MULTISTATE TAX COMMISSION

Report of the Hearing Officer
Regarding Proposed Amendment to
Multistate Tax Commission Regulation IV.17

November 2006

I. Introduction

In May, 2006, the Multistate Tax Commission (MTC) Executive Committee approved for public hearing a proposal to amend MTC Regulation IV.17. This regulation addresses Article IV. §17 of the Multistate Tax Compact. Among many other things, this section of the Compact states that if a taxpayer has a receipt from a transaction other than a sale of tangible personal property, that receipt is assigned to the numerator of the sales factor of the state where the income producing activity is located. Under the current regulation, income producing activity "does not include the transactions and activities performed on behalf of a taxpayer, such as those conducted by independent contractors." The proposed amendment would eliminate that exclusion.

The appointed hearing officer held the public hearing and received one written comment and one oral comment. This Report covers the proposal's procedural and substantive background, summarizes the proposal and the public comment received at hearing, and recommends adoption of the proposal with one modification (Exhibit A).

The proposal is now before the Executive Committee. The Committee may approve the proposal, with or without modifications, remand the proposal to an earlier stage of the process for further development, or reject the proposal. If the proposal is approved, it will be submitted to a bylaw 7 survey of Compact member states. The bylaw 7 survey asks whether the state would consider adopting the proposal in its jurisdiction. If a majority of Compact member states respond in the affirmative, the proposal will be submitted to a vote of the Commission.

II. Procedural Background

A. Development of the Proposal

An amendment to MTC Reg. IV.17. was first proposed at the November, 2004 Uniformity Committee meetings by the Committee's representative from California (Mr. Michael Brownell, California- FTB). At that meeting, the Committee expressed interest in the proposal, and asked that a white paper be prepared explaining the rationale for such an amendment. A white paper was drafted by Mr. Brownell and presented to the Income & Franchise Tax Uniformity Subcommittee at its March, 2005 meetings, and, after discussion and an opportunity for public comment, the Subcommittee voted to initiate a uniformity project to address the proposal. On July 24, 2005, the white paper was again presented to the Income & Franchise Tax Uniformity Subcommittee, along with a draft proposed amendment. After discussion and an opportunity for public comment, the Committee voted to recommend the proposed amendment favorably to the Uniformity Committee. On July 25, 2005, after further discussion and opportunity for public comment, the full Uniformity Committee voted to recommend the proposal to the Executive Committee for public hearing.

At its meeting on July 27, 2005, the Executive Committee remanded the proposal to the Uniformity Committee in order to ensure adequate input from both member states and the public. The Committee directed the proposal be given additional consideration, via teleconference, and brought back to the Committee at its November, 2005 meetings.

The Income & Franchise Tax Uniformity Subcommittee met via teleconference to further consider the proposal on September 20, 2005 and October 18, 2005. At those teleconference meetings, the Subcommittee received additional input both from member states and the business community. A small drafting group consisting of two members of the Uniformity Subcommittee (Mr. Carl Joseph, California – FTB; Ms. Andrea Chang, California-FTB) and MTC staff was formed to incorporate changes to the draft based on the additional input. On November 6, 2005, the Income & Franchise Tax Uniformity Committee met again to consider the redrafted proposal and take public input. Another small work group consisting of two members of the Uniformity Subcommittee (Ms. Leonore Heavey, Louisiana; Mr. Carl Joseph, California – FTB) and MTC staff incorporated additional changes based on the input received. On November 7, 2005, the Subcommittee again considered the proposal and offered another opportunity for public input. After further discussion and changes to the proposal, the Subcommittee voted to recommend the proposal favorably to the full Uniformity Committee. On November 7, 2005, the full Uniformity Committee voted to recommend the proposal favorably to the Executive Committee for public hearing.

On November 10, 2005, the revised proposal came before the Executive Committee for possible approval for public hearing. After Committee review and discussion, and another opportunity for public input, the Committee determined discussion should be continued at its next meeting, scheduled for January 5, 2006. Following the Executive Committee's November meeting, a small group of Uniformity Committee members (Mr. Ted Spangler, Idaho; Mr. Carl Joseph and Ms. Andrea Chang, California – FTB) and MTC staff drafted additional amendments to the Uniformity Committee proposal that would address comments made by Executive Committee members at the November 2005 meeting. The January 2005 Executive Committee meeting was cancelled, and the proposal was placed on the Agenda for the next scheduled Executive Committee meeting, May 10, 2006. At this May meeting, the Executive Committee approved the proposal for public hearing.

B. Public Hearing

After 30 days notice, a Public Hearing was held October 26, 2006 in Washington, D.C. Oral public comments were received from Diann Smith, Council on State Taxation and written comments were submitted by Kimberley Reeder and Bo Kim for Baker & McKenzie LLP (Exhibit B).

III. Substantive Background

Under the Multistate Tax Compact (Compact), a multistate company's business income is apportioned among the states in which it does business in accordance with a three factor apportionment formula.[1] The three factors are property, payroll and sales.[2] The sales factor for each state is defined as a fraction, the numerator of which is equal to gross receipts attributable to that state, and the denominator of which is equal to total gross receipts.[3] The amount of gross receipts attributable to a state is determined in one of two ways, depending on whether or not the business income to be apportioned arises from a sale of tangible personal property. If the business income does not arise from the sale of tangible personal property (i.e. it arises from the sale of services or intangibles, or the lease of tangible or intangible property), then the gross receipts from that transaction are attributable to that state if the "income producing activity" which gave rise to the receipts is in that state.[4] If the income producing activity takes place in more than one state, then the receipts are attributed to the state with the greater income producing activity, based on the "cost of performance."

The Multistate Tax Commission is charged with the responsibility to develop model regulations interpreting the terms of the Compact.[5] In 1972, MTC Model Regulation IV.17 was adopted to interpret the terms "income producing activity" and "cost of performance." Under MTC Reg.IV.17(2), income producing activity "applies to each separate item of income and means the transactions and activities directly engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit." The regulation further states that income producing activity "does not include the transactions and activities performed on behalf of a taxpayer, such as those conducted by independent contractors." It is common for a taxpayer that contracts to perform a service to delegate or subcontract a portion, and sometimes all, of the actual performance of the contract to a third party. However, under this rule, any portion of taxpayer's activity which has been so delegated is excluded from the calculation of taxpayer's "income producing activity." A cost paid to an entity that performs all or part of the service on the taxpayer's behalf is not considered part of taxpayer's cost of performance for purposes of determining where the receipt from that service will be attributed in calculating taxpayer's sales factor numerator.

To illustrate: Assume a taxpayer contracts with a customer to perform a service for $1 million, and hires a subcontractor that performs the service on the taxpayer's behalf in state B. Assume that the taxpayer will incur costs of its own in State A of $100,000, and will pay $500,000 to the subcontractor to perform the rest of the service in State B. If the costs paid to the subcontractor acting on behalf of the taxpayer are disregarded, the greater cost of performance ($100,000) is located in State A, and the $1 million sale would be in numerator of the State A sales factor. If the costs paid to the

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[1] Portions of this substantive background are attributable to the White Paper developed by Mr. Michael Brownell.

[2] Multistate Tax Compact, Art. IV.9. Note: Article IV of the Compact incorporates the Uniform Division of Income for Tax Purposes Act (UDITPA).

[3] *Ibid*, Art. IV. 15.

[4] *Ibid*, Art. IV. 17.

[5] *Ibid.* Art. VI. 3(b) and Art. VII.1.

subcontractor acting on behalf of the taxpayer were considered, the greater cost of performance ($500,000 of $600,000) would be located in State B and the $1,000,000 sale would be in the numerator of the State B sales factor.

IV. Concerns with the Current Regulatory Language

A. Application Vague

The scope of the "on behalf of" actors whose activities may be disregarded is not clear. There is a range of possible actors that include 1) employees, 2) members of a combined reporting group, 3) members of a unitary group not included in the combined group, 4) affiliated but not unitary corporations, 4) individuals or corporations acting as agents,[6] and 5) individuals or corporations acting as independent contractors.

While an employee in some sense acts "on behalf of" the corporation for which he or she is employed, a strong argument can be made that the employee should be considered an extension of the taxpayer itself, and the employee's salary should not be disregarded as a cost of performance under the "on behalf of" rule.[7] Next in the range of "on behalf of" actors is a member of the taxpayer's combined reporting group. In a *Finnigan* state, the whole of the unitary enterprise is a "taxpayer" for apportionment purposes so it may be expected that acts by one unitary member "on behalf of" another would be treated as acts of component parts of the same "taxpayer." In a *Joyce* state, however, for purposes of the numerator of the sales factor, each "taxpayer" member of a combined reporting group is considered a distinct entity, and one could argue the activity performed on behalf of the taxpayer by a subcontracting member of the combined group, and intercompany payments to that member, are not "income producing activities" of the prime contractor taxpayer that actually receives the receipt from its customer.

One could argue that the "on behalf of" rule should be *limited to* independent contractors. However, such an interpretation could arguably be inconsistent with language of the rule itself, which applies to those acting on behalf of a taxpayer "*such as*" independent contractors. The phrase "such as" implies that the scope of the "on behalf of" rule may be broader than independent contractors alone. Thus, activity performed and costs paid to a non-independent contractor agent (i.e., an agent under the control and supervision of its principal) might also be excluded from income producing activity and costs of performance under the "on behalf of" rule.

B. Potential for Manipulation

If non-independent (or dependent) contractors are within the scope of the "on behalf of" actors, a taxpayer would have a substantial planning opportunity. This opportunity arises because the taxpayer could essentially control the location of the numerator state by choosing to either perform the contract itself (in the example above, by performing the service itself in State B) or to hire an affiliate, possibly even a member

[6] For purposes of this discussion, an agent is a person or entity sufficiently acting under the control and supervision of a principal so as not to be considered an "independent contractor."
[7] MTC Reg.IV.17(2)states "...Accordingly, income producing activity includes but is not limited to...: (A) The rendering of personal services by employees...in performing a service." Thus, the services (or at least the "personal" services) of an employee are considered income producing activities of the taxpayer.

of its combined group, to perform the contract (and thus, in the example above, shift the receipts to State A). A taxpayer wishing to exclude its cost of performance in a particular state could simply separately incorporate the segment of its business being performed in that state. State Departments of Revenue have begun to receive inquiries regarding whether or not this result from separate incorporation is indeed possible. Under the current rule, it appears it might be.[8]

C. Potentially Inadequate Statutory Support

Of interest to this inquiry, in *General Motors Corp. v. Commonwealth*) [(Record No. 032533) (September 17, 2004) (Doc 2004-18598)] the Virginia Supreme Court held that third party costs should not have been disregarded in that state's cost of performance factor used for financial institutions. Virginia statute requires that the "taxable income of a financial corporation...shall be apportioned within and without this Commonwealth in the ratio that the business within this Commonwealth is to the total business of the corporation. Business within this Commonwealth shall be based on cost of performance in the Commonwealth over cost of performance everywhere." Virginia regulations defined the term "cost of performance" as used in the Virginia statute as "the costs of all activities directly performed by the taxpayer for the ultimate purpose of obtaining gains or profit." The regulation also provided that cost of performance did not include "activities performed on behalf of a taxpayer, such as those performed on its behalf by an independent contractor." The court found nothing in the language of the Virginia statute that limited the costs of performance to direct costs or anything to suggest that the department was permitted to exclude costs incurred for activities performed on behalf of a taxpayer by a third party.

There are certainly differences between the language of the Compact and the Virginia statute. Under Art.IV.17 of the Compact:

> Sales, other than sales of tangible personal property, are in this State if:(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.

And, under the MTC regs, "on behalf of" activity is excluded from income producing activity, rather than from the cost of performance. But the two statutes may not be different in any way that is relevant to the issue here. Under the Virginia statute, the apportionment factor is "cost of performance." Under the Compact, the apportionment factor is "income producing activity," but cost of performance is the means for quantifying the relative significance of the income producing activity in one state versus another. The Compact uses the term "income producing activity" as a kind of intermediate concept, rather than the bottom line apportionment factor, but ultimately apportionment still depends on the relative cost of performance.

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[8] Of course, a separately incorporated entity operating in State B would have its own tax liability in State B and would attribute its own intercompany receipts to State B. However, this attribution would not produce the same result as if the taxpayer had performed the contract itself in State B. Even if the transaction is at arm's length, there would be a mark-up between what the subcontractor in state B charged its customer, the prime contractor in State A, and what the prime contractor charges the ultimate customer. This mark-up will not be reflected in the income sourced to state B. If the transaction is not at arm's length, the discrepancy could be much greater.

Of course this decision is precedential only in Virginia. But it does point out a possible weakness in the current regulation.

D. Rationale for Rule Unclear

The origins of the "on behalf of" rule are unclear. There may be a hint of a rationale in the fact that amounts paid to independent contractors are also excluded from the payroll factor. These rules may have reflected a notion that acts of an independent contractor were remote from the acts of the taxpayer and thus not properly chargeable to the taxpayer. This would be consistent with the cases that pre-date *Scripto v. Carson* that adopted a principle that acts of an independent contractor were not acts of the party for whom they acted. Section 17 doesn't have a throwback rule, so if a cost of performance is incurred in a state where the taxpayer doesn't have nexus, there is no standard mechanism in that statute or regulation for preventing a "nowhere sale." On the other hand, the view that an independent contractor doesn't confer nexus on the out-of-state seller was rejected in *Scripto*, at least in the context of a sales solicitation. *Scripto* was a 1959 case, decided well before the regulation was completed in 1972. However, if the independent contractor (or the independent contractor's own subcontractor) has discretion as to where its portion of the contract is performed, it is possible that *Scripto v. Carson* would not impute nexus to the taxpayer in the state where the subcontractor services are performed, on a theory that the acts in that state were not "purposefully directed" by the taxpayer. In that case, if amounts paid to an independent contractor would be considered a cost of performance, it would still be possible to have the greater cost of performance located in a state where the taxpayer does not have nexus.

Another reason the "on behalf of" rule might have been adopted is to avoid the audit difficulties associated with determining the location where the "on behalf of" actor actually performed its portion of the services under the contract. However, if the prime contract with the taxpayer's customer calls for the performance of a service in a specific state, or the service can only be done in that state (e.g., an earth-moving contract), it is not that difficult to identify the location where the "on behalf of" actor actually performed the service. On the other hand, the "on behalf of" actor might have discretion as to where its portion of the service is to be performed. For example, if a subcontractor is adding component value to an advertising contract, it might be able to perform its subcontracting services anywhere. In still other cases, a subcontractor might "outsource" its subcontracting services to still another party. As the actors become increasingly more remote from the prime contracting party, identification of the location of costs of performance could become increasingly difficult.

Any reversal of the "on behalf of" exclusion can and should address these two possible rationales for the current rule.

V. Summary of Proposed Amendment

A. Include Cost of Activity Performed "On Behalf Of" Taxpayer

The proposal from the Uniformity Committee would strike the exclusion of activity performed on behalf of the taxpayer from the definition of "income producing activity." Instead, the definition would include all of taxpayer's activity, regardless of whether it is performed by the taxpayer itself or by another entity acting on the taxpayer's behalf. The proposal would include the activity of all third party contractors, both dependent and independent. Treating all contractors similarly will avoid creating tax incentives or disincentives for taxpayers to contract with one over the other.

B. Address Potential Lack of Information Re Location of Activity

The proposal adopts a sequence of rules for determining the location of the taxpayer's income producing activity performed by a third party. Under the rule, the activity will be located where it actually takes place, if the taxpayer can make that determination. If the taxpayer cannot determine where the activity takes place, then the activity is sourced to the location specified by the contract between the taxpayer and the contractor, or if no such location is specified, then by the location specified for performance in the contract between the taxpayer and its customer. If neither contract specifies a location, then the activity is attributed to the location of the taxpayer's customer's (commercial) domicile.

C. Preclude "Look Through" to Subcontractor's COP

The purpose of the rule is to determine the location of the taxpayer's income producing activity, not the subcontractor's income producing activity. The taxpayer's income producing activity may be quantified using the taxpayer's cost of performance, not the subcontractor's cost of performance. Therefore, the only cost relevant to an inquiry regarding performance by a third party acting on behalf of the taxpayer, are the taxpayer's costs associated with that performance – the payments made by the taxpayer under the contract between the taxpayer and the subcontractor. In fact, taxpayer's payments to a subcontractor are "direct" costs to the taxpayer for the performance of the service being provided to taxpayer's customer. The costs should not include indirect costs such as the subcontractors cost of performing the service for its customer (the taxpayer). Nor should cost of performance include the costs of taxpayer activities that are not "directly engaged in ...for the ultimate purpose of obtaining gains or profit [i.e. of producing the item of income]," such as an assignment of costs for negotiating the contract with the subcontractor. This latter exclusion is consistent with the treatment of other direct costs, which include only the cost of taxpayer's personnel or property used to produce the item of income, and not the costs of negotiating the contract for that personnel or property.

D. Address Potential for Lack of Nexus

If the (commercial) domicile cannot be determined, or if the taxpayer does not have nexus in the state to which the rule would attribute the activity, then the activity is disregarded. The result is similar to a sales factor "throw-out" rule, although it only applies for purposes of determining the location of a particular receipt. It is not a throw-out of the receipt itself, which may still be attributed to some other state on the basis of the remaining costs – similarly to how the current rule would function.

VI. Public Comment and Hearing Officer Recommendations

The public hearing for this proposal was well attended, but only two sets of comments were received: Diann Smith (COST) testified orally, and Kimberley Reeder and Bo Kim (Baker & McKenzie LLP) submitted written comments. Exhibit A shows the hearing officer's recommendations for amendment in light of these public comments. The relatively low volume of public comment may reflect the fact that significant comment was received, and significant changes were made in light of that comment, during earlier stages of the uniformity process.

- ***Compliance Burden***

Baker & McKenzie LLP suggested that including "on behalf of" activities in the definition of "income producing activity" creates an addition compliance burden by increasing the number of activities that taxpayers will be required to track. (B&M LLP, p. 1) It is true that additional information will require additional tracking, but the comments do not give an indication of the extent of the burden or suggest that the addition burden is not outweighed by the benefits of more reasonable sourcing. The lack of specificity on this point and the lack of input from other taxpayers, suggest that any increased administrative tracking will not be unduly burdensome in light of the benefits to be achieved. Therefore, the Hearing Office does not recommend a change.

- ***Activities Engaged in "Directly"***

A question was raised as to whether deleting the term "directly" from the phrase "the transactions and activity 'directly' engaged in by the taxpayer in the regular course of its trade or business" goes beyond the purpose of the amendment to imply that any indirect activities must be taken into account as income producing activity. (B&M LLP, p.1-2) After considering the proposal as a whole, the Hearing Officer does not believe a change would be appropriate. A distinction should be made between *activities* in which the taxpayer is directly engaged and *costs* which the taxpayer directly incurs. The regulation continues to restrict included costs of performance to *direct costs.* The Taxpayer is engaging in activities indirectly through a contractor, but the included costs are limited to the direct payments the taxpayer makes to that contractor, i.e. the direct costs of the taxpayer. This retention of the requirement that any included costs must be direct costs of the taxpayer adequately limits the proposal to its intended scope.

- ***Definition of "Item of Income"***

It was suggested that the term "Item of Income" should be defined (B&M LLP, p. 2). The Hearing Officer generally agrees with that suggestion, however such an amendment is outside the narrow scope of this particular project and would best be addressed, if necessary, through the Commission's larger project regarding revisions to the language of Section IVI.17 of the Compact itself.

- ***"On Behalf Of" Services, More Than Just Personal Services***

Baker & McKenzie LLP suggested that the language seemed to limit the "on behalf of" services to only personal services. (B&M LLP, p.2) This was not intended and the Hearing Officer recommends a clarifying amendment to sections (2) and (3).

- ***Sourcing Income Producing Activity to State Where Actually Performed***

The proposal provides that income producing activity is in this state:

> " … when the taxpayer can reasonably determine at the time of filing that the income producing activity is actually performed in this state by the agent or independent contractor, but if the activity occurs in more than one state, the location where the income producing activity is actually performed shall be deemed to be not reasonably determinable at the time of filing under (4)(C)(a)(i)"

It was suggested that the provision unnecessarily limits the taxpayer's ability to source receipts to the state where a service is actually performed when a contractor performs the service in more than one state. The proposal does limit ability to source in this manner, but that limitation is necessary in order to avoid requiring the taxpayer to "look through" its own direct costs of performance to the costs of performance of its contractors.

In determining taxpayer's cost of performance, we would like to look at all of the taxpayer's direct costs of performance in a particular state, including any payment to a subcontractor performing in that state. But if the subcontractor, in turn, is performing its activity on behalf of the taxpayer in more than one state, the taxpayer may not know in which state those activities are actually being performed. Even if the taxpayer does know the various locations of the subcontractor's activity, there may be no clear cut way to determine the portion of its payment to the subcontractor (the taxpayer's cost of performance) that is associated with the subcontractor's activity in each state. Under the general rule, if the activity takes place in more than one state, you look to cost of performance. But we certainly do not want to create any need to "look through" to the *subcontractors* cost of performance (the subcontractors own costs of performing its contract with the taxpayer). We only want to look at the *taxpayer's* cost of performance in fulfilling its contract with its customer, and not any costs incurred by a subcontractor in fulfilling its contract with the taxpayer.

If the taxpayer has a simple way of determining which portion of the subcontractors activity is taking place in each state, and which portion of it's payments to the subcontractor is associated with the subcontractors activity in each state (e.g. a contract that breaks out the taxpayer's payment responsibilities for activity performed in each state), then under the current language of the proposal, that information could be used in determining the taxpayer's cost of performance in each state. Therefore, the Hearing Officer does not recommend further amendment.

- ***Throwout Rule***

Both commenters, COST and Baker & McKenzie LLP, object to the use of a throwout rule. (B&M LLP, p. 5) Baker & McKenzie LLP argue that "given that there is no comparable throwout rule for sales of tangible personal property to states in which the taxpayer is not taxable, the amendment treats taxpayers deriving receipts from providing services differently from taxpayers deriving receipts from selling tangible personal property…" (B&M LLP, p 5) This is true. A throwback rule applies to taxpayers selling tangible personal property. This rule would apply a throwout rule under certain circumstances to the determination for sourcing receipts from other than sales of tangible personal property. Nonetheless, the Hearing Officer sees no reason why the two would have to be the same. There are many provisions in both the Compact and the Regulations that treat taxpayers deriving receipts from …services differently from taxpayers deriving receipts from selling tangible personal property." And, in fact, eliminating the throwout provision as suggested would still not result in the treatment being the same.

COST expressed concern that this type of throwout provision could create anomalies by sourcing receipts for otherwise similarly situated taxpayers to different states if one of the taxpayer did not have nexus in a particular state. This is indeed a negative result of throwout (and of throwback as well). However, without throwout, the result would be even more anomalous as the one taxpayer would avoid tax altogether on that portion of its income sourced to a state in which it doesn't have nexus. Throwout is a partial, though not complete, correction for that anomalous result. Thus, the Hearing Officer does not recommend deleting this provision.

Respectfully Submitted,

Shirley K. Sicilian
Hearing Officer