hearing Officer's draft below incorporates the view that penalties are not appropriate when a taxpayer reasonably follows the statute, although he realizes that some will object on the grounds that this is a procedural matter that should be left to a state's existing rules on penalties. But the Hearing Officer regards the ancillary procedural rules implementing Section 18 as furthering uniformity in that taxpayers should not be punished in some states for behavior that is not punishable in other states.

iv. No Retroactive Revocation of Alternative Apportionment

One comment suggested that if a taxpayer successfully petitions for, and receives, Section 18 alternative apportionment, that permission should not be revoked retroactively. In other words, the tax administrator should not be able to reject a return already filed using the agreed-upon alternative. The Hearing Officer agrees provided that the taxpayer's petition for alternative apportionment did not misstate or misrepresent any material facts. The Hearing Officer would go even further and protect any transaction that has already occurred regardless of whether a return has yet been filed. The reliance interests that deserve protection are those accompanying the transaction, not the filing of a return.

v. Regulations under Section 18 Should be Consistent with the Legislature's Intent

The Draft grants broad discretion to a tax administrator under Section 18 to draft regulations. Those regulations will replace the specific apportionment and allocation provisions of the Act, as adopted by a legislature. Situations could arise where the regulations (or indeed alternative apportionment imposed on an ad hoc basis) are inconsistent with the intent of the legislature.

Consider, for example, the following illustration. Suppose a legislature rejected a bill that would have adopted an alternative method for apportioning the income of Industry X. Should a tax administrator be free to adopt that same method through a regulation (or on an ad hoc basis) under Section 18 that is applicable to Industry X (or to a firm in that industry)?

The problem is that discerning legislative intent is not always straightforward. Not all tax proposals are presented to a legislature for a final "up or down" vote. There can be hearings on bills that are never voted out of committee. Others will never even be set down for a hearing. Some proposed legislation will die for lack of a sufficient number of sponsors. Others will be traded for something of more interest to an industry. Not all of these situations are tantamount to the full legislature having rejected a particular proposal. And even where there is a straight "up-or-down" vote, a proposal might be rejected for reasons having nothing to do with the merits.

A tax administrator can be expected not to waste administrative resources adopting a regulation that a legislature is likely to overrule by statute. In the end, this problem of discerning legislative intent is best left to the judgment of tax administrators. (The same problem can arise today under the existing Act when a tax administrator invokes alternative apportionment on an ad hoc basis.)

vi. When Should a Department's Position on Alternative Apportionment be Published as a Regulation or Rule (or Equivalent)?

On the one hand, if alternative apportionment were limited to unique, non-recurring, isolated situations, few would argue that a tax department should publish that result in a regulation—there would be no value in doing so because few, if any, other taxpayers would care.

On the other hand, a position on alternative apportionment that has broad application to an entire industry and was intended to be applied generally and uniformly to that industry should be published as a regulation. (Indeed, a state's administrative procedures act might require that a regulation be issued under these circumstances.) These are two bookends between which a wide variety of situations can arise.

Some contend that an ad hoc application of alternative apportionment is improper when the problem being addressed is widespread. Situations are becoming common, involving advertising, financial services, and broadcasting where a department is using alternative apportionment to contravene the interaction of various elements in a state's tax regime. For example, consider the logical consequences of a state's adoption of a single-sales factor with a cost of performance (COP) rule, (or a rule that uses the percentage of days spent in the taxing state) for assigning receipts from services. An out-of-state service provider with numerous in-state customers may never spend any time in the state and accordingly assign no sales to that state under COP (or under the percentage of days spent) methods. Consequently, the taxpayer would apportion no income to the state.

This result is entirely predictable. It is hardly an isolated, limited, or non-recurring situation. The taxpayer is representative of a common pattern. There is nothing unique about the taxpayer's facts. Some might conclude that under these facts alternative apportionment is inappropriate. Nonetheless, if a tax department objects to a taxpayer apportioning no income to the state and invokes alternative apportionment and applies some version of market-based sourcing, that approach should be adopted in the form of a regulation because of the broad application to all out-of-state service providers. (In the interests of disclosure, the Hearing Officer was involved in a case raising this issue.)

A regulation serves the goals of transparency, notice, and even-handed treatment of similarly situated taxpayers. In addition, the procedures governing the promulgation of a regulation will in the normal course of events bring the situation to the attention of the legislature, providing it with the opportunity to evaluate whether the interaction of its statutes was intentional or inadvertent. A taxpayer could, of course, also contact the legislature but may not wish to do so out of fear of offending—or undercutting—its working relationship with the department.

The Draft implicitly and only weakly serves the goals of transparency, notice, and even-handed treatment of similarly situated taxpayers by allowing, but not requiring, the tax administrator to establish appropriate rules or regulations if the alternative apportionment affects all taxpayers engaged in a particular industry or in a particular activity. The Hearing Officer believes that the goals of the democratic process and sound principles of tax administration are best served if alternative apportionment of general and widespread applicability is *required* to be established as a rule or regulation, which must be applied uniformly.

Without this safeguard, Section 18 becomes a way for a tax department to undercut a tax regime that might reflect a legislature's value judgments and that was the result of a process that benefited from public input and comments. A function of a legislature is to balance competing interests of taxpayers and the government. The non-public use of alternative apportionment is tolerable when unique, non-recurring, or special circumstances are involved. Non-disclosure, however, is inappropriate when alternative apportionment has widespread and broad applicability.

vii. Obsolete References to Illustrations of Alternative Methods

Art. IV.18(a)(1) contains three examples of acceptable alternative methods under Section 18: separate accounting; the exclusion of one or more of the factors; or the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this State. A residual rule provides for the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income. Presumably, the three examples are subsumed by the residual rule.

In 1957 when the Act was adopted, the three examples might have been useful because of the limited experience by the states with concepts like equitable apportionment. Unlike Art. IV.1 where the Draft’s incorporation of the existing definitions of business income is valuable because of the long history of judicial interpretation, *see* Section III.C(1), here the three illustrations have had much less impact, especially in light of the residual rule. While there is no harm in retaining them, in the interest of a cleaner and more modern draft they can be eliminated without any loss in clarity or interpretation, relying on the residual rule to provide for a broad range of possible alternatives.

4. Proposed Draft by the Hearing Officer

The Hearing Officer’s comments above are incorporated in his proposed statute as follows:

18. (a) If the allocation or apportionment provisions of this Act 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, any reasonable method to effectuate an equitable allocation and apportionment of the taxpayer's income.

(b)(1) If the allocation or apportionment provisions of this Article do not fairly represent the extent of business activity in this State of taxpayers that are engaged in, or representative of, a particular industry, or that engage in a particular transaction or activity of general applicability, then a [tax administrator] that requires a reasonable method to effectuate an equitable allocation and apportionment of income that it applies uniformly to such industry, or to such transactions or activities, shall publish that method in appropriate rules or regulations.

(b)(2) Rules or regulations 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 (a), must prove by [Drafter’s note: insert standard of proof here]: (1) that the allocation or apportionment provisions of this Article do not fairly represent the extent of the taxpayer's 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.

(d) If the [tax administrator] requires any method to effectuate an equitable allocation and apportionment of the taxpayer's income, he or she cannot impose any civil or criminal penalties solely because the taxpayer reasonably relied on the allocation and apportionment provisions of this Article in filing a return.

(e) A taxpayer that has been permitted by the [tax administrator] to use a reasonable method to effectuate an equitable allocation and apportionment of the taxpayer's income shall not have that permission revoked with respect to transactions and activities that have already occurred unless there has been a material change in, or a material misrepresentation of, the facts provided by the taxpayer upon which the [tax administrator] reasonably relied.

C. Business Income

The Uniformity Committee recommended the following amendments:

Art. IV.1(a) "~~Business~~Apportionable income" means:

(i) all income that is apportionable under the Constitution of the United States and is not allocated under the laws of this state, including:

(A) income arising from transactions and activity in the regular course of the taxpayer's trade or business, and ~~includes~~

(B) income arising from tangible and intangible property if the acquisition, management, employment, development, ~~and~~ or disposition of the property ~~constitute integral parts of~~ is or was related to the operation of the taxpayer's ~~regular~~ trade or business ~~operations~~; and

(ii) any income that would be allocable to this state under the Constitution of the United States, but that is apportioned rather than allocated pursuant to the laws of this state.

Art. IV.1(e) "Non-~~business~~apportionable income" means all income other than ~~business~~apportionable income.

1. Reasons for Change

The Report states that "[a] majority of states have interpreted this definition to provide two tests for identifying apportionable business income: a transactional test and a functional test. The transactional test refers to 'income arising from transactions and activity in the regular course of the taxpayer's trade or business.' It focuses on the frequency and regularity of the transaction that produces the income. For example, income from the sale of taxpayer's products to its customers would meet the transactional test. The functional test refers to 'income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.' The functional test focuses on the property that is being disposed in the transaction that produces the income. For example, income from the sale of machinery or equipment that the taxpayer used to produce its product, or otherwise used in its unitary business, would meet the functional test.

“However, the language of the Act is not very clear and some state courts have held UDITPA provides only a transactional test. Under this minority view, the words ‘and includes’ make the second clause (the functional test) a qualifying clause that serves to exemplify a certain type of income that is included only if it also fits within the first clause (the transactional test). Under this interpretation, income from the sale of machinery used in the taxpayer’s unitary business would only be included in business income if that type of machinery is sold on a regular basis. For example, a car rental agency that routinely sells and replaces cars used in its rental fleet would treat income from such sales as business income. In states where the courts found that the definition contains only a transactional test, the legislatures generally followed-up with a statutory amendment to clearly add the functional test.

“There has also been a legislative trend over the last few years to define business income simply as all income apportionable under the U.S. Constitution. In part, this trend is a reaction to judicial decisions holding that income arising from the liquidation of a business cannot be included business income. In a nutshell, the theory behind these decisions is that income can’t be ‘business income’ if there is no longer any business. A policy concern with this theory is the potential mismatch from allocating gain on the sale of a unitary asset after apportioning expenses, such as depreciation, associated with that same asset.

“Although the definition of ‘business income’ is changing in many states through judicial interpretation and legislative amendment, there remains a high level of uniformity because states have moved largely in the same direction–toward maintaining a broad interpretation of business income. The question is whether the model provision should be amended to clarify the existence of both a transactional and functional test, and to include gain from the sale of unitary business assets . . . Report, pp. 7-8.

“The proposed language begins with a broad statement of intent to include all income that is apportionable under the constitution . . . This broad definition is intended to include gains from liquidation of a unitary business, including a liquidation that is a deemed sale of assets under I.R.C. 338(h)(10) and regardless of how the gains are used. To address confusion over how ‘business income’ could include income from selling the business itself, the draft would rename ‘business income’ as ‘apportionable income.’ One option would be to end the definition after this broad statement referencing the constitution. But, constitutional boundaries can be amorphous. In order to provide more statutory guidance, the transactional and functional tests are retained. Under the proposal, business income includes, but is not limited to, income that falls within one of these two tests.

“The proposal also clarifies the functional test in four ways. First, the list of activities which describe how property can become integrated into the business are expanded from ‘acquisition, management, and disposition’ to include ‘employment’ and ‘development’ as well. Presumably, ‘employment’ and ‘development’ are contained within the meaning of ‘management,’ but they are now listed explicitly. Second, this list of activities is now connected with an 'or' rather than an 'and' to clarify that any one of these activities can integrate property into the business.

. . . .

"The third functional test clarification is to delete the word 'regular.' In the current rule, both the transactional and functional tests use the word 'regular.' This has led to questions of whether 'regular' limits the functional test to frequent transactions . . .

"Because there is potential for confusion, and little to be gained, by modifying 'trade or business' with the word 'regular;' the term is deleted.

"The fourth functional test clarification is to require that the property be 'related to the operation,' rather than constitute an 'integral part,' of the taxpayer's trade or business. In the current rule, the term 'integral' is the touchstone for determining whether property has a close enough relationship to the taxpayer to satisfy the functional test. But the term is subject to multiple interpretations . . . The language of the U.S. Supreme Court in *Container* and *Allied Signal* requires that the property from which the income arises performed an 'operational' function, that it be 'operationally related to' or 'related to the operation of' the taxpayer's business, in order for the income to be apportionable. This phrase–'related to the operation'–was chosen because it is more concrete than 'integral part' . . ." Report, pp. 8-10.

2. Public Comment

Mr. Bucks endorsed all proposed changes in Art. IV.1(a) and (e). Mr. Miller endorsed replacement of the word "business" with "apportionable," in order to promote uniformity. However, comments provided by Mr. Miller and Sutherland objected to the new constitutional standard. Mr. Miller believed the standard would be constantly changing; Sutherland stated the standard would be too broad and would lead to inconsistent interpretation.

Mr. Miller approved of the change to Art. IV.1(a)(i), clarifying that there are two separate tests for determining apportionable income. He stated, "the proposed change makes it clear that income arising on the disposition of property that is or was an asset of a unitary business gives rise to apportionable income. The majority of the disputes in state courts have arisen on the disposition of assets that were used in the business and, in particular, when the assets were disposed of in terminating a line of business or activities in a state. From my perspective, there are several compelling justifications for treating the results of these dispositions as apportionable income."

Sutherland objected that the phrase "is or was," in the proposed language effectively terminates what is commonly referred to as the "cessation of business" exception from business income. Mr. Faber objected to the phrase "is or was" on grounds that it is not time-limited. Furthermore, he stated subparagraphs (A) and (B) were unnecessary, and could be viewed as limiting the generality of the basic proposition that all income that is constitutionally apportionable should be apportioned.

Mr. Miller supported the addition of Art. IV.1(a)(ii), noting that states would encourage uniformity by choosing to apportion an item of income which other states could only apportion.

3. Comments and Recommendations by the Hearing Officer

Much of the Hearing and written comments focused on the addition of Draft Art. IV.1(a)(i): "all income that is apportionable under the Constitution of the United States and is not allocated under the laws of this state, including . . . "

On the one hand, comments at the Hearing asked whether the above language, the constitutional standard, might be viewed as rendering (A) and (B) unnecessary, or even worse, that those paragraphs could be viewed as limiting the basic proposition that all income that is constitutionally apportionable should be apportioned.

On the other hand, some asked whether the redrafting of (A) and (B) would make the constitutional standard unnecessary. The constitutional standard was criticized as lacking any real guidance and inviting unending litigation.

No one challenged the clarification in (A) and (B) that the definition of business income (appropriately changed in the Draft to read "apportionable income") includes both the transactional and functional tests. Nearly all states have reached that position, either through court decisions or through changes in their statutes (often in response to a court decision). Besides clarifying that there are two tests, the Draft proposes some changes in the wording of these tests. None of the comments specifically focused on these changes.

i. Change in Name from Business Income to Apportionable Income and from Non-business Income to Non-Apportionable Income

The term "apportionable income" is more descriptive and informative than the term "business income." Similarly, "non-apportionable income" is more descriptive and informative than "non-business income." The reason is that the goal of Art. IV.1 is to determine what income is apportionable. The prior use of the term "business income" failed to capture or convey that goal. Moreover, the term "non-business income" was misleading because the income being described was indeed income of a business. By skipping the intermediate terms of business or non-business income and proceeding directly to the ultimate goal of apportionable or non-apportionable income, the Draft should further sound analysis and reduce confusion.

ii. Modifying the Definition of Transactional Income in (A)

The Draft properly deletes the word "includes" between Draft Art. IV.1(a)(i)(A) and Draft Art. IV.1(a)(i)(B). The "includes" led to confusion about whether the functional test in (B) was an independent second definition or an example of what was included within (A). The Draft ends that confusion and makes it clear that two tests exist, a position that is the consensus view among the states. Consistent with that change, the word "and" at the end of (A) should be changed to "or." *Compare* Int. Rev. Code of 1986, Sec. 61.

Aside from the deletion of the word "includes," Draft Art. IV.1(a)(i)(A) tracks the language in Act Art. IV.1(a). It thus incorporates the phrase "income arising from transactions and activity in the regular course of the taxpayer's trade or business." This definition is narrower than constitutionally required and is inconsistent with the broader philosophical approach of apportioning income to the fullest extent of the Constitution.

In addition, Draft Art. IV.1(a)(i)(B) deletes the word “regular” from the Act’s functional definition, but retains it in (A). In the opinion of the Hearing Officer, “regular” is not required for a constitutional definition of the transactional test in (A), and its existence has led to adverse litigation in some states. The retention of “regular” in the transactional test in (A), combined with its deletion in the functional test in (B), is certain to be the target of future litigation. The Hearing Officer recommends that “regular” be deleted from (A).

Without the term “regular” in (A) some transactions might fall within both (A) and (B). (Services would fall only within (A)). The Hearing Officer is less concerned about this situation than about a transaction falling within neither (A) nor (B).

One possible change for the Executive Committee to consider is drafting (A) to read “income related to, or part of, the operation of a taxpayer’s trade or business.” This change would free the definition from the need to interpret the word “regular,” which has been eliminated for good reason in (B). The word “operation” is used to reference the language of *Allied Signal*, which some might argue is unnecessary, but nonetheless seems a cautious change.

The Hearing Officer recognizes that there is some advantage in not straying too far from the existing language in the Act. There is value to auditors, taxpayers, and the courts in being able to rely on existing precedent interpreting the current (A) (assuming it would be relevant to the redrafted (A)). Accordingly, tracking the language of current (A), without incorporating its existing weaknesses, serves a useful purpose even if some situations might now be covered by the redrafted (A) and the redrafted (B).

In addition to the benefits of predictability and guidance, the more similar the proposed language in (A) tracks the existing language in (A), the less the need to resort to the constitutional standard. This would appear to be an adequate answer to the argument that (A) and (B) are not needed at all if apportionable income is defined *solely* as all income apportionable under the Constitution. As a theoretical matter this argument is correct; as a practical matter of drafting, however, there is value in keeping (A) and (B), provided both sections are broadened as suggested by the Uniformity Committee and in the Hearing Officer's proposed draft below.

iii. Modifying the Definition of Functional Income in (B)

The Draft expands the existing definition in (B) by adding "employment, development," Draft Art. IV.1(a)(B), a useful change that raised no discussion at the Hearing or in the comments. The Draft also deletes the word "and" in (B) and replaces it with "or," clarifying that the series of terms are in the disjunctive and not conjunctive. This clarification eliminates a major source of prior controversy over the interpretation of (B) and comports with the goals of the Draft.

The Draft deletes "regular" and "integral part," and replaces these references with "related to the operation." Draft Art. IV.1(a)(i)(B). These changes eliminate prior confusion, and make it clear that partial or full liquidations of a business will constitute apportionable income, which is one of the goals of the Draft. In the opinion of the Hearing Officer, these changes in (B) are constitutional and overdue.

The Draft includes property that *was related to the operation of the trade or business*, with no time limit imposed. Draft Art. IV.1(a)(i)(B). Consequently, property used in the past but no longer being used would be included within (B). This raises the possibility that if property had been used in the taxpayer's business operations many years ago but had been held purely as an investment since then, its sale would produce apportionable income.

On this point, the Draft appears inconsistent with an MTC Regulation providing that "property that has been converted to nonbusiness use through the passage of a sufficiently lengthy period of time (generally, five years is sufficient) or that has been removed as an operational asset and is instead held by the taxpayer's trade or business exclusively for investment purposes has lost its character as a business asset . . . Property that was an integral part of the trade or business is not considered converted to investment purposes merely because it is placed for sale." MTC Reg. IV.1(a)(5)(A).

The reference in the Draft to property that *was related to the operation of the business* might have been intended to resolve any doubt that a partial or full liquidation of a business will constitute apportionable income. But it also has another salutary effect. To the extent the property when used in the business generated deductions that reduced taxable income, such as depreciation, it would be appropriate to recapture those deductions on the sale of the asset. This approach is complicated because the deductions might have occurred in years when the apportionment formula was different (both quantitatively and qualitatively) from that in the year of the sale.

This latter problem, of course, is not limited to assets that have changed their characterization from operational assets to investment assets, but applies more generally to assets that have always generated deductions in the taxable periods prior to their sale. The problem of apportioning the income from depreciable assets is discussed more generally in Section III.E below.

In evaluating the Draft and the changes recommended by the Hearing Officer, it should be noted that the Draft narrows the Act's sales factor to include only the receipts received from transactions and activity in the regular course of the taxpayer's trade or business. Accordingly, the Draft introduces an interdependency between the transactional test and the receipts factor. That change to the receipts factor is criticized by the Hearing Officer. *See* Section III.E below. The receipts factor is also affected by the Draft's adoption of a throwout rule in the context of market-based sourcing. *See* Section III.D(8) below.

iv. Expanding the Definition to Include Income Apportionable Under the Constitution of the United States

The most controversial of the proposed changes is the incorporation of the constitutional standard. This change is not novel; at least six states have similar provisions. Statutes dealing with other areas of the law have also adopted a similar approach. The Hearing Officer asked whether other states incorporating the constitutional standard have encountered problems but no one has offered any examples.

Constitutional considerations are often part of the backdrop to the existing definitions in (A) and (B) of the Act. For example, if a taxpayer concludes that a transaction satisfies (A) or (B) of the Act, it must take the next step and ask whether that characterization is constitutional. Further, even if a taxpayer concludes that a transaction does not satisfy a statutory definition, it should also consider whether that finding is constitutionally mandated. In some cases, this type of inquiry may be obvious or trivial; in other cases it will not. Explicitly adopting a constitutional standard should not affect significantly the thought process that already accompanies the application of current (A) and (B).

As the definitions in (A) and (B) are broadened as proposed by both the Draft and the Hearing Officer in his proposed statute below, more transactions will be covered by these sections. Anticipated litigation is likely to focus on the terms in the definitions and, if covered, whether that result would be constitutional. These arguments will probably be the same whether or not the Draft explicitly incorporates a constitutional standard.

The real impact of including the constitutional standard will be on situations that do not neatly fall within the broadened redrafting of (A) or (B), and these should be fewer in number than under the current narrower language of the Act. In short, there should be fewer gray areas under either the Draft or the Hearing Officer's proposed draft than under current law.

The broader definitions may cover nearly all common situations today in a generally accepted constitutional manner, making it unnecessary to refer to the new constitutional standard at all. But even if it is assumed that (A) and (B) in the Draft cover all appropriate transactions today, rendering the constitutional standard unnecessary as some argue, no one can predict the shape of tomorrow's transactions. The future can be expected to bring unanticipated situations that might fall into the gray areas of redrafted (A) and (B). In that case, the constitutional standard would be available to cover the unexpected and act as a safety net.

Accordingly, the Hearing Officer rejects suggestions that the reference to the constitutional standard be deleted. In addition, because there is value in terms of predictability, guidance, certainty and familiarity in continuing (A) and (B) with the elimination of prior defects, the Hearing Officer also rejects the suggestion that those paragraphs should be replaced *solely* by reference to the constitutional standard. At the least, those paragraphs offer guidance to auditors, who tend not to be lawyers, and even if lawyers, may not be that familiar with constitutional law. The same might be true of those who prepare returns on behalf of taxpayers.

Furthermore, replacing (A) and (B) with a reference to only the constitutional standard might make it harder for legislators to vote in favor of the Draft. There may simply be too little guidance on what legislators are being asked to vote on to garner enough support for passage. Continuing the existing language (as modified) will make it easier for legislators to feel comfortable in supporting the Draft.

Consequently, the Hearing Officer concludes that on balance the reference to the constitutional standard is desirable and that the broadened sections (A) and (B) should continue to be part of the definition of apportionable income.

v. Allocable Income that is Apportioned

Draft Art. IV.1(a)(ii) provides that apportionable income includes any "income that would be allocable to this state under the Constitution of the United States, but that is apportioned rather than allocated pursuant to the laws of this state." One Comment stated: "[t]his proposed change recognizes that with respect to a particular item of income that a state could [c]onstitutionally choose to allocate, assign it to itself and tax accordingly, it may choose to forgo that choice and include the item of income in apportionable income. By choosing to apportion such an item of income which other states could only apportion it promotes uniformity."

An example of the above would be a state of commercial domicile that does not allocate dividends to itself but instead chooses to apportion them. Presumably, if the state of commercial domicile could constitutionally allocate 100% of the dividends to itself it also has the constitutional right to tax less than 100% and *Mobil Oil v. Vermont* suggests as much. 445 U.S. 425, 444-445 (1980).

Consequently, the apportionment of otherwise allocable dividends would seem to be described by Draft Art. IV.1(a), "Apportionable income" means: (i) all income that is apportionable under the Constitution of the United States." Accordingly, it is unclear what purpose is served by Draft Art. IV.1(a)(ii). Furthermore, the reference to income that a state could "constitutionally choose to allocate" provides little certainty because the constitutional standards on what income is allocable are undeveloped.

Another difficulty is that “apportionable income” would not normally be viewed as encompassing allocable income. In fact, if allocable income is thought of as synonymous with nonbusiness income, it would not normally be viewed as “apportionable income.”

The Hearing Officer believes that this situation of apportioning certain categories of income, such as dividends, capital gains, or interest, rather than allocating them, is uncommon and is best addressed by state-specific legislation rather than through the Draft.

vi. The Effect of the Draft on Shifting Income and Deductions Among the States

Unaddressed by the comments or the Report is the shift in revenue that might result from the Draft. Two effects will occur that have revenue implications.

First, by broadening the definition of apportionable income, less income will be treated as non-apportionable income (known as non-business income under the Act). That will shift income away from states to which it was previously allocated, often the states of commercial domicile, to the states to which it will now be apportioned.

Second, like Section 265 of the Internal Revenue Code of 1986, states deny deductions that are viewed as being associated with, or related to, the generation of nontaxable income. A common situation at the state level is interest expense that is viewed as attributable to the generation of income not apportionable or allocable to the taxing jurisdiction. For example, a non-domiciliary corporation might borrow money that it uses to produce allocable dividends or capital gains. The non-domiciliary states that apportioned the corporation’s business income should not allow a deduction for that interest because from their perspective, the interest would be a cost of generating income that they would not be taxing. The interest might be deductible in the state to which the income was allocated. In the case of dividends, capital gains, and interest the income would be allocated to the taxpayer's commercial domicile; if they exempt such income, as some do, no deduction for interest should be allowed.

The Draft's broadening of the categories of apportionable income would not only shift formerly allocated income from the states of allocation (where the income might not have been taxed) to the states in which the income would now be apportioned, but also would now shift deductions from offsetting allocable income to offsetting apportionable income. As an a priori matter, it cannot be predicted whether taxpayers will benefit or not from these changes or the revenue effects on the states.

4. Proposed Draft by the Hearing Officer

The Hearing Officer proposes that the Executive Committee consider the following redraft:

Art. IV.1(a) "Apportionable income" means:

(i) all income that is apportionable under the Constitution of the United States and is not allocated under the laws of this state, including but not limited to:

(A) income related to the operation of the taxpayer's trade or business; or

(B) income from tangible intangible property if the acquisition, management, employment, development, or disposition of the property is, or was, related to, or part of, the operation of the taxpayer's trade or business.

Art. IV.1(e) "Non-apportionable income" means all income other than apportionable income.

This proposed language eliminates terms in the existing Act that have no constitutional significance, that have led improperly to adverse results for the states, and that invite needless litigation and controversy. The conjunctive "and" between (A) and (B) has been replaced with the disjunctive "or" to eliminate any possible ambiguity. The Hearing Officer's draft makes it clear that the transactional test in (A) and the functional test in (B) are independent of each other, and illustrate two of the possible categories—albeit broad ones--that constitute apportionable income. Quite possibly, transactions might simultaneously satisfy both definitions, but there is no reason these two categories have to be mutually exclusive. Situations not falling within either (A) or (B) will be tested against the constitutional standard, although with the broadening of (A) and (B) these should not be common. The proposed language in (A) and (B) is broad enough to reach changes in the economy and in the new business practices that will inevitably accommodate and facilitate those changes, but the constitutional standard will be available to test the gray areas.

D. Market-Based Sourcing

The Uniformity Committee provides the following new Section 17.

Art. IV.17

(a) Sales, other than sales ~~of tangible personal property~~ described in Section 16, are in this State if the taxpayer's market for the sales is in this state. The taxpayer's market for sales is in this state:

~~(a) the income-producing activity is performed in this State; or~~

~~(b) the income-producing activity is performed both in and outside this State and a greater proportion of the income-producing activity is performed in this State than in any other State, based on costs of performance.~~

(1) in the case of sale, rental, lease or license of real property, if and to the extent the property is located in this state;

(2) in the case of rental, lease or license of tangible personal property, if and to the extent the property is located in this state;

(3) in the case of sale of a service, if and to the extent the service is delivered to a location in this state; and

(4) in the case of intangible property,

(i) that is rented, leased, or licensed, if and to the extent the property is used in this state, provided that intangible property utilized in marketing a good or service to a consumer is "used in this state" if that good or service is purchased by a consumer who is in this state; and

(ii) that is sold, if and to the extent the property is used in this state, provided that:

(A) a contract right, government license, or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area is "used in this state" if the geographic area includes all or part of this state;

(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 sales factor.

(b) If the state or states of assignment under subsection (a) cannot be determined, the state or states of assignment shall be reasonably approximated.

(c) If the taxpayer is not taxable in a state to which a sale is assigned under subsection (a) or (b), or if the state of assignment cannot be determined under subsection (a) or reasonably approximated under subsection (b), such sale shall be excluded from the denominator of the sales factor.

(d) [The tax administrator may prescribe regulations as necessary or appropriate to carry out the purposes of this section.]

1. Reasons for Change

These proposed changes, the most sweeping of all the amendments, generated most of the discussion at the Hearing. Typical complaints were the Draft's lack of detail and thus the lack of certainty and predictability about how common transactions would be treated.

The Uniformity Committee's approach in Draft Art. IV.17 stands in sharp contrast with its approach in Draft Art. IV.1. There the Uniformity Committee took a minimalist approach that tracked much of the existing definitions in that section; here, by contrast, there was no attempt to salvage anything of the Act's costs of performance (COP) approach in Act Art. IV.17.

The proposed market-based sourcing in Draft Art. IV.17 is creative and thoughtful and provides a constructive overall structure. The MTC anticipates that key terms will be resolved by subsequent model regulations. The substance of those regulations and the speed with which they will be issued will be the key to the MTC's success in achieving uniformity.

The heart of the Draft is the general rule that sales not described in Act Art. IV.16 (i.e., anything other than the sale of tangible personal property) are assigned to a state if the taxpayer's market for the sales is in that state. That general rule is supplemented by a series of sub-rules that carve out special situations and define when a taxpayer's market is considered to be in a state. Act Art. IV.16 uses a destination principle for assigning the receipts from the sale of tangible personal property. Market-based sourcing is intended to mirror that approach.

The goal of harmonizing Act Art. IV.16 and Draft Art. IV.17 with respect to the destination principle is laudable. No theoretical reason exists why the receipts from the delivery of a DVD through the mail of a movie should be assigned to a state differently from the on-line streaming of that same movie. Similar questions can be raised about software, music, books, newspapers, magazines and the like that have both tangible and electronic counterparts. As discussed below, the difference between Act Art. IV.16's destination principle and Act Art. IV.17's COP—destination v. origin—does not reflect any rigorous, analytical thinking by the Uniform Law Commissioners in 1957. The challenge is in implementing administrable rules that apply a destination principle to the receipts from the sale of services and from the sale and licensing of intangible property.

2. Public Comment

Mr. Miller was in favor of updating Art. IV.17 to reflect more accurately the purpose of the sales factor. He particularly favored abandoning UDITPA's previous all-or-nothing assignment rule for sales of other than tangible property. He also endorsed assignment of profits from services on a market basis. Mr. Miller recommended the MTC establish a hierarchy via regulations with respect to where delivery occurs.

Regarding sales of intangible property, Amy Pitter, from the Massachusetts Department of Revenue, offered a comment expressing support and stating the proposed MTC amendments resemble rules that are currently used in Massachusetts. The Idaho State Tax Commission stated the amendments would provide a sourcing method that better reflects what Idaho believes to be the purpose of the receipts factor. Mr. Faber contended the changes to Article

VI.17(a)(4)(ii)(A) could result in multiple counting if the geographic area of use included multiple states and each state took the position that the property was being used within its borders. Mr. Miller felt in most cases the specific sourcing rules are workable, although the sourcing of some receipts, in particular those received from multistate entities, may be difficult to determine precisely.

Sutherland stated it is unclear that market-based sourcing presents enough of an improvement over the current regime to warrant a complete change of policy. It encouraged the MTC to explore the possibility of preserving some form of costs-of-performance sourcing. It also argued against inclusion of a throwout rule.

Mr. Bucks acknowledged objections to the amendments, but felt none of those issues appear to justify rejecting a market-based sourcing rule. He encouraged adoption of the amendments.

3. Real Property

The sub-rule for real property is clearly noncontroversial and was not the subject of any Comment. The sub-rule provides that "in the case of sale, rental, lease or license of real property," the taxpayer's market for the sales is in this state "if and to the extent the property is located in this state." Draft Art. IV.17(a)(1). The result is to assign the receipts on a situs basis, which presumably would be the same result under Act Art. IV.16's destination principle (albeit a somewhat strained reading of "destination").

(The phrasing "if and to the extent that" is used throughout the Draft Art. IV.17. The "if" is superfluous and in the interests of a cleaner draft could be deleted. Two other places in the Act, Arts. IV.5(b), IV.8(a), use the “if” phrasing, but one Article does not. Art. IV.4. One Article apparently hedges and uses the “if” phrasing in one subsection and deletes it in two others. Compare Act Art. IV.8(a) with (b), (c).

4. Tangible Personal Property

The sub-rule for tangible personal property is unexceptionable in principle: “in the case of rental, lease or license of tangible personal property,” the taxpayer’s market for the sales is in this state “if and to the extent the property is located in this state.” Draft Art. IV.17(a)(2). The rule does not apply to the *sale* of tangible personal property, which is covered by the destination principle in Act Art. IV.16.

To say something is unexceptionable in principle does not mean that it is straightforward in application. For example, a rental car company probably does not know where—or the extent to which—its tangible personal property is being used in any specific state. (Sometimes a lessee is prohibited from leaving the state but that is the exception.) That uncertainty is not a new problem because it can arise under the Act today. *See* Act Art. IV.5(b).

What is new, however, is that the Draft adds an exculpatory provision applicable to most of the sub-rules in Draft Art. IV.17; nothing comparable exists in the Act. If the market state cannot be determined under the relevant sub-rules, it shall be “reasonably approximated.” Draft Art. IV.17(b). Presumably either the taxpayer or the tax department can make a reasonable approximation. A reasonable approximation for a rental car company might be to assume that a car is used in the state in which it is rented. But given a small state where tourists typically rent cars to tour a region of the country, such as New

England, that assumption might not be as reasonable as it might be for cars rented in Miami (or Hawaii).

If the market state cannot be reasonably approximated, the Draft provides a throwout rule, Draft Art. IV.17(c), an approach a small number of states already use as part of their market-based sourcing rules, and which implicitly underscores the problems posed by services and intangible property. Under the throwout rule, the receipts are excluded from the denominator of the sales factor (and implicitly from the numerator). (Stylistically, the draft is inconsistent in that Draft Art. IV.17(c) excludes the receipts from the denominator of the sales factor but does not explicitly exclude them from the numerator; Draft Art. IV.17(a)(4)(ii)(C), by contrast, discussed below, explicitly excludes the receipts from both the numerator and denominator of the sales factor.) The result would be no receipts in the numerator and no receipts in the denominator, which presumably is intended to be a zero sales factor (as a mathematical matter, however, zero divided by zero is indeterminate and not zero). No further residual rule is provided in case the factor is zero. The throwout rule, of course, is inconsistent with a destination principle (but so is the throwback rule for tangible personal property in Act Art. IV.16(b)).

The throwout rule applies not only if the market state cannot be determined or provided, but also if the taxpayer is not taxable in a state to which a sale is assigned. Draft Art. IV.17(c). Act Art. IV.3 defines when a taxpayer is taxable in another state and apparently by inference, when a taxpayer is not taxable. *See* MTC Reg. IV.3(a). Presumably that definition would continue to control the throwout rule in Draft Art. IV.17.

In a state having only a sales factor, a taxpayer's inability to make a reasonable approximation could result in no income being apportioned at all, unless on audit the tax department were to invoke alternative apportionment. But alternative apportionment cannot be invoked unless an auditor can first determine problematic filing positions. To make that more likely, a state should require that any receipts that are ultimately thrown out must first appear on the return. The return should be designed so that an auditor can easily determine the extent to which receipts are being thrown out and the reason for doing so.

The rental of cars is used as a simple example to illustrate the general structure of the Draft. Tangible personal property does not pose the same degree of difficulty as do the rules for services and intangible property discussed below.

5. Services

The destination principle in Act Art. IV.16 is hard to mimic in the case of services. Tangible personal property has the advantage of involving assets that in most cases can be seen and traced. In theory, their destination is knowable. Services (and intangible property) present different—and more difficult considerations.

The market for sales in the case of services is "if and to the extent the service is delivered to a location in this state." Draft Art. IV.17(a)(3). No definition is provided for "delivered." Presumably this key term and others will be dealt with in the model regulations if the MTC adopts the Draft.

The lack of a definition of "delivery" limits the extent to which the Draft can be evaluated. "Delivery" will pose few problems if the customer is an individual who is a resident of the same state in which the service provider is located. Similarly, if the customer is an intrastate corporation in the same state in which the service provider is located “delivery” should also pose few problems. In both cases, the strong likelihood is that only one state–that of both the provider and the customer–can be the place of delivery. The customer’s billing address might serve as an acceptable proxy for “delivery.”

A multistate provider with out-of-state offices can complicate matters. These offices might serve as the place of delivery (again depending on how that concept is defined).

To illustrate the discussion above, suppose an architectural firm performs its design services in State A, for a corporate client based in State B, involving a project in State C. The firm sends drawings to the corporate contact as an e-mail attachment. Where does delivery take place if the client downloads the attachment while on a plane, at home, or at a hotel? What if the architectural firm makes the drawings available at its web site, located on a server in State D, which is accessed by the client while in State E? In which state did delivery take place and how would the firm know?

What if the drawings are delivered in hard copy to the client’s office in State B, or handed to the client when she visits the firm in State A? Does it matter that the project is in State C? For a rule on delivery to be workable it cannot require information unknown to the provider. A sound rule must also not be easily manipulated.

A sound definition of “delivery” should not allow the firm’s receipts (its fees) to be assigned to a state under tenuous, fortuitous, or serendipitous circumstances, having little to do with any reasonable policy considerations underlying how income should be apportioned. Moreover, any rule for assigning sales should not be easily susceptible to manipulation by the taxpayer.

If the scenarios above can result in assigning the service fee to different states, the place of delivery could become elective. Digital services could be delivered to low-tax jurisdictions and retransmitted. To be sure, this same possibility exists under the destination principle in Act Art. IV.16, (especially with boats and planes) but in the case of services, there are fewer transaction costs and constraints on the place of delivery, which facilitates tax planning. It is tempting to use the customer's billing address as an acceptable proxy for "delivery," at least in the case of individuals who have less opportunity to change it in cooperation with the service provider and the regulations should address this possibility.

Some might argue that a customer has little incentive to cooperate with a service provider in manipulating a malleable delivery rule in order to save the seller some income tax. But if the amounts are large enough, there may be an incentive to share the savings (taking into account the risk of audit). The parties might also find it great sport (or enjoy the absurdity) that a meaningless change in an economically irrelevant consideration could have tax consequences. And what better message for a tax adviser to send to a client than to show how income taxes can be saved by altering the place of delivery?

If a service provider is not taxable in the state to which the sale is assigned, or if a reasonable approximation of the market state cannot be made (presumably by either the taxpayer or the tax administrator), the receipts from the service would be excluded from both the numerator and the denominator of the sales factor, raising the possibility of a zero sales factor. In a state that uses only a sales factor, the provider might apportion no income anywhere; if there is an audit and this situation is discovered, the tax department's invocation of alternative apportionment can be expected. Regulations under Draft IV.17 or under the new power granted under Section 18, *see* Section III.B above, should address this situation.

6. Intangible Property (Other than Marketing Intangibles)

The Draft provides two basic sub-rules, depending on whether intangible property is (1) rented, leased, or licensed; or (2) sold. "Intangible property" is undefined.

The market for intangible property "that is rented, leased, or licensed," is in a state "if and to the extent the property is used in" that state. Draft Art. IV.17(a)(4)(i). (The rule for "marketing intangibles," discussed below, assigns the receipt to the state of the consumer.) Like "delivery" and "intangible property," no definition is provided for the key term "used" but definitions will no doubt be forthcoming in the model regulations.

Because the Draft anticipates model regulations, it leaves many questions regarding intangibles unanswered. To again take one of many possible common situations, suppose a corporation providing customized computer programming provides a site license for its software to an interstate corporation. Where is the software used? The vendor may not know about how the customer is legally organized or structured. The vendor might have provided a site license to a holding company with numerous related entities. Persons accessing the software may be employees of these entities. The vendor may be unaware of which individuals will use the software within the purchaser's corporate enterprise, let alone where those persons are physically located. This level of detail may be inaccessible to the vendor.

To be sure, the Draft allows the vendor to make a reasonable approximation, but there may be no basis for doing so. Presumably, model regulations will address what constitutes a "reasonable approximation." Some states use proxies for place of use, such as the billing address or the corporation's commercial domicile. These provide knowable answers, but may not reflect the actual use of the software or the "market" in the case of business consumers; billing address may be more acceptable for individuals. If the goal is to parallel the destination principle of Act Art. IV.16, these proxies may fall short in some cases. (In some states the customized software transaction described above might be characterized as a service, which would be covered under the "delivery to a location" rule, Draft Art. IV.17(a)(3), as the license of tangible personal property, which would be covered by the "located in this state" rule, Draft Art. IV.17(a)(2), or as the license of intangible property, which would be covered by the "used in this state" rule, Draft Art. IV.17(a)(4)(i). Presumably the model regulations will address these definitional issues.)

In defense of the Draft, one Comment submitted at the Hearing suggested that it is common for a taxpayer to have the ability to audit the use of an intangible to ensure the compensation is proper. In other words, in the case of intangible property that is rented, leased, or licensed, a common method (but not exclusive) of compensation is for the licensee to pay a royalty based on some measure of use; the Comment suggests that an audit to determine whether the proper royalty is being paid will also provide information on *where* the intangible property is being used.

The Hearing Officer has examined the license agreements in cases in which he has been involved. A few licenses provide for an audit, many do not. In no agreement that the Hearing Officer examined does the licensor have the right to determine where the licensed intangible is being "used" (however that term might be defined) because that would be irrelevant to determining the amount of royalty owed. Practitioners have indicated to the Hearing Officer that the licenses they use do not provide for the right to know where the licensed property is being used, and they also emphasized the problem of defining the place of use.

From the perspective of the licensor, the relevant issue is whether the licensee has paid the proper amount of royalties. Typically, that means verifying the amount of sales made by the licensee that triggers the payment of a royalty. That amount can be verified by examining the federal tax return or the financial accounting records, without determining *where* the intangible is used. Indeed, to determine "use," whoever was hired by the licensor to verify that the proper amount of royalties had been paid (presumably a third party, such as an accounting firm) would first have to determine a state's definition of "use," and hope that the books of the licensee were kept in a manner that comports with that definition, and that it had access to such records.

A licensee, however, might treat place of use as proprietary, and be unwilling to provide that information or be unwilling to enter into a license agreement requiring it to do so. Going forward, the licensor could attempt to have the licensee provide whatever information is required under the Draft, but licensees might refuse for reasons ranging from the cost of doing so to issues of confidentiality. A licensee might regard information on its manufacturing or production activities as proprietary and be unwilling to provide details to the licensor.

Again, a range of transactions can exist, some that are likely to pose administrative problems and others that will not. Presumably, the regulations will provide workable approaches for the former. One illustration of the latter involves franchisors, discussed below.

7. Marketing Intangibles

The Draft creates a new category of "intangible property utilized in marketing a good or service to a consumer" ("marketing intangibles") which is a subset of "licensed intangibles." Draft Art. IV.17(a)(4)(i). The general rule that the market for licensed intangibles is where they are used is further refined in the case of marketing intangibles. A sub-rule provides that "[i]ntangible property utilized in marketing a good or service to a consumer is 'used in this state' if that good or service is purchased by a consumer who is in this state." Id. Report, p. 23, refers to this as a "look-through" rule, presumably because the licensor of the marketing intangible, typically intellectual property, looks through the license agreement to determine where the licensee sells a good or service incorporating such property.

The Report states the theory of the look-through rule as follows: “regardless of where the licensee is located, the taxpayer is able to enter into that license agreement because there is a consumer demand for its intangible in the state of the ultimate consumer. And in many cases, the taxpayer will focus its marketing efforts in that consumer state, not the state of the licensee.” Id. The first statement is an accurate description of the economic reality of the transaction, but does not mean that the look-through rule can be easily administered. The second statement might be true in some circumstances but not necessarily in “many.” True, marketing efforts will occur in the consumer state, but they may take place by the licensee and not by the licensor. For example, if a famous athlete licenses her image for use on a T shirt she might not engage in any marketing in the states where the product is sold—her licensee may. She might not know the states where her T shirt is being sold. The licensee will report that information as part of assigning its income under Act Art. IV.16, but that would not be available to the licensor.

One of the difficulties in evaluating the treatment of marketing intangibles is the large number of diverse situations covered, some of which might raise no problems but others that could. To take an easy example, the Report cites a taxpayer entering into a franchise agreement with a franchisee operating a restaurant utilizing the franchisor’s trademark. Report, p. 23. Presumably, the franchisor will have no trouble in applying the look-through rule. Other franchise situations should also pose no problem as the franchisor will typically know where the franchisee is making its sales. Franchising is a large part of the American economy so the look-through rule should work well in many situations.

Large, sophisticated licensors that do their own marketing either directly or through controlled entities should also present few problems. Many licensors that generate large revenues from their intellectual property can be expected to receive detailed geographical breakdowns on sales and be very active in the marketing by their licensees.

More difficult problems might accompany the licensing of intellectual property for use on a T-shirt, hat, towel, clothing, a box of cereal or other consumer goods that occur through uncontrolled entities in the business of performing these functions on behalf of third parties. (Presumably, the licensing of technology, know-how, formulas, processes, designs, or patterns for use in manufacturing or production would not be considered a marketing intangible but the Draft provides no definition). In many of these cases, the licensors will not focus their marketing efforts in the state of the consumer because they have no expertise, experience, or the resources to do so. For example, a university that licenses its name for use on clothing is unlikely to send people across the state or the country in order to drum up demand. The university may promote sales through its web site, which would not occur in the consumer states. Third parties exist specifically to perform marketing functions for licensors and to act as intermediaries with licensees. The question is whether these latter types of situations will present a significant administrative challenge and how much economic activity they represent compared with situations that present no problems.

The Hearing Officer notes that no look-through rule is generally required under Act Art. IV.16 for tangible personal property. For example, under the Act a vendor that sells its product to a distributor assigns those sales based on the place of delivery rule. No explicit look-through rule attempts to determine where the distributor resells the product. If the vendor has specific and verifiable information on where the distributor ultimately sells to the end user, the sale could be assigned to that state. (In the interests of disclosure, the Hearing Officer is involved in a case raising this issue under Act Art. IV.16.) Moreover, the throwback rule under Act Art. IV.16, and the throwout rule under Draft Art. IV.17 are inconsistent with destination-based principles.

One type of look-through rule, however, has been developed by the courts under Act Art. IV.16 where a purchaser takes delivery in one state for use in another. In that so-called dock sale, a "look through" rule is often used. But that is a much easier rule to administer than when an intangible is involved.

A licensor that cannot determine where the marketing intangible is used under the look through rule can make a reasonable approximation of the market state. A state's percentage of the nation's population might serve as a reasonable approximation. Some goods, however, might serve regional markets, special political groups, particular sports fans, unique age groups, certain religions, or ethnic groups. Presumably, the regulations will address the elements of a "reasonable approximation."

Where a marketing intangible is licensed to a manufacturer, the look-through becomes problematic. The manufacturer is likely to sell to a distributor, who will then sell to a retailer. The licensor might know where the manufacturer produced a consumer good incorporating the licensed intangible property, but the purpose of the look-through rule is to determine the ultimate consumer. That information might not be known to the manufacturer, let alone to the licensor.

Possibly survey data might exist that would allow the licensor to make a reasonable approximation. If the market state cannot be determined or approximated, however, the sales (royalties in many cases) will be thrown out.

There is little in the Act to help resolve many of the problems identified above. Act. Art. IV.8 covers the allocation of non-business royalties from copyrights and patents—presumably a narrow category. Act Art. IV.8 provides that patent and copyright royalties are allocable to a state to the extent that the patent or copyright is utilized by the payer in the state. A copyright is utilized in a state to the extent that printing or other publication originates in the state, Act. Art. IV.8(c). This rule has little in common with the type of market approach that the Draft intends to implement with respect to marketing intangibles, which is to capture the state of the end user. Because Act Art. IV.8 deals only with the narrow category of allocable non-business income, little litigation has resulted and the MTC has no regulations on the matter.

Whether copyrights are considered marketing intangibles under the Draft is unclear. There may be little difference between the sale of a T shirt with the licensed picture of a well-known athlete—a marketing intangible--and the sale of that athlete's autobiography, copyrighted by that same athlete.

A patent is utilized in a state to the extent that it is employed in production, fabrication, manufacturing, or other processing in the state, Act. Art. IV.8(b). Like the allocation rule for nonbusiness copyrights, little litigation has resulted and the MTC has no regulation on point.

The Act's residual rule for non-business copyrights and patents provides that if the basis of receipts from such nonbusiness royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the royalties are allocated to the taxpayer's commercial domicile, not the customer's. Act. IV.8(b), (c). This residual rule, used by other states as part of their market-based sourcing, does not necessarily capture the "market" if that is viewed as use by the end user. In addition, it shows that even in 1957 there was some concern that the licensor might not know where the licensee was using the copyrights or the patents.

8. Sale of Intangibles

The Report explains that in the case of a *sale* of an intangible, a taxpayer is unlikely to know where the purchaser will use it, presumably because the sales price will not be based on productivity. Report, p. 23. The Hearing Officer has raised the possibility that a licensor might not know the place of use in the case of a license providing for royalties. Even if that possibility is overstated, however, a taxpayer selling an intangible is unlikely to be entitled to information on the place of use by the purchaser.

The Draft provides in Art. IV.17(a)(4)(ii) that intangible property that is *sold* (rather than licensed) is assigned to a state "if, and to the extent the property is used" in that state subject to three sub-rules.

The first sub-rule, Draft Art. IV.17(a)(4)(ii)(A), covers the sale of an intangible that relates to a specific geographical area. The geographical area will be obvious from the nature of the intangible. The Report illustrates this exception with the sale of "gate rights" at an airport. Report, p. 23. The predictable result is that the receipts from the sale will be assigned to the state in which the airport is located. Another example would be an FCC license covering a specific geographical area.

The second sub-rule, Draft Art. IV.17(a)(4)(ii)(B), covers a sale made on a contingent basis. Here the Draft implicitly assumes that the seller has a continuing relationship with the purchaser and should be analogized to a licensor and thereby subject to the rules described above that cover the rental, lease, or license of intangible property. If those rules do not work well in particular cases, as discussed above, they will not work well in the case of a sale on a contingent basis.

The last of the three sub-rules, Draft Art. IV.17(a)(4)(ii)(C), provides that all other receipts (that is, receipts not described in the preceding two sub-rules) are thrown out. The throwout rule in Draft Art. IV.17(a)(4)(ii)(C) is presumably meant to be exclusive of the throwout rule in Draft Art. IV.17(c). In addition, if Draft Art. IV.17(a)(4)(ii) applies, presumably the approximation rule in Draft Art. IV.17(b) is inapplicable. This interpretation is implicit in the structure of the Draft but should be made explicit by the regulations in order to avoid litigation.

The throwout rule in Draft Art. IV.17(a)(4)(ii)(C) would cover, inter alia, the sale of stock, bonds, financial assets, contracts, leases, and the like. (An MTC Regulation adopts a similar approach in the context of COP. MTC Reg. IV.I8(c)(3) provides: "[w]here business income from intangible property cannot readily be attributed to any particular income producing activity of the taxpayer, the income cannot be assigned to the numerator of the sales factor for any state and shall be excluded from the denominator of the sales factor." The Regulation is confusing because "business income" is not assigned to the numerator of the sales factor—receipts are. Apparently the Regulation is referring to receipts that are received from, or associated with, transactions or activities generating apportionable business income.

The Report is clear on what the Draft intends, but the actual language is confusing. Suppose, for example, a sole proprietor sells all the tangible and intangible assets of a business for a fixed sum. The intangibles might include goodwill, operating systems, patents, copyrights, formulas, processes, designs, patterns, know-how, customer-based intangibles, supplier-based intangibles, trademarks, and trade names. (While not all businesses will have this range of intangibles, almost all will have goodwill.) Typically, the new owner can operate the business wherever he or she wishes. Accordingly, this situation would fall outside of the first sub-rule, Draft Art. IV.17(a)(4)(ii)(A), because of the lack of a geographical connection. The sale was for a fixed sum so that the second sub-rule applicable to contingent sales would not apply. The operative sub-rule would be the third, which would throw out the receipts.

But what if the seller knows where the buyer will "use" some of the intangibles? Does the fact that the seller knows the "extent the property is used" in a state trump the sub-rules? The regulations should clarify this situation.

The throwout rule in Draft Art. IV.17(a)(4)(ii)(C) will throw out from the sales factor the receipts from three common transactions: the sale of stock in a corporation, the sale of a partnership interest, or the sale of a membership interest in an LLC (other than a single member LLC or an LLC electing to be treated as a corporation).

An asset sale of a business, however, would be treated differently. An asset sale would include both tangible and intangible assets (at a minimum goodwill). The receipts from the sale of any intangible assets would be thrown out under Draft Art. IV.17(a)(4)(ii)(C). The receipts from the sale of tangible assets would be assigned under the destination principle of Act Art. IV.16. (The sale of real property would fall under Act Art. IV.17 but the result should be the same as if a destination principle applied.)

If the Draft's proposals on the receipts factor, *see* Section III.E, are accepted, no difference would exist in how the sale of a business was structured. The Draft proposes that Act Art. IV.1(g) be amended to provide that the receipts factor include only gross receipts from "transactions and activity in the regular course of the taxpayer's trade or business . . ." Gross receipts from transactions or activities satisfying the functional test would not be included. The latter would include gross receipts from the sale of a business regardless of how that sale would be structured. Draft Art. IV.1(g) has the advantage of treating an asset sale of a business the same as a partnership, member interests, or stock sales. The Hearing Officer, however, has concerns about the Draft's approach to Art. IV.1(g) and has proposed an alternative approach. *See* Section III.E below.

Draft Art. IV.17(a)(4)(ii)(C) would throw out the receipts from the treasury function (receipts from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities) and from hedging. In both of these cases, the underlying assets, whether stocks, bonds, commercial paper, repos, contracts and the like constitute intangibles. Consequently, the receipts from their sale (or from the redemption of a bond, which is treated as a sale) would be thrown out. Draft Art. IV.1(g) explicitly throws out from the sales factor the receipts from the treasury function and from hedging. But because these receipts are already thrown out under Draft Art. IV.17(a)(4)(ii)(C), no need exists to deal with these situations under Draft Art. IV.1(g) and there are advantages in not doing so. *See* Section III.E below.

The treasury function typically involves intangible assets and not cash per se. Cash, which is sometimes referred to as a financial asset, should be classified as an intangible asset, just like a bond, CD, repos, commercial paper or other financial assets, removing any doubt that they are covered by Draft Art. IV.17(a)(4)(ii)(C). MTC Reg. IV.10(a) excludes coin and currency from the term tangible personal property for purposes of the property factor. The model regulations under Draft Art. IV.17, which will no doubt define "intangibles," should make it clear that cash is included in that definition.

The Hearing Officer understands that the Uniformity Committee did not focus on the implications of Draft Art. IV.17(a)(4)(ii)(C) throwing out receipts from the sale of stock, bonds, financial assets, partnership interests, goodwill and so forth, and instead relied on Draft Art. IV.1(g) to deal with these situations. The Uniformity Committee threw these receipts out of the sales factor under Draft Art. IV.1(g) by excluding receipts from transactions and activity satisfying the functional test. Because many of the items the Uniformity Committee dealt with under Draft Art. IV.1(g) are already thrown out under Draft Art.

IV.17(a)(4)(ii)(C), Draft Art. IV.1(g) does not have to sweep so broadly. *See* Section III.E below. The Hearing Officer, for reasons discussed in Section III.E below, is concerned about the Draft's approach to Art. IV.1(g). He thinks the preferred approach is to deal with the receipts from the sale of intangibles, including by implication the treasury function and hedging, under Draft Art. IV.17(a)(4)(ii)(C), which is why Draft Art. IV.17 is discussed in this report before Draft Art. IV.1(g).

The Draft provides no special treatment for the receipts from a license for a fixed, lump-sum royalty. A lump sum license has more in common with a sale of an intangible than with a license for royalties and is thus discussed in this section. Fixed, lump sum royalty licenses are sometimes purposely used to avoid a state applying a *Geoffrey* rule. A fixed, lump sum royalty makes it difficult for a *Geoffrey*-state to connect the use of an intangible in that state with a receipt because the consideration is not contingent on use. Draft Art. IV.17(a)(4)(i), which covers receipts from licenses, requires a connection between the receipt and the use of the property in a state. The use of a fixed, lump-sum royalty license agreement makes determining that connection difficult. If they are not treated as sales, lump sum licenses might be dealt with under the rules calling for a "reasonable approximation." The possibility of a "reasonable approximation" in the case of a fixed sum royalty should be addressed through regulations.

If fixed lump sum licenses are analogized to sales because the consideration is not based on productivity, Draft Art. IV.17(a)(4)(ii)(C) would appear to throw out the receipt from the sales factor.

9. Not Taxable In a State to which a Sale Is Assigned

In addition to the special throwout rule for the sale of intangibles in Art. IV.17(a)(4)(ii)(C), a more general throwout rule is provided in Art. IV.17(c) for other receipts (most notably, receipts from services and licenses of intangibles) if, inter alia, the taxpayer is not taxable in the market state.

Market-based sourcing for services and intangibles raises special issues of nexus. In the case of the solicitation of the sale of tangible personal property, P.L. 86-272 can prevent the market state from imposing an income tax even if nexus would otherwise exist. But P.L. 86-272 does not apply to services or intangibles, the leasing of tangible personal property (or to corporations incorporated in the taxing state). These situations are outside the protection of P.L. 86-272. Whether nexus exists with the provider of a service or the licensor of intangible property used in the state requires determining the extent to which the holding in *Quill* applies to an income tax–an issue that is unresolved in many states and one which the United States Supreme Court has not yet chosen to resolve.

The look-through rule raises its own set of nexus issues. What if the taxpayer licenses its trademark to a manufacturer that affixes it to a good that is ultimately sold in the taxing state? Is that enough to make the taxpayer taxable in the market state?

In keeping with the general structure of UDITPA, which is silent on issues of nexus, the Draft does not attempt to resolve these questions or to formulate a nexus standard.

10. Throwout Rule

The Act uses a throwback rule rather than a throwout rule in the case of tangible personal property. Act. Art. IV.16(b) throws back sales of tangible personal property to the office, store, warehouse, factory, or other place of storage from which it was shipped. In the case of services and intangible property, no compelling or logical “origination” state exists to which the receipts should be thrown back. Accordingly, the Draft opts for a throwout rule.

Although the throwout rule was infrequently used in the past, it came to prominence in 2002 when New Jersey adopted that approach as part of then-Governor McGreevey’s tax reform. (In the interests of disclosure, the Hearing Officer was a consultant to New Jersey.) The traditional throwback rule was unacceptable to key N.J.-based businesses and the throwout was a reluctant compromise. The throwout rule is the subject of ongoing litigation in New Jersey and has been eliminated by the State.

The Draft’s throwout rule can lead to problematic situations. Consider, for example, a service provider entirely based in State A whose customers are all located in State B, where the provider is not taxable. Assume that under the Draft, the service provider assigns all the receipts from its services to State B. Under the throwout rule applied to these facts the service provider would have a zero receipts factor (assuming zero divided by zero is meant to be zero). If State A used only a single-sales factor, the service provider would pay no income tax. As a policy matter, that result might be troubling, but raises no constitutional issue and would be the same result even if no throwout rule existed. If discovered on audit, a tax administrator might be expected to invoke alternative apportionment.

Suppose, however, that one customer moved from State B to State A and the service provider assigned one percent of its sales to State A and 99% of its sales to State B. Assuming a single-sales factor, the movement of one customer would have the effect of State A taxing the service provider on 100% of its income, a constitutionally suspect result.

11. Approaching the Regulations by Industry or Type of Transaction

The Draft anticipates that the MTC will flesh out the bones of Art. IV.17 through model regulations. The Hearing Officer believes that deferring critical definitions and issues to state tax administrators without MTC model regulations would be a strategic error. Upon adoption of the Draft, the MTC should immediately begin a model regulation project. The MTC has some of the most experienced and sophisticated talent in the country. If any group should provide these critical regulations it should be the MTC.

One thing seems clear (at least to the Hearing Officer): “one size will certainly not fit all.” Key terms such as “delivery,” “use,” or “marketing intangibles,” might be defined one way in the context of a specific industry but in a slightly different way in other contexts. The Hearing Officer fears that defining these and other critical terms in the abstract will be less useful than doing so in a particular context, responding to concrete and identifiable problems. In short, it might be more fruitful to tackle definitional issues on a narrower, industry-specific or transaction-specific basis. That is why criticism about the Draft being long on principle but short on detail is misguided. The details should be provided in the context of specific industries and transactions. The drafting would be greatly facilitated through a more narrow, industry, or transaction-oriented approach.

One overriding goal of the regulations should be to minimize the implications of whether a transaction is characterized as a service, an intangible, or a tangible. A perfect example is electricity. The commercial use of electricity has existed for more than 100 years and there is still no consensus on whether it constitutes tangible personal property, covered Act Art. IV.16, intangible personal property, or a service, both covered by Act Art. IV.17. Nothing should turn on that characterization. The regulations should eliminate these characterization issues and that goal is more likely to be achieved if the drafting is targeted and not done in the abstract.

12. Comments by the Hearing Officer on Draft Art. IV.17

The Uniformity Committee has offered the outline of a creative approach to the assignment of receipts from services and intangible property. (Alabama and Massachusetts have adopted statutes that track the Draft.) The Draft substitutes market-based sourcing for the COP standard in Act Art. IV.17. The Draft enters the brave new world of market-based sourcing with broad principles and relegates key definitions to model regulations. This drafting judgment call should promote flexibility and the ability to deal with definitional issues on an industry-wide basis.

Without any guidance from the MTC, states have started to plough this ground on their own. In the case of services, for example, some approaches, whether set forth in statues, regulations, bulletins, or announcements, assign receipts: to where the benefit is received; to where the service is delivered; to where the service is received; to where the customer is located; if the receipts are attributable to a state's marketplace then to that state; if the service is provided to individuals physically present in a state when the service is received then to that state; if an office of the customer from which the services were ordered is located in a state then to that state; if the service is provided to a person engaged in a trade or business in a state and the service relates to that business then to that state. At least one state has separate rules for individuals.

Intangible property poses sourcing problems under a market-based approach because it has no meaningful geographical location. Just like with services, states differ in how they source the receipts from the sale of an intangible. Some rules assign the sale receipts: to the state where the intangible was managed or controlled; to the location of the purchaser; if the buyer uses the intangible in the regular course of business at a location in the state then to that state.

States also use different approaches for assigning receipts from the licensing of intangibles. Some rules assign the receipts from licensing based on: where the intangible was used; on the proportion of use within a state; where the purchaser used the property in its regular course of business; proportionately to the states in which the product or process protected by a patent is manufactured; in the case of a copyright, to the states where the publication protected by the copyright is produced or printed.

Some states have residual rules assigning receipts: to the commercial domicile of the customer; the domicile of the business; the customer's headquarters; the customer's principal place of business; the location of the office of the customer from which the services were ordered in the regular course of the customer's business; or the customer's billing address. These residual rules do not always capture the place of use by the end user and may not be an improvement over COP.

The Hearing Officer has surveyed regulations, bulletins, notices, pronouncements, advisory opinions and the like that try to put some flesh on these approaches; in his opinion, they demonstrate the difficulty inherent in market-based sourcing of services and intangibles. The field is still in a gestation period, with no consensus yet emerging. The result is uncertainty, the lack of uniformity, inconsistencies, administrative difficulties, and the possibility of manipulation by taxpayers. Both over taxation and under taxation can be expected from the poor interfacing of disparate and inconsistent approaches.

As a practical matter, this situation cries out for a uniform set of rules under the leadership of the MTC. Without the imprimatur of the MTC, it is understandable that states have adopted disparate approaches; some inconsistent with each other, and many using residual rules that may not capture the place of use by the end user.

The Report explains that the Draft rejects the approach used by some states that assigns receipts based on where the benefit of the service is received, and that in "most cases, the benefit will be received where the service is delivered." Report, p. 22. According to the Report, where the service is delivered is a better rule because that is within the knowledge of the provider. Id. An auditor may find it easier to determine years after the fact where delivery by the taxpayer took place rather than where a benefit was received by the customer. Id.

A provider of services will oftentimes be unaware of where the "benefit" (usually undefined in the statutes adopting this approach) will materialize. For example, a provider may deal only with a corporation's purchasing agent. The provider might not know where the actual benefits accrue and neither might the purchasing agent. Even if they are able to make that determination, an auditor may be unable to verify the taxpayer's reporting position years later. The purchaser might be unwilling (or unable) to cooperate with either the taxpayer or the auditor. Finally, as corporations go bankrupt, merge, or change their computer and operating systems, and as key persons retire, move, die, or let go, the relevant information might not be easily available.

The dilemma is that delivery may possibly be more malleable than benefits, but benefits are known only to the buyer. California has recently adopted a "benefits" approach but it is too early to draw any conclusions from its experience. A more robust discussion of the merits of various rules is impeded by the Draft's lack of any definitions of operational terms.

In the case of services, the Report describes the use of "delivery" as paralleling the destination principle in Act Art. IV.16, avoiding the need for determining whether a transaction involves a service or tangible property, which is increasingly difficult in the case of digital goods. Report, p. 22.

Conforming Art. IV.16 and 17 is a worthwhile goal. But the delivery of a service has little in common with the delivery of tangible property as many of the examples above illustrated. Unless adequately defined in model regulations, it may turn out that letting Act Art. IV.16's destination principle drive the treatment of services (and intangibles) will be misguided. Moreover, as long as the receipts from services and licenses are subject to rules not found in Act Art. IV.16, such as "reasonable approximation" and "throwout," definitional issues will remain as taxpayers will have an incentive to characterize a borderline transaction in the most favorable manner. In addition, because receipts from intangible property are generally assigned on the basis of use and not delivery (assuming these are not coterminous concepts in practice), there will still be the problem of whether a transaction involves a service, intangible property, or tangible property.

Obviously, there are many situations that do not raise problems and for which the Draft in its present form is adequate. These include services by in-state providers to in-state individuals and to in-state businesses. But too many commonplace situations involving interstate businesses have no predictable answers under the Draft (which may also be true of other state statutes imposing market-based sourcing). A sample of situations suggested at the Hearing as having no straightforward, predictable, or clear answers under the Draft include cloud computing; the use of computer data bases like Lexis and Westlaw; applications downloaded for use on a cell phone; services provided by a call center; the remote repair of a computer; web design performed in one state for a web site stored on a server located in another state, which is accessed by persons around the world; advertising provided by Google; and the installation of Microsoft software on laptops and PCs. These situations await the model regulations.

Taxpayers fear that without a uniform approach by the states, multiple taxation will be inevitable. The Hearing Officer fears the tax planning that will be facilitated by manipulable rules. Any weaknesses in the rules are magnified in a state using only a single-sales factor.

The relative newness of market-based sourcing, the lack of a common understanding of terms, let alone any consensus, the number and diversity of situations impacted, make it incumbent on the MTC to make model regulations its highest priority.

The model regulations face a formidable challenge, needing to define critical terms like service, delivery, use, intangible property, sale, lease, license, utilized in marketing, and reasonable approximation. Similar definitional challenges mark the approaches used by other states so that on administrative grounds it is hard to argue which of the numerous extant approaches is superior. The “devil is in the details,” as well as in the administrative compromises that might be made on audit.

A few of the above terms are used at various places in the Act today, but are undefined, which has undercut uniformity. Surprisingly, there is only one place where the MTC Regulations define “tangible personal property.” In the context of the property factor, that Regulation provides: “[t]he term ‘real and tangible personal property’ includes land, buildings, machinery, stocks of goods, equipment, and other real and tangible personal property but does not include coin or currency.” MTC Reg. IV.10(a). Intangible property is undefined but is excluded by inference from the property factor, Act, Art. IV.10.

In defining key terms, the MTC should examine the Streamlined Sales Tax Project (SSTP), and state sales tax statutes. A term defined for purposes of one tax regime like the sales tax, does not necessarily have be defined the same when used in a different tax regime, like the income tax. The Second Circuit made this point over fifty years ago when it warned about avoiding the trap of interpreting the term “gift” the same whenever it is used in the Internal Revenue Code. The court explained that the same transaction might be called a "gift" in the gift tax law, a "gaft" in the income tax law, and a "geft" in the estate tax law. *Commissioner v. Beck's Estate*, 129 F.2d 243, 246 (1942). Just because the term “gift” is used in these various contexts does not mean it has to be defined the same. Words take their meaning from context.

But the sales tax is (or should be) concerned with the concept of consumption and where it occurs—an inquiry that is relevant to market-based sourcing. The SSTP has also dealt with many problems that are inherent in the Draft, including how to characterize a bundled transaction. That characterization issue must be confronted in determining whether a transaction is covered by Art. IV.16 or Art. IV.17. In any event, definitions that other groups have struggled with, whether it be the SSTP, or attempts (not all successful) to tax services under a sales tax by Florida, Massachusetts, Michigan, and Maryland, or other consumption taxes like the VAT, suggest approaches that might be a source of wisdom and inspiration.

The Hearing Officer has identified problems that the Uniformity Committee should consider addressing. Trying to evaluate the degree to which the problems are serious or overstated is difficult because key definitions await the regulations. Some might point to the lack of litigation in states that have already adopted market-based sourcing similar to the Draft as evidence that the Hearing Officer has exaggerated the defects. But practitioners have assured the Hearing Officer that it is still too early to expect any litigation to have occurred.

13. Revisiting Costs of Performance

The Report criticizes the COP rules in Act Art. IV.17. One set of criticisms is directed at defects in the rule; the other is directed more broadly at the rule being origin based whereas Act Art. IV.16 is market based.

The Report correctly notes that in 1957 "origin" and "market" may have been coterminous for many services but that is no longer as true today. Report, p. 19. Because of the limited role of interstate services that marked the 1950's (and the Act's exclusion of financial organizations and public utilities), COP might not have received the same attention during the drafting of UDITPA as that given to Act Art. IV.16. That is understandable because of the dominant role played by mercantile and manufacturing activities at the time the Act was being formulated, and the smaller role of interstate services (especially given the exclusion of financial organizations and utilities). In addition, the COP rules tend to overlap with the property and payroll factors, a criticism more relevant when the Act was adopted and the prevailing apportionment method was the evenly-weighted, three-factor formula.

The Hearing Officer (who in the interest of disclosure has participated in litigating COP cases) believes that the perceived weaknesses of that method can be addressed. Whether it is too late in the day to do so, especially in states that have already adopted a single-factor sales apportionment (or clearly moving in that direction) is another matter. The discussion below might be more relevant for states that still use COP and for states that may (or have) become disillusioned with market-based sourcing and may wish to revisit COP.

i. Replacing the All or Nothing Feature of COP with a Proportionate Approach

One common criticism of COP is that it assigns all of the receipts from a service or from the sale or licensing of an intangible to the state that has a plurality of the costs of performing a taxpayer's income-producing activities. Consequently, a corporation that incurs 3% of such costs in 32 states and 4% in the 33rd state will assign all of the receipts to the 33rd state. The Hearing Officer has never seen anything approaching this rather uniform distribution of costs but theoretically it could occur.

Instead of an "all or nothing" method, a proportionate approach could be used. In the example above, each of the 32 states would be assigned 3% of the receipts and the 33rd state would be assigned 4% of the receipts. A few states use this proportionate approach.

A disadvantage of the proportionate approach is that it requires a taxpayer to calculate its COP on a yearly basis. By contrast, the advantage of the "all or nothing" approach is that a taxpayer that clearly has the overwhelming plurality of its direct costs in one state year-after-year is free of an annual calculation. Unless there are drastic changes in the conduct of the business, that taxpayer can rely on having done the COP calculation once and avoid the expense of redoing it annually. A proportionate approach will increase the number of controversies.

Another perceived disadvantage is that even a proportionate approach might not assign receipts to the market state if the taxpayer's efforts there are insignificant (but nonetheless satisfy the nexus requirement). A proportionate approach might do nothing to eliminate the differences between the shipment of tangible personal property assigned to a state under Art. IV.16 and the downloaded electronic counterpart of that property. But that is the logical implication of an origin-based factor.

ii. Definition of Direct Costs

Act Art. IV.17 does not limit the costs of performance to "direct" costs but an MTC Regulation imposes this condition. MTC Reg. IV.17 provides: "[t]he term 'costs of performance' means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer." Many states incorporate the "direct costs" rule in their COP rules without further definition. The Hearing Officer has found that generally accepted accounting principles and accepted conditions or practices in the trade or business are often of little help in defining direct costs.

The Hearing Officer's experience is that there are selected categories of costs, such as depreciation, research and development, sales and marketing, technical support, and billing, which cause most of the problems in a COP calculation. These tend to be the focus of controversy and litigation. The question is whether rules can be developed for these categories that cannot be manipulated and can be easily implemented by taxpayers without extensive and costly analysis and be appropriately audited by the states.

iii. Treatment of Independent Contractors

Act Art. IV.17 does not refer to independent contractors but MTC Reg. IV.17(4)(C) does, and states have been influenced by it. The basic issue is whether payments to an independent contractor can constitute direct costs. If so, a taxpayer has to know where the independent contractor performs its services so that the cost can be assigned to a specific state for purposes of the COP calculation. The MTC has done much work on this issue, as the regulation above suggests.

The dilemma is that unless independent contractors are included in the measure of direct costs, definitional issues may arise about how to characterize a particular service provider. In extreme cases, an employer might be tempted to terminate employees and hire them back as independent contractors. Experience under the Internal Revenue Code in classifying service providers is not encouraging so there is value in extending COP to cover independent contractors. Yet in many situations, the taxpayer may have no idea where the independent contractor performs its services. In that case, the MTC Regulation provides a default rule that uses the customer's domicile, and if that cannot be determined, payments to independent contractors are ignored.

iv. Defining Income-Producing Activity

One of the great sources of controversy under COP is how to define an income-producing activity. Act Art. IV.17 is silent on this and an old MTC Regulation is not very helpful. *See* MTC Reg. IV.17(4)(B).

Instead of this knotty definitional problem, the entire apportionable business income of a unitary business could be viewed as the income-producing activity, which would greatly simplify the COP calculation.

After all, a business is not a charity; it engages in activities to produce a profit. All of its activities are intended to produce income—otherwise why spend the money? Assuming the dictates of Allied Signal are satisfied, all of the apportionable business income can be viewed as the "income producing activity."

Formulary apportionment is premised on the theory that in a unitary business it is impossible to segregate on a state-by-state basis income-producing activities. That segregation is what separate accounting required, and has been long rejected in most cases. The theory of a unitary business is that it is meaningless to try to match a particular activity with a specific item of income, which is one of the reasons why formulary apportionment has generally replaced separate accounting.

One goal of the apportionment formula is to determine the income produced by activities occurring in the taxing state. The income produced by activities in a state are what the formula attempts to measure; consequently, such activities should not be used to determine the receipts that enter into a state's formula intended to measure the income produced by those activities.

v. No Need for a Throwback or Throwout Rule

Art. IV.17 does not contain a throwback (or throwout) rule. Because it is an origin-based approach, nexus is virtually assured with the state in which the taxpayer has a plurality of its costs of performance. The same conclusion would hold even under a proportionate approach. Consequently, no need exists for a throwout or throwback rule if COP is retained. The idiosyncrasies of the throwout rule are avoided.

vi. Interaction with the Single-Sales Factor

The Hearing Officer believes that COP's warts and weaknesses are known; whether they can be cured is a technical question. The political problem is that COP is an origin-based approach, the antithesis of market-based sourcing, the destination principle in Section 16, and the direction the states seem to be moving towards. In theory, COP can be used in conjunction with a single-factor sales formula, but as a practical matter, a state adopting that formula will likely reject an origin-based assignment of sales in favor of market-based sourcing. States adopting single-sales apportionment typically adopt market-based sourcing, and eliminate any throwback rule. (There is at least one state, however, with a single-factor sales formula that nonetheless uses a throwback rule.)

COP is incompatible with the economic development considerations that led to single-factor apportionment. As the Report notes, "[COP's] duplication of the property and payroll factors is particularly counter-productive for states that have tried to more heavily weight the sales factor as a means of encouraging economic development." Report, p. 19. States adopting a single-factor sales formula would be unexpected to adopt COP (or revert back to even a double-weighted, three-factor formula). Even if a new and improved COP could be made workable, its era may have passed.

14. Concluding Comments

As an a priori matter, the Hearing Officer cannot predict whether refining the COP method will be less productive or useful than refining market-based sourcing. Both COP and market-based sourcing require further guidance. The question is whether the COP problem areas identified above are manageable and if not, can they be excluded from the calculation in their entirety without nullifying the methodology. The Hearing Officer has total confidence in the intellectual prowess of the MTC and those taxpayers willing to work with it in good faith to refine COP.

Some might worry that pursuing COP would somehow undercut the special industry rules developed by the MTC, which have successfully applied a mixture of COP and market-based sourcing approaches to specific industries. The Hearing Officer was not asked to address those special industry rules. He believes, however, that they are a source of guidance and insight about the problems raised by market-based sourcing. In general, there is great value in dealing with industry-specific problems rather than drafting in the abstract. In any event, the Hearing Officer is not recommending that any of these special industry rules should be revisited. The Hearing Officer assumes that these industry-specific regulations can co-exist with COP or with the Draft's market-based sourcing.

The MTC's earlier work on Act Art. IV.17 stopped in order to let the ULC project proceed. It was widely understood that the ULC was going to make Art. IV.17 a high priority. While it was entirely appropriate for the MTC to have suspended its efforts and not run a parallel project to the ULC, the lost time was unfortunate. With a large minority of the states having adopted some form of market-based sourcing with diverse rules, a pressing need for uniformity exists. Once the ULC abandoned its project, the MTC became the logical body to bring some order and uniformity to the field and encourage coordination by the states.

The Executive Committee has a threshold decision: should it try to refine the Act's COP or should it adopt the Draft's Art. IV.17 and proceed with model regulations. The Hearing Officer presumes that the Executive Committee will endorse the Draft, and proceed with drafting of model regulations. Speed is of the essence if the MTC is to exert influence in this area. It can only be hoped that the states that have already marched down the path of market-based sourcing will reverse their current practices if those turn out to be inconsistent with MTC model regulations.

E. The Receipts Factor

The Uniformity Committee recommends that:

> Article IV.1(g) ~~Sales~~Receipts" means ~~all~~ gross receipts of the taxpayer that are not allocated under ~~Sections 4 through 8 of this Act~~ 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 other than a securities dealer from hedging transactions and from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities, shall be excluded.

1. Reasons for Change

This proposal elevates the heart of a 1973 MTC Regulation into the body of the proposed statute. MTC Reg. IV.15(a) provides that "for the purposes of the sales factor of the apportionment formula for each trade or business of the taxpayer, the term 'sales' means all gross receipts derived by the taxpayer from transactions and activity in the regular course of the trade or business." Accordingly, the regulation excludes from the sales factor gross receipts related to transactions satisfying the functional test, such as the sale of a machine, equipment, plant, or a business.

Closely related to this regulation is MTC Reg. IV.18(c), which provides that "substantial amounts of gross receipts from an incidental or occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business" are excluded from the sales factor. This regulation would seem to be unnecessary under MTC Reg. IV.15(a). More recent MTC Regulations exclude from the sales factor the so-called treasury function activities. MTC Regs. IV.2(a); IV.18(c)(4). All of these regulations seem inconsistent with Act Art. IV.1(g), which provides that "'[s]ales' means all gross receipts of the taxpayer not allocated under paragraphs of this Article," and are best understood as sweeping propositions under alternative apportionment.

The Draft thus rejects the view that if an item of income is included in the preapportionment tax base, the related receipts should be included in the sales factor. The throwout rule proposed by Draft Art. IV.17 also rejects this view (as does any throwout rule).

The Report's strongest argument for including the gross receipts from only the transactional definition is that it is "generally agreed that the purpose of the sales factor is to reflect the taxpayer's market activity, not its production activity. If that is the case, then the type of receipts that are included in the sales factor should be those that reflect the contribution of the taxpayer's market to the earning of income. It is unnecessary, and may be counter-productive, to include receipts from transactions involving the taxpayer's production property—such as plant, machinery, and equipment—in the sales factor. Including receipts from these types of assets would not reflect the market for the taxpayer's product and could essentially double count the property factor.

"In a three-factor apportionment formula, the sales factor is intended to balance the property and payroll factors, and it should be defined to offset rather than amplify the contributions of the production states. If the Executive Committee were to adopt a single sales factor, then this analysis may be different. In that case, it may be reasonable to provide for some reflection of the contributions of production states, even if that is accomplished through the sales factor." Report, p. 16.

2. Public Comment

Mr. Miller characterized the existing definition of receipts as "overly broad," which has led to efforts to inflate the denominator, resulting in "nowhere" income. He would prefer to define sales more narrowly. He also challenged the view that receipts from business income have to in the sales factor.

Sutherland objected to the exclusion of receipts from hedging transactions, stating that hedging activity directly relates to some taxpayers' ability to establish and maintain a marketplace, and excluding them does not reflect the taxpayer's sales.

3. Comments and Recommendations by the Hearing Officer

The United States Supreme Court has never endorsed the Report's view of the sales factor. The Report's view is also inconsistent with the Act, which defines sales as including all gross receipts that are not allocated. (The defect in this definition is addressed below.) The MTC Regulations cited above would be unnecessary if the Act had adopted the Report's narrow view of the sales factor.

By including only receipts received from transactions under the transactional test but excluding all other receipts, the Draft might place more weight on that category than its definition may be able to bear. A taxpayer wishing to include (or exclude) the receipts from a transaction would have an incentive to characterize an activity as falling within (or without) the transactional test, creating the potential for litigation that the Draft's broadened definition of business income was appropriately supposed to reduce.

A taxpayer seeking to include receipts in the sales factor would want to avoid the functional test and would have an incentive to characterize a transaction as a service rather than as property. Services are outside the functional test but could satisfy the transactional test. Conversely, a taxpayer seeking to exclude the receipts would have an incentive to characterize a transaction as property rather than a service and then argue the functional test rather than the transactional test was satisfied. Especially in a digital world, the line between property and services can be blurry (as well as the line between tangible and intangible property). The goal should be to reduce pressure on these categories but the Draft does the opposite.

The Draft's incorporation of the Act's definition of the transactional test with its reliance on the concept of "regular" is inconsistent with the Hearing Officer's proposed draft of apportionable income. *See* Section III.C above. The Draft would resurrect the very problem that the Hearing Officer was trying to avoid in his draft—litigation over the word "regular." The Hearing Officer fears that the definition of "regular," with all of its ambiguities, will become the focus of future litigation if the Draft's definition of receipts is adopted.

These comments expose the interplay between the definition of apportionable income and the definition of receipts in the sales factor. That interplay is minimized in the Act because the sales factor includes all receipts from business income. The Draft, however, includes in the sales factor only a subset of receipts generated by apportionable (business) income.

Another significant interplay is between the throwout rule under the Draft's proposed market-based sourcing and the receipts factor. Draft Art. IV.17(a)(4)(ii)(C) throws out certain receipts from the sale of intangibles. For example, receipts from the sale of stocks and bonds and other intangible financial assets would be excluded from the receipts factor under Draft Art. IV.17. *See* Section III.D(8) above. Receipts from hedging and from the treasury function (discussed below) are generated by the sale of intangibles. Accordingly, the adoption of Draft Art. IV.17 would eliminate the need to address these receipts in Draft Art. IV.1(g).

Whether the sales factor should be viewed as the Report suggests, rather than partly as a political compromise as described in Section III.A above, the apportionment formula must yield to the constitutional mandate that it be fair, reflect a reasonable sense of how income is generated, and be rationally related to values connected with the taxing state. That principle trumps a particular view of the sales factor.

To be sure, the constitutional mandate should not be woodenly followed any more than the proposition that the receipts factor should be limited to transactions satisfying the transactional definition should be slavishly followed. But the Hearing Officer believes there should be strong and compelling reasons for excluding from the sales factor the receipts related to income that is included in the preapportionment tax base. And the Hearing Officer views the sales factor as more in the nature of a political compromise than the result of any grand economic theory or model.

Excluding receipts from the sales factor has the result of apportioning the gain (or loss) generating those receipts using the status quo ante apportionment formula. The Hearing Officer recognizes that situations exist for which excluding the receipts would be acceptable but others in which it would not. Much depends on the apportionment formula (e.g., three factor or one factor), the nature of the income generating the receipts at issue (e.g., the sale of a depreciable or amortizable asset), and the ability to assign the receipts in an acceptable manner to the numerator of a particular state's sales factor. The difficulty of saying anything very useful in the abstract is that transactions come in so many sizes and shapes.

Consider, for example, a corporation that at the beginning of January sold a trivial amount of inventory and shortly thereafter sold the plant in State A that manufactured that inventory and ceased operations. Assume the gain on the sale reflected increases in the value of the real property in State A, and that the inventory was delivered outside of State A. If State A used a single-sales factor, and the receipts from the sale of the plant were excluded as the Draft proposes, none of the gain would be apportioned to State A, which has a strong claim to tax such gain. If all the destination states also used a single sales factor and excluded the receipts from the sale of the plant, the gain would be apportioned based entirely on the receipts from the inventory. In this case, a very tiny tail would wag a very large dog, perhaps violating the external consistency doctrine or triggering Section 18 relief.

One could describe the above problem as being caused not by the exclusion of the receipts but rather by the adoption of a single sales factor. As a matter of logic, the problem is caused by *both* the exclusion of gross receipts and the adoption of the single sales factor. But one teaching of *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978) is that the Supreme Court is not likely to mandate particular types of apportionment formulas; accordingly, in litigation the formula will probably be accepted as the starting point. The framework of analysis is likely to be on whether as applied the formula is fair and reflects a reasonable sense of how income is generated if the gross receipts from the sale of the plant are excluded from the sales factor.

Obviously, the illustration above has been purposely skewed to mark one polar point on the continuum of possible situations, whose results under the Draft could vary dramatically. Excluding the receipts from the sale of goodwill by a manufacturer ceasing operations, for example, might be acceptable under a three-factor formula. (Draft Art. IV.17(a)(4)(ii)(C) would, however, throw out these receipts from the sales factor.)

Depreciable personal property raises a further complication because it involves assets whose gain on the sale might recapture in whole or in part the previously deducted depreciation. Under the Draft (and Act) there is a disconnect between the states bearing the cost of the depreciation deductions associated with the asset and the states that tax the gain that recaptures that depreciation. (Loss assets are discussed separately below.)

In other words, the apportionment of taxable income can be viewed as the apportionment of gross income less the apportionment of expenses, one of which would be depreciation. Depreciable business property would have generated deductions, which would have reduced taxable income and thus income taxes in the states to which the taxable income was apportioned. Depreciation reduces the basis of an asset and gain on the sale recaptures in whole or in part those deductions.

To illustrate, consider an asset that cost $1000 and that was depreciated over a number of years to $100. If the asset were sold for $1000, it will generate a tax gain of $900. That gain represents a recapture of the entire $900 of depreciation previously taken. Cf. Int. Rev. Code of 1986, Section 1245. The Draft (and the Act) would tax the $900 of tax gain using the taxpayer's apportionment formula in the year of sale. The Act includes the $1,000 receipts in the sales factor; the Draft would not.

An alternative approach, perhaps more defensible (albeit not very administrable) would be to apportion the gain to the states that bore the cost of the recaptured depreciation. For example, assume the corporation was taxable in two states: A and B. Assume State A's apportionment percentage remains constant at 10% and State B's apportionment percentage remains constant at 90%. Assume further that State A's tax rate remains constant at 5% and State B's tax rate remains constant at 10%. Using the asset described above, if $900 of depreciation were claimed over the life of the asset, $90 would have been apportioned to State A, reducing taxes because of that deduction by $4.50. The corporation would have apportioned $810 of depreciation to State B, reducing taxes because of that deduction by $81.

Of the $900 gain on the sale of the asset, $90 would be apportioned to State A, increasing tax by $4.50, which offsets the cost of the depreciation previously apportioned to State A. Of the $900 gain on the sale of the asset, $810 would be apportioned to State B, increasing tax by $81, which offsets the cost of the depreciation previously apportioned to State B. The correct result is reached by excluding the gross receipts from the sale.

That result, however, would be achieved under a very specific—and unrealistic—set of conditions. The apportionment percentage would have to be the same in each of the states in which the corporation was taxable over the life of the asset, the tax rate would have to remain the same, and the corporation would have to be taxable in exactly the same states.

Obviously, apportionment percentages change, both quantitatively and qualitatively. Tax rates change. The states in which the corporation is taxable will change, not only because business operations might expand or contract, but also because of changes in the interpretation of nexus. In addition, the economic life of an asset is likely to be longer than the period over which depreciation is claimed, virtually ensuring that none of these conditions will be satisfied. It would be sheer serendipity if apportioning the gain in the year of sale without including the gross receipts would reach the correct answer.

The receipts factor alone cannot begin to deal with these considerations, nor can the property factor. One approach to this problem would be to segregate the sold asset for schedular treatment. Consider the $900 tax gain in the asset above. Under a scheduler approach, if the asset had been depreciated over five years, the amount of each year's depreciation that is recaptured could be multiplied by each state's apportionment percentage in each of those years, then multiplied by the appropriate tax rate in each year, and the results aggregated (putting aside credits and NOLs and the like). The aggregate amount would be that state's share of the tax on the gain.

A further complication is that if the asset were sold for more than $1000, only $900 would represent a tax gain. The excess of the sales price over $1000 would be an economic gain. The economic gain might reflect changes in market conditions independent of actions by the taxpayer, making the normative treatment of the gain harder to determine.

If expenses were deducted that helped create the tax gain, such as drilling expenses that led to the discovery of oil, making the property worth many times its purchase price, then the same arguments for recapturing depreciation could apply to "recapture" those expenses.

Losses become trickier. A loss on the sale of an asset can be viewed as functionally equivalent to the amount of depreciation that should have been allowed in an ideal world with perfect information. Put differently, if the rules on depreciation reflected the actual decline in the value of an asset, there would generally be no loss on the sale of an asset because its adjusted basis would equal its fair market value.

To conform the treatment of loss assets with the above approach for gain assets, a taxpayer would apportion the loss in the year of sale based on an imputed annual amount of additional depreciation. That amount would be multiplied by each state's apportionment factor in each of the years in which the asset was depreciated. That amount of apportioned imputed depreciation would then be multiplied by the appropriate state tax rate in each of the years the asset was depreciated, and the results then aggregated (again putting aside credits and NOLs and the like). The result would be each state's share of the loss.

The reader should rest assured that the Hearing Officer is not seriously suggesting that the above approach be implemented; only showing how apportioning the gain (or loss) in the year of sale to the states in which the taxpayer is doing business in that year, which may be quite different from the states in which the asset was depreciated, using an apportionment percentage quite different from the percentages that applied in the years of depreciation, and tax rates that might have changed over time, does not begin to recapture the cost of previously claimed depreciation, regardless of whether the gross receipts on the sale are included or excluded from the sales factor.

So what to do? Intertemporal differences are typically ignored by most states (installment sales being the exception). Either including the gross receipts generated by income satisfying the functional test as the Act does, or excluding such receipts as the Draft does, can raise external consistency and Section 18 issues, and it is not clear that there is a systemic bias one way or the other. The Hearing Officer has seen situations that triggered Section 18 issues where the gross receipts were included and ones where they were excluded. Generalizations are simply not very useful given the wide range of transactions that can occur.

Excluding the gross receipts from transactions satisfying the functional test, however, has one advantage not set forth in the Report. If a business is sold as a stock sale, the sale of a partnership or membership interest, Draft Art. IV.17(a)(4)(ii)(C) would throw out the receipts. If a business is sold as an asset sale, the receipts from tangible assets would be assigned under Art. IV.16 using the destination principle. By excluding such receipts from the sales factor, the Draft would conform stock sales, partnership sales, and membership interests in an LLC with asset sales.

i. **Exclusion of Receipts from Hedging Transactions and from the Maturity, Redemption, Sale, Exchange, Loan or other Disposition of Cash or Securities**

The Report defends its exclusion of receipts from hedging and from the so-called treasury function (which is a shorthand for the maturity, redemption, sale, exchange, loan or other disposition of cash or securities) as follows: "[b]asing the definition of 'sales' on the purpose of the sales factor has implications for whether to include receipts from the treasury function and other financial activities where there is no 'customer' (e.g., receipt of dividends or interest income). If the purpose of the sales factor is to reflect the taxpayer's market for its product, then, unless the taxpayer is a securities dealer, receipts from its treasury function and other financial activities should be excluded. These exclusions are consistent with the MTC's current model regulations. Some states exclude these receipts entirely. Some limit inclusion to net rather than gross receipts. If the problem were only distortion, then a limitation to net may be fine. But if there is also a policy problem of inconsistency with the purpose of the sales factor, or a practical problem of how to source these treasury function receipts, then exclusion may be the better approach. The Committee chose exclusion." Report, p. 16.

In the interests of disclosure, the Hearing Officer has participated in cases involving both the treasury function and hedging on the issue of whether the gross receipts involved were sales within the definition of Act Art. IV.1(g). In all of these cases, the persons in charge of these transactions were unaware of state tax considerations and operated under strict guidelines that constrained their discretion to buy and sell. And one crucial difference between the two situations is that certain taxpayers might not be in business without the ability to hedge their purchases of critical raw materials. For these taxpayers, hedging is part of an inventory control function, which goes to the heart of generating business income. Nonetheless, the Hearing Officer is aware of the theoretical and pragmatic arguments against including the receipts in the sales factor from both the treasury function and from hedging.

The Hearing Officer will not debate the merits of excluding the receipts from the hedging or the treasury function. In his opinion, the Draft needlessly creates a bad precedent of excluding a class of transactions from the sales factor. It is not difficult imagining that the tables might be turned on a state with a taxpayer (or industry) lobbying for the exclusion of a class of receipts that will be in its favor, citing for support the precedent of the state having previously excluded the receipts from hedging and the treasury function. The club today can become a snake that bites tomorrow. Because Draft Art. IV.17(a)(4)(ii)(C) already throws out the receipts from hedging and the treasury function, *see* Section III.D(8) above, Draft Art. IV.1(g) need not address these transactions.

The Hearing Officer prefers a statute that sends the message that exclusion of gross receipts is the exception and should be limited to exceptional circumstances. The specific exclusion for hedging and the treasury function sends the wrong message. To be sure, the throwout rule in Draft Art. IV.17(a)(4)(ii)(C) could be viewed as sending that same message, but it is more muted. As a political matter, the Hearing Officer believes that the throwout rule for the sale of intangibles in Draft Art. IV.17(a)(4)(ii)(C) is less likely to be successfully seized upon by lobbyists seeking similar treatment for their clients than if the sales factor explicitly excluded hedging and the treasury function.

Some might argue that the treasury function and hedging are so significant that they merit a "belts and suspenders" approach, being both thrown out under Draft Art. IV.17(a)(4)(ii)(C) as well as in Draft Art. IV.1(g). But this "belts and suspenders" approach invites a court to reconcile the two provisions, which may result in the more specific—Draft Art. IV.1(g)—superseding the more general—Draft Art. IV.17(a)(4)(ii)(C).

If a court were to do so, a policy issue would then arise regarding the exception for securities dealers. The exception's rationale is clear: for dealers the so-called treasury function represents transactions and activities that would be described under the transactional test. But so might the income of market makers and others that might not be described as a "securities dealer." Indeed MTC Reg. IV.18(c)(4)(E)(Ex.(ii)) excludes traders as well as dealers from the treasury function, but the Draft excludes only the latter. A similar question can be raised about those involved in hedging that might be the counterpart of a "securities dealer." The risk of singling out securities dealers as an exception from the treasury function is that other persons exist that perform equivalent activities. This drafting problem is avoided under the throwout rule of Draft Art. IV.17(a)(4)(ii)(C).

Dealers will still have to assign the receipts from their treasury function activities to the numerator of a state's sales factor. That assignment will presumably take place under the rules of Draft Art. IV.17(a)(4)(ii)(C), which will throw out the receipts. Accordingly, the carve out would seem to have no effect on where the receipts would be assigned under the Draft but will lend some support to a dealer's Section 18 claim for equitable apportionment.

For the reasons above, the Hearing Officer concludes that the preferred course is to deal with hedging and the treasury function only under Draft Art. IV.17(a)(4)(ii)(C) and encourages the MTC to deal with the issue through a regulation and also address whether others, like traders, should also be covered.

On an administrative note, the Hearing Officer recommends that any time an exclusion from a factor is provided as the Draft does for receipts generated by business income satisfying the functional test, or as the Draft does with its throwout rule under Art. IV.17, the tax return should be designed so that the items at issue are identified. If a return is filed with the exclusion or throwout already being taken so that the item never appears in the first instance, an auditor is handicapped in determining whether the statute has been followed.

Finally, the Hearing Officer fully endorses the Draft's change in the name from "sale" to "receipts." Receipts better captures the range of items that can be included, such as dividends, interest, capital gains, rents, royalties, and services.

4. Proposed Draft by the Hearing Officer

The Hearing Officer presents two alternative drafts. Each assumes that Draft Art. IV.17(a)(4)(ii)(C) has been adopted by the Uniformity Committee and that receipts from the treasury function and from hedging do not have to be addressed by Draft Art. IV.1(g).

The alternatives clean up a problem with the Draft. The Draft retains the language of the Act referring to the "gross receipts of the taxpayer not allocated . . . " The problem is that receipts are not allocated, gain or loss is. The two alternatives below eliminate that reference.

i. Alternative One

"'Receipts' means gross receipts of the taxpayer that are received from, or associated with, transactions or activities generating apportionable business income defined in Art. IV.1."

Alternative One is broader than the Draft and broader than Alternative Two. It implements the principle that if income is apportionable, the concomitant receipts should be included in the sales factor so that the apportionment formula is more likely to be fair and reflect a reasonable sense of how income is generated and prevail on a constitutional challenge.

The Hearing Officer prefers his proposed draft of business income in Art. IV.1(a) to that proposed by the Uniformity Committee, *see* Section

III.E, but the reference in Alternative One to Art. IV.1 will incorporate whatever the MTC decides.

Alternative One would cover receipts from transactions or activities that might not satisfy either the transactional or functional tests but would nonetheless satisfy the constitutional test. The Hearing Officer considers this an advantage but presumably the Uniformity Committee would not.

Compared with the Alternative Two, Alternative One will reach more situations that raise potential claims of alternative apportionment. Some might welcome that; others will not.

Less fundamentally, Alternative One replaces the conjunctive “and” with the disjunctive “or” and changes “activity” to “activities.” A disadvantage of Alternative One is that it does not treat asset sales of businesses the same as stock, partnership, or LLC sales.

ii. Alternative Two

“’Receipts’ means gross receipts of the taxpayer that are received from, or associated with, transactions or activities generating apportionable business income defined in Art. IV.1, excluding substantial amounts of such gross receipts from an incidental or occasional sale of a fixed asset or other property that was, or is, related to, or part of, the operation of the taxpayer’s trade or business.”

This alternative adopts the hoary MTC Reg. IV.18(c) cited above, which excludes a subset of transactions satisfying the functional test. Alternative Two excludes some situations that might otherwise raise issues of alternative apportionment under Alternative One.

Alternative Two would presumably exclude the receipts from the typical sale of a business, thereby having the effect of equating the treatment of stock, partnership, or LLC sales whose receipts are excluded from the sales factor under Art. IV.17(a)(4)(ii)(C) with asset sales of a business. The terms “substantial,” “incidental,” and “occasional,” have apparently not spawned significant litigation. These terms can be dealt with through regulations. The absence of litigation can be ambiguous of course, and does not necessarily mean things are working well; sometimes it merely means that problems are not being discovered on audit or that the rule or regulation favors taxpayers. Nonetheless, the Hearing Officer prefers Alternative Two to the Draft.