

## Implications of the MTC's Market-Based Sourcing Model Regulations

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In this edition of *A Pinch of SALT*, the authors discuss the Multistate Tax Commission's recent amendments to its Model General Allocation and Apportionment Regulations.

Nearly every state that imposes a corporate income tax includes a sales factor in its apportionment formula. Generally, the sales factor is computed by comparing a taxpayer's "in-state" sales to its total sales. Determining in-state sales of tangible personal property is a straightforward concept — goods shipped to a customer's location are included as in-state sales only in the state of the customer's location.

It is more complicated to determine an in-state sale regarding the provision of multistate services or licenses of intangibles. Historically, states looked to a taxpayer's costs of performing the service or licensing the intangible. Some states have become critical of this cost-of-performance method and replaced it with a market-based method of computing in-state sales.

On February 24, 2017, the Multistate Tax Commission adopted amendments to the MTC's Model General Allocation and Apportionment Regulations (model regulations) that have been in the making since 2014.<sup>1</sup> The model regulations provide some finality to the MTC's three-year drafting process (for now). The model regulations invite numerous questions, including: How could the model regulations be further improved? How are states responding to the model regulations? What's next for the MTC?

### I. Background

#### A. Traditional Cost-of-Performance Approach

The cost-of-performance approach was established in section 17 of the Uniform Division of Income for Tax Purposes Act, which was first adopted by the National Conference of Commissioners on Uniform State Laws in 1957 and last amended in 1966.<sup>2</sup> The approach as set forth in UDITPA provides that receipts from sales of multistate services or intangibles are in

<sup>1</sup> MTC Model General Allocation and Apportionment Regulations With Amendments (adopted Feb. 24, 2017).

<sup>2</sup> National Conference of Commissioners on Uniform State Laws, Uniform Division of Income for Tax Purposes Act (approved 1957) (amended 1966).

the sales factor numerator based on the greater proportion of the income-producing activity performed as measured by costs of performance.<sup>3</sup>

The MTC included the same language from UDITPA section 17 in its original Model Multistate Tax Compact<sup>4</sup> (MTC compact) and issued implementing regulations interpreting the MTC compact, which the model regulations most recently revised to reflect a market-based, instead of a cost-of-performance, approach to sourcing.<sup>5</sup> A criticism of the cost-of-performance approach is that it results in an all-or-nothing means of assigning receipts between states.<sup>6</sup> Other criticisms reflect a concern that the cost-of-performance approach is dependent on the location of the taxpayer's activities and not the location of the taxpayer's customers.<sup>7</sup>

## B. Market-Based Sourcing

Market-based sourcing approaches arose as an alternative to cost of performance. Under a market-based sourcing approach, receipts from the sales of services and intangibles are sourced to the customer's location. However, determining the location of a customer raises numerous issues.

States have adopted variations of market-based sourcing rules that specify different definitions for what the taxpayer's "market" entails, including:

- where the purchaser "receive[s] the benefit of the services";<sup>8</sup>
- where "the service is received";<sup>9</sup>

- "the location of the customer";<sup>10</sup> and
- where the "service is delivered."<sup>11</sup>

The drafter's notes to the model regulations acknowledge these market-based sourcing variations and state that "it is expected that in most cases the same sourcing result will be reached under any approach."<sup>12</sup> However, the above alternatives can produce vastly different results in assigning receipts to a customer location. For instance, if a taxpayer generates receipts from selling tickets to a concert, Massachusetts sources the sale to Massachusetts if the concert occurs in the state (that is, where "the service is delivered").<sup>13</sup> In contrast, California presumes that "receipt of the benefit" of such a service occurs in California if the individual customer's billing address is in the state.<sup>14</sup>

In 2014 the MTC amended the MTC compact and recommended that states adopt a market-based approach — instead of cost of performance — for sourcing receipts from sales of intangibles.<sup>15</sup> The new section 17 of the MTC compact was brief, less than a page in length, and left many questions regarding how states should implement the new rule. With the intent to create more clarity and uniformity, an MTC working group was created. The group, which includes representatives from several states and encourages input and participation from taxpayer representatives, was formed to meet weekly to discuss and draft a more lengthy and detailed model market-based sourcing regulation to implement the new section 17 directive. The working group started with the Massachusetts market-based sourcing regulation (830 CMR 63.38.1) for draft language and discussion points.

<sup>3</sup> UDITPA section 17.

<sup>4</sup> The MTC adopted UDITPA as Article IV in its original compact. MTC, Multistate Tax Compact ("Article IV of the compact is composed of the Uniform Division of Income for Tax Purposes Act (UDITPA).").

<sup>5</sup> The MTC defined "costs of performance" as "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." The MTC also defined "income-producing activity" as "the transactions and activity engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of producing that item of income." MTC Allocation & Apportionment Regulations, Reg. IV.17(2), (3) (adopted Feb. 21, 1973) (rev. through July 29, 2010).

<sup>6</sup> Richard Pomp, Report of Hearing Officer — MTC Article IV Proposed Amendments at 90 (Oct. 25, 2013).

<sup>7</sup> *Id.* at 92-93.

<sup>8</sup> *E.g.*, Cal. Rev. & Tax. Code section 25136.

<sup>9</sup> *E.g.*, R.I. reg. CT 15-04.

<sup>10</sup> *E.g.*, N.Y. Tax Law section 210-A.

<sup>11</sup> *E.g.*, La. Stat. section 47:287.95.

<sup>12</sup> Model regulations, drafter's notes at 11-12.

<sup>13</sup> 830 CMR 63.38.1(9)(d)4.b.ii(A).

<sup>14</sup> Cal. Code Regs. tit. 18, section 25136-2(c)(1)(A). Note that if the taxpayer assigns the sale of a service to an individual based on a billing address, the state "must accept this method of assignment." *Id.* ("If the taxpayer uses the customer's billing address as the method of assigning the sales to this state, the Franchise Tax Board will accept this method of assignment.")

<sup>15</sup> MTC, Article IV Amendments to the MTC compact (approved July 30, 2014).

## C. Summary of Model Regulations

Rather than applying one sourcing rule to receipts from the sales of services and intangibles, the model regulations establish *three* different “significant substantive subsections.”

### 1. Sales of services

The first significant substantive subsection is section 17(d), “Sale of a Service,” which provides that receipts from the sale of services are generally sourced to a state “if and to the extent that the service is delivered to a location” in the state.<sup>16</sup> The term “delivered to a location” refers to the location of the taxpayer’s market for the service, which may not be the location of the taxpayer’s employees or property. Section 17(d) is further divided into three primary service categories: (1) in-person services;<sup>17</sup> (2) services delivered to the customer or for the customer or delivered electronically through the customer;<sup>18</sup> and (3) professional services.<sup>19</sup> According to the model regulations drafter’s notes, “the first and third categories are fairly straight-forward in terms of their scope” and the second category “may be viewed as a ‘catch-all’ category.”<sup>20</sup>

#### a. In-person services

Receipts from in-person services are sourced to a state “if and to the extent the customer receives the in-person service” in the state.<sup>21</sup> When the location where an in-person service is received cannot be determined, but the taxpayer has “sufficient information regarding the place of receipt from which it can reasonably approximate<sup>22</sup> the state or states where the service

is received, the taxpayer shall reasonably approximate such state or states.”<sup>23</sup> The model regulations provide specific guidance for different types of in-person services, including services performed on the body of an individual, services performed regarding the customer’s real estate, and services performed on tangible personal property that is shipped to the customer.

The model regulations also include a throwout rule for in-person services, which provides that receipts assigned to another state where the taxpayer is not taxable are excluded from the denominator of the taxpayer’s receipts factor.<sup>24</sup>

#### b. Services delivered to, or for, a customer, and services delivered electronically

The assignment of receipts in the “catch-all” category (that is, services delivered to the customer or for the customer, or delivered electronically through the customer) depends on the method of delivery of the service and the nature of the customer.<sup>25</sup> Stated another way, how receipts in this category are sourced depends on both how the service was delivered to the customer and the type of customer receiving the service. For example, receipts from a sale of a service delivered to a customer or for a customer through a physical means, such as direct mail services, are sourced to the state or states where the service is delivered.<sup>26</sup>

For services delivered electronically, the model regulations provide different rules for (1) services delivered to individuals, (2) services delivered to business customers, and (3) services delivered through or for either an individual or business customer. For services delivered to individuals, services delivered by electronic transmission are sourced to a state if and to the extent that the individual receives the service in the state.<sup>27</sup> If the state where the individual customer receives the service cannot be determined, the taxpayer can reasonably approximate the state using the individual

<sup>16</sup> Model regulations, section 17(d)(1).

<sup>17</sup> Model regulations, section 17(d)(2) (“in-person services” are services in which the customer or the customer’s property on which the services are performed is in the same location as the service provider when the services are performed).

<sup>18</sup> Model regulations, section 17(d)(3).

<sup>19</sup> Model regulations, section 17(d)(4).

<sup>20</sup> Model regulations, drafter’s notes at p. 9.

<sup>21</sup> Model regulations, section 17(d)(2)(B)1.

<sup>22</sup> “Rules of Reasonable Approximation” apply if the state or states of assignment provided in the model rules cannot be definitively determined. In some instances, like here, the rules provide specific methods for reasonable approximation. In other instances, taxpayers are permitted to approximate using “a method that reflects an effort to approximate the results that would be obtained under the applicable rules or standards set forth in Reg. IV.17.” Model regulations, section 17(a)(5).

<sup>23</sup> Model regulations, section 17(d)(2)(C).

<sup>24</sup> Model regulations, section 17(d)(2)(C).

<sup>25</sup> Model regulations, section 17(d)(3)(B).

<sup>26</sup> Model regulations, section 17(d)(3)(B)1.a.

<sup>27</sup> Model regulations, section 17(d)(3)(B)2.a.i.

customer's billing address.<sup>28</sup> For services delivered to business customers, services delivered electronically are generally sourced to the state where the service is received, which for businesses is the location where the service is used by the employees.<sup>29</sup> If this location cannot be determined, the service is sourced based on a series of cascading rules: first, where the contract of sale is principally managed by the customer; second, the customer's place of order; and third, the customer's billing address.<sup>30</sup>

For services delivered electronically "through"<sup>31</sup> or for an individual or business customer,<sup>32</sup> the service is delivered to a state "if and to the extent that the end users or other third-party recipients" are in the state.<sup>33</sup> When the taxpayer cannot determine the state where some enumerated services<sup>34</sup> are delivered to the end user or third party, the model regulations provide that the taxpayer may approximate the location where the service is delivered using a ratio of the state's population in the specific geographic area where the service is delivered relative to the total population in the delivery area.<sup>35</sup>

### c. Professional services

The last category, professional services, covers services that require specialized knowledge and in some cases require a professional certification, license, or degree. Whether professional services are sourced to a state depends on whether the customer is an

individual or a business. For an individual, the service is sourced to the customer's state of primary residence, or if that state cannot be determined, the customer's billing address.<sup>36</sup> However, if the taxpayer derives more than 5 percent of its receipts from sales of all services from one individual customer, the taxpayer is required to identify the customer's state of primary residence and assign the receipts to that state, and thus cannot source services receipts to the customer's billing address.<sup>37</sup> For a business customer, the service is sourced first to the state where the contract of sale is principally managed<sup>38</sup> by the customer; second, to the customer's place of order; and third, to the customer's billing address.<sup>39</sup> If the taxpayer derives more than 5 percent of its receipts from sales of all services from one business customer, the taxpayer is required to identify the customer's state in which the contract of sale is principally managed by the customer, and cannot source services receipts to the customer's billing address.<sup>40</sup> Special rules apply for sourcing some professional services, including architectural and engineering services, services provided by a financial institution, and transactions with related parties.<sup>41</sup> The model regulations also provide a throwout rule for all sales of professional services, which provides that receipts assigned to another state where the taxpayer is not taxable are excluded from the denominator of the taxpayer's receipts factor.<sup>42</sup>

## 2. Leases or licenses of intangible personal property

The second significant substantive subsection is section 17(e), "Lease or License of Intangible Personal Property," which provides that if an

<sup>28</sup> Model regulations, section 17(d)(3)(B)2.a.ii.

<sup>29</sup> Model regulations, section 17(d)(3)(B)2.b.i.

<sup>30</sup> Model regulations, section 17(d)(3)(B)2.b.iii. Note the model regulations also provide a "safe harbor" under which the taxpayer may assign its receipts to its customer's billing address under some circumstances. Model regulations, section 17(d)(3)(B)2.b.iv.

<sup>31</sup> A service delivered electronically "through" a customer to third-party recipients means a service "that is delivered electronically to a customer for purposes of resale and subsequent electronic delivery in substantially identical form to end users or other third-party recipients." Model regulations, section 17(d)(3)(B)3.

<sup>32</sup> A service delivered electronically "on behalf of" the customer means a service "in which a customer contracts for a service to be delivered electronically but one or more third parties, rather than the customer, is the recipient of the service." Model regulations, section 17(d)(3)(B)3.

<sup>33</sup> Model regulations, section 17(d)(3)(B)3.a.

<sup>34</sup> The specified services include advertising delivered to a known list of subscribers and service delivered to a customer that acts as the taxpayer's intermediary in reselling that service to other users. Model regulations, section 17(d)(3)(B)3.c.i and ii.

<sup>35</sup> Model regulations, section 17(d)(3)(B)3.c.i and ii.

<sup>36</sup> Model regulations, section 17(d)(4)(C)1.a.

<sup>37</sup> *Id.*

<sup>38</sup> The "[s]tate where a contract of sale is principally managed by the customer," is "the primary location at which an employee or other representative of a customer serves as the primary contact person for the taxpayer with respect to the day-to-day execution and performance of a contract entered into by the taxpayer with the customer." Model regulations, section 17(a)(3)(I).

<sup>39</sup> Model regulations, section 17(d)(4)(C)1.b.

<sup>40</sup> *Id.*

<sup>41</sup> Model regulations, section 17(d)(4)(C)2, 3, and 4.

<sup>42</sup> Model regulations, section 17(d)(2)(C).



intangible is “used” in the state, then the corresponding receipts are also in the state.<sup>43</sup> The term “use” refers to the location of the taxpayer’s market, not the location of the property or payroll of the taxpayer.<sup>44</sup> There are also specific rules for marketing intangibles, production intangibles, mixed intangibles, and intangibles resembling a sale of goods or services.<sup>45</sup> The model regulations also provide a throwout rule for all licenses and leases of intangible property, which provides that receipts assigned to another state where the taxpayer is not taxable are excluded from the denominator of the taxpayer’s receipts factor.<sup>46</sup>

### 3. Sales of intangible property

The third and final significant substantive subsection is section 17(f), “Sale of Intangible Property,” which assigns receipts from sales (not licenses) of intangible property depending on the nature of the intangible property. For instance, receipts from contract rights or government rights that authorize business activity in a specific geographic area are assigned to a state to the extent the intangible is proportionally or exclusively used or authorized to be used within that state.<sup>47</sup> Sales of intangible property that resemble a license or resemble a sale of goods or services are treated the same as the corresponding categories for leases and licenses of intangible property.<sup>48</sup> The model regulations also provide specific rules for some excluded receipts, including a throwout rule that excludes receipts assigned to another state where the taxpayer is not taxable from the taxpayer’s receipts factor.

The remaining portions of section 17 of the model regulations provide guidance regarding real property,<sup>49</sup> tangible property,<sup>50</sup> software and digital goods,<sup>51</sup> and dispute resolution.<sup>52</sup>

<sup>43</sup> Model regulations, section 17(e)(1)(A).

<sup>44</sup> *Id.*

<sup>45</sup> Model regulations, section 17(e)(2), (3), (4), and (5).

<sup>46</sup> Model regulations, section 17(e)(1)(D).

<sup>47</sup> Model regulations, section 17(f)(1)(A).

<sup>48</sup> Model regulations, section 17(f)(1)(B) and (C).

<sup>49</sup> Model regulations, section 17(b) (Sale, Rental, Lease or License of Real Property).

<sup>50</sup> Model regulations, section 17(c) (Rental, Lease or License of Tangible Personal Property).

<sup>51</sup> Model regulations, section 17(g) (Special Rules).

<sup>52</sup> Model regulations, section 17(h) (Mediation).

## II. How Could the Model Regulations Be Improved?

The model regulations include several new rules, changes to existing rules, and notable absences of rules that leave taxpayers and, in some cases, state taxing authorities less than fully satisfied. Specifically, the model regulations present difficulties regarding terms that lack workable definitions or lack definitions altogether. For example, the general rule for sales of services in section 17(d)(1) sources sales of a service to a state “to the extent that the service is delivered to a location” in the state. The model regulations go on to specify that “delivered to a location” refers to “the location of the taxpayer’s market for the service, which may not be the location of the taxpayer’s employees or property.”<sup>53</sup> But this raises further questions such as whether the location of a taxpayer’s market for a service is different from where the service is physically performed. For instance, if a taxpayer provides repair services on a customer’s equipment in State A, but the equipment is only used and stored by the customer in State B where the customer lives, it is not clear whether the sale should be sourced to the state where the service was actually performed and “delivered” (State A) or the state providing the “market for the service” where the equipment is used and the customer is located (State B).

Also, when a service provider provides a service to a customer that benefits the customer’s customers, where is the “location” of the taxpayer’s market? For instance, if a taxpayer provides accounting services for members of an organization that would otherwise be obligated to provide such services itself, is the taxpayer providing services to the organization or its members? The model regulations lack guidance regarding which customer benefiting from the taxpayer’s service determines the location of the taxpayer’s market.

The model regulations also fail to provide any definition of the term “actual evidence” as used in the rule for sourcing marketing intangibles. Section 17(e)(2) provides that “where a taxpayer has actual evidence of the amount or proportion

<sup>53</sup> Model regulations, section 17(d)(1).

of its receipts that is attributable to [state], it shall assign that amount or proportion to [state].” But the model regulations make no distinction between “actual evidence” and just evidence. The model regulations should be improved to avoid potential miscommunications between state tax authorities and taxpayers regarding what type of evidence is acceptable.

Also, the model regulations are deficient regarding reasonably approximating a taxpayer’s market. For example, when the location where an in-person service is “actually received cannot be determined, but the taxpayer has sufficient information regarding the place of receipt from which it can reasonably approximate the state or states where the service is received, the taxpayer shall reasonably approximate such state or states.”<sup>54</sup> Taxpayers are left with no examples or other guidance regarding the type of information that constitutes “sufficient information” for reasonable approximation purposes. For instance, if a taxpayer provides landscaping services to properties in various states, it is unclear if a declaration listing the properties in each state constitutes “sufficient information” or if the taxpayer must provide detailed invoices with the work and charges for each property. The standards for reasonable approximation in the model regulations would be dramatically improved if the MTC explicitly created a presumption of correctness and put the burden on the taxing authority to demonstrate why the taxpayer’s approximation was not reasonable, as at least one state has proposed doing.<sup>55</sup>

In other circumstances, the model regulations provide that instead of allowing the taxpayer to reasonably approximate how to source receipts, the taxpayer must use U.S. census population data as the metric for reasonable approximation.<sup>56</sup> Generally, taxpayers are experts in their own business, and taxpayers should be allowed to first use whatever method they determine is most appropriate for their lines of business. The model

regulations unnecessarily restrict the taxpayers’ method for reasonably approximating the market and do so in a potentially arbitrary manner.

The model regulations may also be improved with the inclusion of some industry-specific rules. Although the model regulations are intended to apply to all sales “other than sales of tangible personal property” and reach a broad range of taxpayers, such a broad scope cannot appropriately cover all situations, which is why industry-specific rules are valuable. On the other hand, industry-based special rules could create a slippery slope of complexity resulting in an overly complicated system. Still, uniform application of the rules is also a priority. Some taxpayers may have preferred to see more examples of the rules applied to different industries. The drafters acknowledged that the goal of the model regulations was to provide general guidance, and it is expected that industry-specific rules would be in subsequent section 18 of the model regulations.<sup>57</sup>

### III. How Are States Responding to the Model Regulations?

Of course, the MTC model regulations are not inherently authoritative and only provide states with recommended language to adopt into their own state tax regulations. Thus, how influential those model regulations prove to be depends on the extent that states implement the model regulations into their own administrative codes or other guidance. While some states have already begun to do so, it will be several years before that question is answered. Beyond mere speculation, it is instructive to examine state adoption of other MTC model rules.

Some previous MTC guidance and recommended language has been well received by state taxing authorities and widely adopted. For example, many states adopted the MTC’s guidance and recommended language regarding P.L. 86-272 nearly word-for-word in their administrative codes<sup>58</sup> or through other guidance.<sup>59</sup> Other states that are associate

<sup>54</sup> Model regulations, section 17(d)(2)(C).

<sup>55</sup> Draft text of Cal. Code Regs. tit. 18, section 25136-2(h)(2)(C) (2017) (“The taxpayer’s reasonable approximation method shall be used unless the Franchise Tax Board shows, by clear and convincing evidence, that such method is not reasonable.”).

<sup>56</sup> E.g., Model regulations IV.17(e)(2) — License of a Marketing Intangible.

<sup>57</sup> Drafter’s notes at 13.

<sup>58</sup> E.g., Ala. Admin. Code section 810-27-1-.19.

<sup>59</sup> E.g., Cal. Franchise Tax Bd., FTB Publication 1050 — Application and Interpretation of Public Law 86-272 (June 2011).

members of the MTC also adopted portions of the MTC's guidance.<sup>60</sup>

Looking at how states received the MTC's previous apportionment regulations is likely the best indicator. In that regard, most states' laws are consistent with some portions of the MTC's previous model regulations for sales other than sales of tangible personal property (for example "nonbusiness income" is defined consistently among many states). However, only three states have adopted almost every section of the MTC's previous model regulations in their administrative codes,<sup>61</sup> which suggests that states might apply a piecemeal approach to the MTC regulations.

However, some states adopted regulations like the model regulations even before they were finalized by the MTC. For example, Tennessee's sourcing rules for intangibles tracks the model regulations and was adopted in Tennessee in June 2016.<sup>62</sup> Other states follow the model regulations' approach of dividing the sourcing of services into three broad categories — "in-person" services; "services delivered to the customer or for the customer, or delivered electronically through the customer"; and "professional services."<sup>63</sup>

Most telling is the activity over the last 11 months since the MTC finalized the model regulations. Arkansas, Montana, North Carolina, and Oregon proposed making changes to their apportionment rules in accordance with the model regulations.

The most significant changes thus far among the states have been Montana's and Oregon's shift from cost-of-performance to market-based sourcing. Consistent with the MTC's 2014 amendments to the MTC compact and the model regulations, Montana's H.B. 511 adopts a market-based sourcing approach for apportionment

purposes and applies the same market-based sourcing principles to intangibles that the state previously applied to tangible personal property.<sup>64</sup> Like the 2014 MTC compact, H.B. 511 adopts a throwout rule applicable to sales other than tangible personal property if a taxpayer is not taxable in a state to which a receipt is otherwise assigned.<sup>65</sup> The governor signed the new law on May 3, 2017, and the law went into effect January 1, 2018.

The Oregon Legislative Assembly proposed and adopted several bills this session regarding market-based sourcing and the model regulations. The most significant bill, S.B. 28, replaced the state's cost-of-performance method for sourcing intangibles with market-based sourcing rules, which the state had already adopted for sales of tangible personal property.<sup>66</sup>

Similar efforts in Arkansas were less successful.<sup>67</sup> H.B. 2100 would have enacted market-based sourcing for receipts from intangibles, but the bill died in the House Revenue and Taxation Committee at *sine die* adjournment.<sup>68</sup> The legislation also followed the model regulations' definitional and technical changes such as the use of the terms "apportionable income" and "receipts factor." Also, H.B. 2100 included provisions that would implement a throwout rule in the state and expand the current throwback rule.

North Carolina also proposed legislation that would follow the model regulations for intangibles by sourcing intangible property to the extent used in the state and services to the extent delivered in the state.<sup>69</sup> S.B. 325 contained other provisions regarding individual income taxes that

<sup>64</sup> 2017 Montana Laws Ch. 268 (H.B. 511).

<sup>65</sup> *Id.* section 1 (amending Art. IV section 17(c)).

<sup>66</sup> 2017 Oregon Laws Ch. 43 (S.B. 28). The second bill, H.B. 2275, adopted the definitions of apportionable income and non-apportionable income from the model regulations and removed the terms "business income" and "nonbusiness income." 2017 Oregon Laws Ch. 43 (H.B. 2275). The third bill, H.B. 2273, eliminated the functional test for determining apportioned income subject to the state's corporate income tax and redefined "sales" to exclude some gross receipts. 2017 Oregon Laws Ch. 622 (H.B. 2273). All three laws apply to tax years beginning on or after January 1, 2018. S.B. 28 section 5; H.B. 2275 section 12; and H.B. 2273 section 5.

<sup>67</sup> H.B. 2100, 91st Gen. Assem., Reg. Sess. (Ark. 2017).

<sup>68</sup> To adjourn *sine die* means to adjourn without assigning a day for a further meeting or hearing.

<sup>69</sup> S.B. 325, 2017 Gen. Assem., Reg. Sess. at Part III (N.C. 2017).

<sup>60</sup> E.g., R.I. Code R. 60-1-128-9; S.C. Revenue Ruling No. 97-15 (Oct. 22, 1997).

<sup>61</sup> Or. Admin. R. 150-314-0335; Idaho Admin. Code r. 35.01.01.330 et seq.; and Utah Admin. Code r. R865-6F.

<sup>62</sup> Tenn. Comp. R. & Regs. 1320-06-01-.42. Tennessee did not adopt the model regulations entirely and in fact has made several important changes to the MTC model regulations, which the Tennessee Supreme Court recently highlighted as important to how courts should apply model rules such as the model regulations. *Vodafone Americas Holdings, Inc. & Subsidiaries v. Roberts*, 486 S.W.3d 496, 529 fn. 41 (Tenn. 2016).

<sup>63</sup> E.g., R.I. Admin Code section 60-1-194:8. The Massachusetts apportionment regulations, on which the model regulations were based, also make this same division of types of services.

gave the legislation the nickname “Billion Dollar Middle Class Tax Cut.” The North Carolina Department of Revenue previously developed rules on market-based sourcing, which generally track the model regulations,<sup>70</sup> but those rules will not go into effect until the General Assembly adopts market-based sourcing as well. The measure was referred to the House Rules Committee on April 10 after passing the Senate, but failed to make it out of committee before the end of the legislative session.<sup>71</sup> While the proposed changes to market-based sourcing were not enacted in 2017, North Carolina did pass legislation that modified the definition of apportionable income to be consistent with the model regulations.<sup>72</sup>

#### IV. What’s Next for the MTC?

Only time will tell when the MTC decides to get the band back together and work on the next round of model market-based sourcing regulation amendments. For the time being, its focus has shifted to other working group projects, including efforts to draft model alternative apportionment regulations as a direct result of the efforts of the model regulations working group. Specifically, the section 18 working group is discussing and drafting regulations to address the following issues, some of which address concerns discussed above with the model regulations (for example, industry-specific regulations):

- address the possible distortion that could be caused by the exclusion of functional receipts from the definition of receipts for purposes of the receipts factor in some circumstances;
- consider exceptions to the definition of receipts, which now excludes receipts from securities and hedging, when those receipts might represent “transactional” receipts for some taxpayers (for example, brokers) as well as how possible distortion might be

avoided (for example, churning of investments);

- consider whether receipts from factoring of receivables should ever be in the receipts factor;
- address any situations in which general population data, used under the draft section 17 sourcing rules, might result in distortion and what methods might be used to address that distortion;
- consider whether there needs to be a “de minimis rule” for sourcing of receipts in some instances so that the taxpayer may use a proxy for sourcing, or possibly throw out those receipts from the factor;
- address regulations that might be needed to interpret and implement the amendments to Article IV, section 18 made by the commission in 2015; and
- consider other special industry rules that might be necessary.<sup>73</sup>

At the time of publication of this article, the section 18 working group had submitted two draft model regulations to the MTC Uniformity Committee for review, comment, and potential approval (that is, recommendation to the MTC Executive Committee). The first draft model regulation had been in development for more than a year, and provides rules for sourcing the gross receipts of taxpayers with apportionable income but no or minimal amounts of includable “receipts” as a result of the narrowed definition of receipts provided in the amended Article IV of the 2014 MTC compact. This model regulation is meant to fill a perceived gap in guidance resulting from the new “receipts” definition in which special-purpose entities otherwise potentially end up with nowhere-sourced income.

The second draft model regulation submitted by the section 18 working group provides rules for apportioning receipts of bank holding companies and subsidiaries in states that have not enacted provisions for the apportionment and allocation of net income of financial institutions, or have enacted such provisions without defining “financial institution” to include bank holding companies and subsidiaries. At the time of

<sup>70</sup>N.C. Department of Revenue, “NCDOR Adopts and Submits to the Rules Review Commission Rules Regarding Market-Based Sourcing” (2017).

<sup>71</sup>N.C. General Assembly, S.B. 325 — Billion Dollar Middle Class Tax Cut (2017).

<sup>72</sup>2017 North Carolina Laws Ch. 204 (S.B. 628).

<sup>73</sup>MTC section 18 Regulatory Project.



publication, the section 18 working group had also requested guidance from the MTC Uniformity Committee on which areas and topics it should address next, including a specific request regarding whether the group should analyze existing special industry model regulations to determine if amendments are warranted.

In the event the model regulations are revisited, other areas that could be addressed include explaining what it means to be “related to” a taxpayer’s business operations under the functional test for apportionable income, and clarifying the burden and adequacy of evidence required to reasonably approximate a taxpayer’s market. ■

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