Multistate Tax Commission
444 North Capitol Street, N.W.
Suite 425
Washington, DC 20001
(202) 650-3000

December 14, 2020

OECD Centre for Tax Policy and Administration
Submitted by Email - cfa@oecd.org

Response to the Public Consultation Document on the Report on the Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint

Dear Secretariat:

The Multistate Tax Commission (MTC) is responding to the Public Consultation Document that asks for comment on the OECD (2020), Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Item III - the nexus standard, and Item IV – the revenue sourcing rules. The MTC has extensive experience with both nexus and sourcing issues and this letter submits a summary of that experience along with information on the approach that the MTC has recommended to its members.

We hope that you will find the information contained in this letter to be helpful in your work. If you have any questions about this information or wish to obtain additional information that we might provide, please do not hesitate to contact me at +1 (202) 650-3000 or hhecht@mtc.gov.

Sincerely,

/s/

Helen Hecht, Uniformity Counsel
Multistate Tax Commission

cc. Greg Matson, Executive Director, Multistate Tax Commission

Response of the Multistate Tax Commission
Public Consultation Document on the Report on the
Tax Challenges Arising from Digitalisation
Report on Pillar One Blueprint – Items III and IV

Context for the Information Provided

The Multistate Tax Commission

The MTC is a voluntary organization of American states whose members are state tax agency heads.[1] The MTC was created by the states in 1967 to assist in developing more uniform or compatible methods of taxing multistate business income.[2] To provide necessary context for understanding the information provided in this letter, the following section summarizes the history of U.S. state-level taxation of business income and the role of the MTC in that history.

Brief Relevant History of U.S. State-Level Taxation of Business Income

Development of the State Business Income Tax System

Under the United States federal system, state governments have independent sovereign authority to impose taxes, subject only to jurisdictional due process standards and the right of the federal government to regulate interstate commerce.[3] While international commerce was rare when the states began imposing business income taxes in the early 20th Century, interstate commerce was common. So, from the beginning, American states recognized the problem of dividing the income of multistate businesses for tax purposes. They also recognized the two basic methods for doing this—separate geographic accounting and formulary apportionment.[4]

The states soon found that separate geographic accounting was unworkable. In part, this was because substantial multistate operations were often conducted by a single entity. This made it necessary to impute all manner of cross-border transactions where none actually existed or were otherwise required to be recognized for any other purpose, determine the tax characteristics of these imputed transactions, and

[1] *See* information about the organization on the MTC website, here: http://www.mtc.gov/The-Commission.
[2] Multistate Tax Compact, Art. I, available on the MTC website, here: http://www.mtc.gov/The-Commission/Multistate-Tax-Compact#Article%20I.
[3] See *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 448 (1980)(holding of the U.S. Supreme Court that it is the well-established norm that U.S. states have taxing authority concurrent with the federal government).
[4] Hellerstein, Hellerstein & Swain, *State Taxation* (Thomson Reuters/Tax & Accounting, 3rd ed. 2001, with updates through November 2020) (online version accessed on Checkpoint (www.checkpoint.riag.com) December 3, 2020), ¶8.02[3].

estimate their arm's-length prices.[5] Separate geographic accounting simply could not achieve sufficient precision to justify this difficulty.[6]

States therefore moved to adopt formulary apportionment instead, using property, payroll, and sales as the elements, or factors, of that formula. Today, while the exact apportionment formula may vary from state to state, all American states that impose a tax on the net income of businesses use formulary apportionment rather than separate geographic accounting. [7]

At the same time, states began to recognize that applying formulary apportionment on a separate entity basis allowed related entities to engineer transactions to shift income to low- or no-tax states. In response, the states began to apply formulary apportionment to the "unitary business"—that is, one whose entity members are under common ownership control and are economically interdependent. The United States Supreme Court has always held that that states may apply formulary apportionment to the unitary business despite the fact that some of the entities or operations, themselves, might be jurisdictionally remote.[8] Today, a majority of states provide that formulary apportionment is generally applied to the unitary business or similar combination of entities.[9]

<u>The Uniform Division of Income for Tax Purposes Act</u>

In 1957, before the MTC was formed, another organization of American states, the Uniform Law Commission, drafted a model law for formulary apportionment of multistate income. This statute, called the Uniform Division of Income for Tax Purposes Act (UDITPA), incorporated the apportionment formula that states had developed, consisting of the average ratio of the property, payroll and sales factors in the state to the total factors for the business.[10] For the following decade, states took steps to make their business taxes more uniform by generally conforming them to the federal net income tax base and adopting UDITPA, or an analogous apportionment formula, as the method of determining the state share of that base. Today, a number of states use a formula that includes only sales or that gives additional weight to the sales factor. Use of a single-sales factor for formulary apportionment was upheld by the U.S. Supreme Court in 1978. [11]

The states formed the MTC in 1967, in part, to assist in developing model rules and regulations for implementing UDITPA, especially the sourcing of the factors for the apportionment formula.[12] The MTC has a Uniformity Committee made up of state tax administrative agency representatives, which holds

---

[5]Ibid, ¶8.03.

[6] Ibid.

[7] Ibid. Some "nonbusiness" income unconnected to the unitary business may be allocated rather than apportioned.

[8] *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 165 (1983)(Where the Court noted: "This Court long ago upheld the constitutionality of the unitary business/formula apportionment method, although subject to certain constraints," citing cases from the 1930's.)

[9] Hellerstein, supra note 4, ¶8.11. The remainder of the states continue to use transfer pricing for transactions between related entities and then use apportionment to determine the share of the income that can be taxed.

[10] Available on the ULC website, here: https://www.uniformlaws.org/viewdocument/final-act-with-comments-27?CommunityKey=f2ef73d2-2e5b-488e-a525-51be29fbee47&tab=librarydocuments. The formula as drafted by the ULC equally weighted each of these factors.

[11] See *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978).

[12] Supra, Note 1.

meetings and establishes projects and work groups to address emerging issues.[13] Any state may participate in the Uniformity Committee or its project work groups. The MTC also follows a public process that encourages input from taxpayers and other stakeholders, and which includes a required public hearing, to develop and then formally adopt model laws and regulations.[14] If adopted, these model tax provisions are recommended to the states for their own enactment. Separate from the Uniformity Committee, the MTC performs joint income tax audits of multistate businesses for participating states which often focus on issues of nexus and the sourcing of factors, particularly receipts from interstate sales.[15]

MTC's Work on Nexus Standards and on Market-Based Sales Sourcing

Substantial Nexus and the MTC Model Factor Presence Nexus Standard

In 1979, the U.S. Supreme Court established a new more rational federal standard for when states may impose taxes on income derived from interstate commerce.[16] The Court held, and has continued to hold, that a state's business income tax must meet certain general requirements including a "substantial nexus" with the activities to be taxed, fair apportionment, and no discrimination against interstate commerce.[17]

The exact requirements for "substantial nexus," however, remained somewhat uncertain until 2018. The Court had previously held that substantial nexus for imposing a sales tax collection duty required the seller to have a physical presence in the state,[18] but the Court had never held this physical presence standard applied to business income taxes.[19] The majority of states eventually took the position that economic nexus was sufficient and physical presence was not required for business income taxes. In 2002, the MTC adopted a model factor presence nexus standard for recommendation to the states to provide bright-line thresholds for business tax nexus. As the basis for the thresholds, the model relied on the same types of general factors that states used for formulary apportionment, that is, the property, payroll, or sales of the unitary business in the state.[20]

---

[13] Information on the MTC Uniformity Committee is available on the organization's website, here: http://www.mtc.gov/.

[14] See the Multistate Tax Compact, Art. VII, available on the MTC website, here: http://www.mtc.gov/The-Commission/Multistate-Tax-Compact#Article_VII; the MTC's Bylaws, Bylaw 7, available on the MTC website, here: http://www.mtc.gov/getattachment/The-Commission/Bylaws/MTC-Bylaws-as-Amended-2020-07-29.pdf.aspx; and the MTC's Public Participation Policy, Section 10, available on the MTC website, here: http://www.mtc.gov/The-Commission/Public-Participation-Policy.

[15] Information on the MTC Joint Audit Program is available on the organization's website, here: http://www.mtc.gov/.

[16] *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

[17] *Complete Auto Transit*, at 1079. The Court has also held that to meet these requirements, the tax must be "internally consistent" (so that if every jurisdiction adopted the same tax, there would be no multiple taxation) and must not be unduly burdensome. See *Comptroller of Treasury of Md. v. Wynne*, 135 S. Ct. 1787, 191 (2015).

[18] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[19] *See* Dan Bucks and Frank Katz, *Explanation of the Multistate Tax Commission's Proposed Factor Presence Nexus Standard, State Tax Notes*, Sept. 30, 2002.

[20] This model, reproduced as Appendix A to this letter, is also available on the MTC website, here: http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/FactorPresenceNexusStandardBusinessActTaxes.pdf.

Most business interests initially opposed adoption of this model factor presence nexus standard, arguing that a level of sales in a state was not, by itself, sufficient for substantial nexus. The implementation of the standard would also be subject to limitation by a 1959 federal statute (15 USC §381, referred to by its session number, P.L. 86-272) restricting the states' ability to tax the income of out-of-state businesses selling tangible property.[21] Finally, in 2018, the U.S. Supreme Court overturned its past precedent that had held physical presence was required for sales tax nexus.[22] This, in turn, removed any reasonable argument that a physical presence nexus standard might apply to business income taxes. Following this development, the factor presence nexus standard has received more support from business and practitioner communities who recognize the greater certainty it provides.[23] This factor presence standard is discussed further below, under Pillar One, III – the development of a nexus rule.

Market-Based Sales Sourcing

Note that the MTC model factor presence nexus standard applied a simplified market-based sourcing approach to calculating all in-state sales for purposes of the sales threshold.[24] In this respect, this nexus standard was ahead of its time as compared to the state apportionment formula under UDITPA. While UDITPA Section 16 sourced receipts from the sale of tangible property to the location of the customer, or market, the drafters did not use this same approach for sourcing receipts from the sales of services and intangibles in UDITPA Section 17. Instead, those receipts were generally sourced to the single state where the seller had its predominant cost of performance of the income producing activities.[25]

This so-called cost-of-performance approach had one potential advantage when it was drafted. It was flexible enough to allow states to apply the approach so that receipts from sales of services and intangibles would be sourced to a state that had clear jurisdiction to impose tax. But this built-in flexibility, even in 1957, also made it difficult to apply in many cases.[26] Furthermore, it often led to receipts being

---

[21] See the press release for the MTC factor presence nexus standard, which noted this limited federal preemption and asked the U.S. Congress to remove that preemption for states that adopted the MTC standard, available on the MTC website, here: http://www.mtc.gov/MTC/media/Uniformity/MTC-Press-Release-on-Factor-Presense-Model.pdf.

[22] *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 201 L. Ed. 2d 403, 2018 BL 219995 (2018)

[23] Written Statement of Jamie C. Yesnowitz on Behalf of the American Institute of Certified Public Accountants Before the United States House of Representatives Committee on Small Business, Subcommittee on Economic Growth, Tax, and Capital Access, Hearing on "South Dakota v. Wayfair, Inc.: How Main Street is Fairing and Whether Federal Intervention is Necessary," March 3, 2020, available here: https://smallbusiness.house.gov/uploadedfiles/03-03-20_mr._yesnowitz_testimony.pdf.

[24] Supra, Note 20, Sec. C.(3).

[25] Supra, Note 10, Sec.s 16 and 17.

[26] See, for example, the case of *Walter E. Heller Western, Inc. v. Arizona Dept. of Revenue*. There, the taxpayer with locations in two states provided financing services which required the taxpayer to perform all manner of activities in both states, including general management and oversight of the business, as well as services for particular customers. The state appellate courts reviewing the state agency's decision disagreed about exactly what activities constituted "income producing activities." *Walter E. Heller Western, Inc. v. Arizona Dept. of Revenue*, 161 Ariz. 45, 775 P.2d 1109 (App. Div. 1 1986) overruled by the state supreme court, 161 Ariz. 49, 775 P.2d 1113 (1989).

sourced to production states, rather than market states.[27] These problems were made worse by trends in the economy toward a greater diversity of services, digital products, and other intangible goods.[28]

Over the years, the MTC used UDITPA Section 18's equitable apportionment authority to adopt a number of special industry rules, including rules for publishing, broadcasting, telecommunications, and financial institutions. These special industry rules made explicit that receipts from certain sales of services and intangibles would be sourced to the customer's location, or market. Experience with these special industry rules showed that this kind of market-based sourcing was workable and could be more widely applied, as discussed further in the section on Pillar One, IV – revenue sourcing rules, below. Then, as states began to assert nexus based on economic rather than physical presence, they also began replacing UDITPA Section 17 with provisions explicitly applying a market-based sourcing approach for all receipts from sales of services and intangibles.[29]

In 2014, after the ULC declined to update UDITPA's sourcing rules, the MTC recommended changes to the model statute (which is incorporated in Article IV of the MTC's founding document, the Multistate Tax Compact). In large part, these changes replaced Sec. 17 of UDITPA and implemented a market-based sourcing approach for sales of services and intangibles—using the location of delivery for services and the location of use for intangibles.[30] The language of the proposed changes to Sec. 17 is included below in the section on Pillar One, IV. By the time the MTC's model provisions were finalized, however, several states had already adopted market-based sourcing using slightly different general theories for the sourcing of services.[31]

In 2017, the MTC adopted detailed regulations for market-based sourcing after following its public process and incorporating input from taxpayers and other stakeholders. The MTC's goal in setting out model sourcing rules in some detail was to achieve greater uniformity in the ultimate result, regardless of the general statutory theory used in a state's market-based sourcing statute, as discussed further below.[32] In part, these regulations built on special industry regulations adopted by the MTC years before, which also used market-based sourcing for certain receipts.

---

[27] Joe Huddleston and Shirley Sicilian, *The Project to Revise UDITPA,* Proceedings of the New York University Institute on State and Local Taxation, 2009, Reproduced on the MTC website, here: http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Minutes/The%20Project%20to%20Revise%20UDITPA.pdf.

[28] Ibid.

[29] Today, of the 46 states plus the District of Columbia that impose a tax on corporate income, 32 use some form of market sourcing for sales of services and intangibles, and some of the remaining states apply UDITPA Section 17 in a manner, or have adopted other special industry rules, that result in market sourcing for certain types of sales.

[30] See Sec. 17 of the amended Model Compact Article IV. Division of Income. [UDITPA], adopted 2014 (revised 2015), available on the MTC website, here: http://www.mtc.gov/getattachment/Uniformity/Article-IV/Model-Compact-Article-IV-UDITPA-2015.pdf.aspx.

[31] Report of the Hearing Officer Multistate Tax Compact Article IV [UDITPA] Proposed Amendments, Professor Richard D. Pomp, Oct. 25, 2013, p. 3.

[32] These model regulations are available on the MTC website, here: http://www.mtc.gov/MTC/media/AUR/FINAL-APPROVED-2018-Proposed-Amendments-042020.pdf, and are reproduced in Appendix B to this letter. See, in particular, the Prefatory Notes as well as Reg. IV.17.(a).

Response to Request for Public Comment – Pillar One, III
The development of a nexus rule.

As discussed briefly in the prior section, the MTC recognized the need for a bright-line nexus rule and recommended a model factor presence nexus standard to the states in 2002. This model uses thresholds based on the same general factors—property, payroll, and sales—that the states have long used for apportioning multistate business income generally. If any one of these factors for the unitary business exceeds the given threshold in a state, then the business would be taxable in the state.

This model factor presence nexus standard, reproduced in Appendix A to this letter, has a number of important features:

1. As the preface notes, the idea of a factor presence standard as the jurisdictional standard for business tax nexus came from Professor Charles McLure, an economist and Senior Fellow with the Hoover Institution at Stanford University based on his work as summarized in an article published in the National Tax Journal.[33]

2. The MTC's primary policy goals in adopting the model standard were clarity, certainty, and equity.[34]

3. Because the model factor presence standard uses the same factors for apportioning income to create the jurisdictional thresholds, the sourcing of these factors for jurisdictional purposes generally relies on model factor-sourcing regulations adopted by the MTC to implement income apportionment under UDITPA. These sourcing and related model rules are reproduced, in full, in Appendix B and discussed further below. Importantly, property and payroll factors are designed to be verifiable in terms of their value and location, which may be confirmed by other information the business is required to maintain or report to the states—such as property tax information or withholding of income taxes from employee wages.

4. As noted above, in 2002, the MTC had not yet recommended to states that they amend UDITPA to adopt a market-based sourcing approach for receipts from sales of services and intangibles. But the model factor presence nexus standard nevertheless took a simplified market-based sourcing approach to these receipts.[35] This simplified market-based sourcing approach in the model factor presence nexus standard is consistent with model regulations that were later adopted by the MTC to implement uniform market-based sourcing for income apportionment and are discussed below and included in Appendix B.

5. The MTC recognized two primary benefits in tying the factor presence nexus standard's thresholds to the factor-sourcing rules used for formulary apportionment. First, those sourcing

---

[33] McLure, Charles E. Jr. (2000), *Implementing State Corporate Income Taxes in the Digital Age*, National Tax Journal, 53:4, pp. 1287-1305.
[34] Bucks, supra, note 19.
[35] The simplified sourcing rules for receipts from sales of services and intangibles used in the factor presence standard were also designed to be consistent with sourcing rules from the Streamlined Sales Tax Project, a project undertaken by the states to simplify the U.S. state-level general transaction tax system. See Bucks, supra, note 17.

rules already existed and were being used by states and taxpayers to calculate state-apportioned income. Therefore, using these same rules reduced the additional administrative or compliance costs involved. Second, using the same factors and sourcing those factors in the same manner as for apportionment purposes tends to greatly reduce the chance that a taxpayer with a substantial potential tax liability would, nevertheless, lack nexus.

6. The states have since moved away from using property and payroll as significant factors in their apportionment formulas. There are numerous reasons for this. But the property and payroll factors still play an important role in the factor presence nexus standard. Under that nexus standard, if a business has only a small amount of property or payroll in the state, it will not be required to pay tax in that state unless it has significant sales.

7. The precise thresholds were not intended to be static. Moreover, due to the inherent simplicity of the model, if a state wished, it could adopt different, higher, threshold amounts without creating significant additional complexity.

8. The nature of the factor presence nexus model gives states some certainty as to the total tax that may be foregone, regardless of the dollar threshold that may be used, since the model also uses a percentage threshold. Even if the potential taxpayer's in-state factors do not exceed the dollar threshold, if the taxpayer has more than 25% of any one factor in the state, then the taxpayer will have nexus. So, the outer-limit of foregone liability can be roughly estimated, assuming a given profit margin and tax rate, as follows:

    $2 million in receipts X 20% profit margin = $400,000 net income

    $400,000 net income X 25% (factor/threshold limit) = $100,000 apportioned income

    $100,000 apportioned income X 10% tax rate = $10,000 in maximum foregone tax

9. Section D of the model factor presence nexus standard instructs businesses to calculate the amounts for testing the thresholds based on the unitary business. This type of provision is necessary to determine when factors of closely related entities will be combined, and to allow for the elimination of intercompany transactions that might overstate the actual third-party sales in the state.

Response to Request for Public Comment – Pillar One, IV
Revenue sourcing rules.

The focus of this section will be the MTC model general allocation and apportionment regulations adopted by the MTC in 2017 for the sourcing of receipts from the sale of services and intangibles on a market basis. But before turning to those regulations, as we noted, the MTC had also adopted special industry regulations going back a number of years, which also incorporated market-based sourcing. These rules provided a foundation for the later adoption of a general market-based sourcing approach and are incorporated into that general approach.

Early Market-Based Sourcing Rules Used by the States

The sales-sourcing provisions of the most important of these special industry regulations recommended by the MTC and adopted by a number of states are set out here:

- Special Rules for Television and Radio Broadcasting – These model rules use an "audience factor" for sales of programming and advertising.[36] The language of this model, last amended in 1996, provides that receipts from these sales will be sourced to the state (that is, included in the state's sales factor numerator) as follows:

  B. Sales Factor Numerator. The numerator of the sales factor shall include all gross receipts of the taxpayer from sources within this state, including, but not limited to the following:

  1. Gross receipts, including advertising revenue, from television film or radio programming in release to or by television and radio stations located in this state.

  2. Gross receipts, including advertising revenue, from television film or radio programming in release to or by a television station (independent or unaffiliated) or network of stations for broadcast shall be attributed to this state in the ratio (hereafter "audience factor") that the audience for such station (or owned and affiliated stations in the case of networks) located in this state bears to the total audience for such station (or owned and affiliated stations in the case of networks). The audience factor for television or radio programming shall be determined by the ratio that the taxpayer's in-state viewing (listening) audience bears to its total viewing (listening) audience. Such audience factor shall be determined either by reference to the books and records of the taxpayer or by reference to published rating statistics, provided the method used by the taxpayer is consistently used from year to year for such purpose and fairly represents the taxpayer's activity in the state.

  3. Gross receipts from film programming in release to or by a cable television system shall be attributed to this state in the ratio (hereafter "audience factor") that the subscribers for such cable television system located in this state bears to the total subscribers of such cable television system. If the number of subscribers cannot be accurately determined from the books and records maintained by the taxpayer, such audience factor ratio shall be determined on the basis of the applicable year's subscription statistics located in published surveys, provided that the source selected is consistently used from year to year for that purpose.

  4. Receipts from the sale, rental, licensing or other disposition of audio or video cassettes, discs, or similar medium intended for home viewing or listening shall be included in the sales factor as provided in Reg. IV. 16.

[36] This model is available on the MTC website, here: http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/SpecialRules-TVRadio.pdf.

- <u>Special Rules: Publishing</u> – These model rules use a "circulation factor," similar to the audience factor uses for broadcasting, for sourcing receipts from advertising, sale of customer lists, and similar activities.[37] The language of this model, last amended in 1993, provides that receipts from these sales will be sourced to the state (that is, included in the state's sales factor numerator) as follows:

> *B. Sales Factor Numerator. The numerator of the sales factor shall include all gross receipts of the taxpayer from sources within this state, including, but not limited to, the following:*
>
> *1. Gross receipts derived from the sale of tangible personal property, including printed materials, delivered or shipped to a purchaser or a subscriber in this state.*
>
> *2. Except as provided in subparagraph (3)(iii)B.3., gross receipts derived from advertising and the sale, rental or other use of the taxpayer's customer lists or any portion thereof shall be attributed to this state as determined by the taxpayer's "circulation factor" during the tax period. The circulation factor shall be determined for each individual publication by the taxpayer of printed material containing advertising and shall be equal to the ratio that the taxpayer's in-state circulation to purchasers and subscribers of its printed material bears to its total circulation to purchasers and subscribers everywhere. The circulation factor for an individual publication shall be determined by reference to the rating statistics as reflected in such sources as Audit Bureau of Circulations or other comparable sources, provided that the source selected is consistently used from year to year for such purpose. If none of the foregoing sources are available, or, if available, none is in form or content sufficient for such purposes, then the circulation factor shall be determined from the taxpayer's books and records.*
>
> *3. When specific items of advertisements can be shown, upon clear and convincing evidence, to have been distributed solely to a limited regional or local geographic area in which this state is located, the taxpayer may petition, or the [Tax Administrator] may require, that a portion of such receipts be attributed to the sales factor numerator of this state on the basis of a regional or local geographic area circulation factor and not upon the basis of the circulation factor provided by subparagraph (3)(iii)B.2. Such attribution shall be based upon the ratio that the taxpayer's circulation to purchasers and subscribers located in this state of the printed material containing such specific items of advertising bears to its total circulation of such printed material to purchasers and subscribers located within such regional or local geographic area. This alternative attribution method shall be permitted only upon the condition that such receipts are not double counted or otherwise included in the numerator of any other state.*
>
> *4. In the event that the purchaser or subscriber is the United States Government or that the taxpayer is not taxable in a State, the gross receipts from all sources, including the*

[37] This model is available on the MTC website, here: http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/SpecialRules-Publishing.pdf.

receipts from the sale of printed material, from advertising, and from the sale, rental or other use of the taxpayer's customer's lists, or any portion thereof that would have been attributed by the circulation factor to the numerator of the sales factor for such State, shall be included in the numerator of the sales factor of this State if the printed material or other property is shipped from an office, store, warehouse, factory, or other place of storage or business in this State.

- Special Rules: Telecommunications and Ancillary Service Providers – These model rules use market-based sourcing for telecommunications and related services.[38] In the case of telecommunications, there was already a federal statute that addressed sourcing receipts of mobile telecommunications services on a market basis for state transactional taxes. The rules adopted by the MTC in 2008 were generally consistent with these federal rules, as well:

(ii) Sales Factor: Sales of telecommunications and ancillary services in this state.

A. Gross receipts from the sale of telecommunications services, other than those defined in subsections C. through G., which are sold on a call-by-call basis are in this state when (a) the call originates and terminates in this state or (b) the call either originates or terminates and the service address is also located in this state.

B. Gross receipts from the sale of telecommunications services, other than those defined in subsections C. through G., which are sold on other than a call-by-call basis, are in this state when the customer's place of primary use is in this state.

C. Gross receipts from the sale of mobile telecommunications services, other than air-to-ground radiotelephone service and prepaid calling service, are in this state when the customer's place of primary use is in this state pursuant to the Mobile Telecommunications Sourcing Act.

D. Gross receipts from the sale of pre-paid calling service, prepaid wireless calling service and post-paid calling service are in this state when the origination point of the telecommunications signal is first identified in this state by either (1) the seller's telecommunications system, or (2) information received by the seller from its service provider, where the system used to transport such signals is not that of the seller.

E. Gross receipts from the sale of a private communication service are in this state:

1. if such service is for a separate charge related to a customer channel termination point, when the customer channel termination point is located in this state;

2. if under such service all customer termination points are located entirely within one state, when the customer channel termination points are located in this state;

3. if such service is for segments of a channel between two customer channel termination points located in different states and such segments of channel are separately charged, when one of the customer channel termination points is in this

---

[38] This model is available on the MTC website, here: http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Telco%20Apprtmnt%20Resolution%20(as%20adopted%202008).pdf.

state, provided however that only fifty percent of such gross receipts shall be sourced to this state; and

4. if such service is for segments of a channel located in more than one state and such segments are not separately billed, when the customer channel termination points are in this state, provided however that only a percentage of such gross receipts, determined by dividing the number of customer channel termination points in the state by the total number of customer channel termination points, are in this state.

F. A portion of the total gross receipts from sales of telecommunication services to other telecommunication service providers for resale is in this state in an amount determined by multiplying such total gross receipts by a fraction, the numerator of which is "total carrier's carrier service revenues" for this state and the denominator of which is the sum of "total carrier's carrier service revenues" for all states in which the taxpayer is doing business, as reported by the Federal Communications Commission [in its report titled Telecommunications Revenues by State, Table 15.6, or successor reports which include such information,] for the most recent year available as of the due date of the return, determined without regard to extensions.

G. Gross receipts attributable to the sale of an ancillary service are in this state when the customer's place of primary use is in this state.

H. Gross receipts attributable to the sale of a telecommunication or ancillary service sold as part of a bundled transaction are in this state when such gross receipts would be this state in accordance with the provisions of sections ii.A. through G.

1. The amount of gross receipts attributable to the sale of a telecommunication or ancillary service which is sold as part of a bundled transaction shall be equal to the price charged by the taxpayer for such service when sold separately, adjusted by an amount equal to the quotient of a) the difference between 1) the price charged by the taxpayer for the bundled transaction, and 2) the sum of the prices charged by the taxpayer for each of the included products when sold separately, and b) the number of products included in the bundled transaction;

2. If the amount of such gross receipts is not determinable under subsection H.1., then it may be determined by reasonable and verifiable standards from taxpayer's books and records that are kept in the regular course of business for purposes including, but not limited to, non-tax purposes.

I. Gross receipts from the sale of telecommunication services which are not taxable in the State to which they would be apportioned pursuant to sections ii.A through G., shall be excluded from the denominator of the sales factor.

- Formula for the Apportionment and Allocation of Net Income of Financial Institutions – These model rules, adopted in 1994 and most recently amended in 2015, provide a comprehensive

apportionment method for income of banks and financial institutions. The provisions for sourcing receipts under these regulations are too lengthy to reproduce here,[39] but include specific rules for sourcing:

- Receipts from fees (including interest) related to real property loans and financing;
- Receipts from fees, interest, and penalties charged to credit card holders;
- Receipts from sales of receivables;
- Receipts from card-issuer's reimbursements;
- Receipts from merchant discounts;
- Receipts from ATM fees;
- Receipts from loan servicing fees; and
- Investment receipts.

Adoption of General Market-Based Sourcing Approach for Services and Intangibles

As the special industry rules above demonstrate, the MTC and the states have long experience using market-based sourcing for certain receipts. But it was not until 2014 that the MTC acted to adopt a general recommendation for states to amend UDITPA, Section 17, and enact market-based sourcing for all receipts from sales of services and intangibles.

Choice of a General Approach to Market-Based Sourcing

The recommended model statutory language adopted by the MTC to replace UDITPA, Section 17, and to which the MTC's detailed regulations speak, was as follows:

> *Recommended Replacement for UDITPA Sec. 17:*
>
> *Sec. 17. (a) Receipts, other than receipts 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:*
>
> *. . .*
>
> *(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:*

[39] This model is available on the MTC website, here: http://www.mtc.gov/MTC/media/AUR/Financial-Institutions-Apportionment-Rule-Amended-2015.pdf.

(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 receipts 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 receipt 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 receipt shall be excluded from the denominator of the receipts factor.

(d) [The tax administrator may prescribe regulations as necessary or appropriate to carry out the purposes of this section.] [40]

The regulations adopted three years later provide much greater detail on where particular receipts would be sourced under this model statutory language. But before turning to those regulations, we should acknowledge that there were two general theories on which market-based sourcing might have been founded and the choices presented by these theories informs both the statutory language used as well as the regulations adopted.

As noted in the first section of these comments, the states did not move to adopt a market-based sourcing approach for sales of services and intangibles as quickly as they might have if it had been clear that the state where the market was located would always have jurisdiction to impose tax under older U.S. Supreme Court case law. States, therefore, migrated to market-sourcing over time after adopting a position that they could assert taxing jurisdiction over the business income of companies lacking physical presence in the state. As they moved to adopt market-based sourcing, therefore, they sometimes applied slightly different theories for determining the market for receipts, and this led to the adoption of slightly different statutory language.

One theory looks to the location of the seller's customer and that customer's acceptance or initial use of the service or intangible. The chief alternative theory, sometimes referred to as the "benefit received" approach, looks not to the location of delivery or use, but to the location where the customer obtains the

---

[40] The proposed amendments to UDITPA, including this Section 17 amendment, can be found on the MTC website, here: http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Section-1-Model-Definition-of-Receipts%E2%80%9D-Regulation/ARTICLE-IV-AMENDMENTS-July-2014-Clean.pdf.aspx.

intended benefit of the service or intangible purchased.[41] Because there were states that had adopted both general approaches, the MTC had the chance to evaluate both before adopting the former.

One way to see the difference between these two main approaches to market-based sourcing is the degree to which those approaches "look through" the primary location of the customer to some other location, often the location of the ultimate consumer of the service or intangible. The prime example of a sourcing approach that does *not* look through the location of the customer is UDITPA's Section 16, which provides rules for sourcing receipts from the sale of tangible property. In that case, the location of delivery to the customer is the location that determines where the receipts are sourced for purposes of determining the sales factor for income apportionment. This approach fits with the manufacturing economy that still dominated the U.S. economy when UDITPA was adopted.

To some extent, whether sourcing receipts from sales of services and intangibles to the location of the seller's customer will best represent the true market for sellers of services and intangibles depends on the nature of those services and intangibles. There is a certainly a need for some consistency between sourcing for receipts from sales of tangible property and receipts from services and intangibles. For example, if a contract manufacturing company sells manufacturing services to a customer that uses that service in manufacturing tangible property for resale to a wholesaler, it would be inconsistent to source the receipts of the contract manufacturer to the ultimate consumer when, if that same seller were taking title to the goods and processing them for resale instead, its receipts would be sourced to the location of its customer.

In other cases, however, sellers of services and intangibles may use intermediaries to simply facilitate distribution of those items to the ultimate consumers. Those intermediaries may be significantly involved in the activity of promoting or handling the sale of the services and intangibles but are not the true customers for those products. So, where the seller's de facto customer is an intermediary that simply facilitates sale and distribution to the ultimate consumer, the true market for the seller may be best determined by looking through the intermediary to that consumer.

There is also an argument to be made that receipts from some intangible transactions, including a number of royalty contracts, are directly dependent upon the level of resale transactions to the ultimate consumer and should, therefore, be sourced to the location of those consumers instead. In those cases, it is the ultimate consumers' activities that drive the amount of the seller's receipts and the location of the seller's customer is not as relevant to locating the market for those intangibles. This, in large part, influenced the adoption of the rule in Sec. 17(a)(4)(i) above for what the MTC model rules term "marketing intangibles."

[41] *See*, for example, California Code, Cal. Rev. & Tax. Code § 25136(a)(1), which provides that: "Sales from services are in this state to the extent the purchaser of the service received the benefit of the services in this state." See also Cal. Code Regs. tit. 18, § 25136-2, Sales Factor, interpreting "to the extent the purchaser of the service received the benefit" so that the focus is the location where the taxpayer's customer has either directly or indirectly received value from delivery of the service, and that if that location is in more than one state, the receipts would be divided between the states proportionally. Note however that California regulations also provide for presumptions that look to the location of delivery to the customer.

One reason that states had for limiting the application of look-through sourcing is the likelihood that sellers, and even their intermediaries, may not have location information for the ultimate consumers of potential products. But another equally critical reason is the continuing concern over jurisdiction. Even though the U.S. Supreme Court now recognizes that the economic benefits derived from a state provide sufficient basis for state tax nexus, when receipts are sourced on a look-through basis, there is a concern that a state might lack sufficient minimum contacts with the seller to sustain basic jurisdiction in some circumstances. (This problem is, perhaps, ameliorated where apportionment is applied only to the income of businesses of a certain size.)

Ultimately, therefore, the MTC adopted a limited look-through approach. In addition to looking to the location of the ultimate consumer for certain broadcasting and publication receipts, the location of the consumer, rather than the seller's customer, will generally determine the location of a seller's receipts where the customer's role is primarily delivery or distribution to consumers, or where the receipts are from licensing of "marketing intangibles." States that follow the benefit-received approach may tend to source a greater potion of receipts to the location of the ultimate consumer, although again, the application of this approach is often limited by the availability of records.

Adoption of Model General Market-Based Sourcing Regulations for Services and Intangibles

The MTC model regulations implementing market-based sourcing of receipts from the sale of services and intangibles are reproduced in Appendix B to this letter and beginning in section Reg. IV.17. at page 40. These regulations can speak for themselves. Nevertheless, they have a number of important features which we discuss briefly here:

1. The drafters of these rules sought to produce practical, predictable results that could be adopted by states even though they might use somewhat different language, embodying a somewhat different theory of market-based sourcing, in their state statutes. The detail in these regulations, as well as the numerous examples used to illustrate the rules, is meant to serve, to an extent, as a proof of concept—that shows the general rule can be applied to different facts with a predictable result.

2. The MTC recognized the need to include certain administrative rules including:
   - A requirement to maintain contemporaneous records (Reg.17.(a)(4) at page 43); and
   - Specific requirements for changing the general methodology of tracking and reporting receipts by the taxpayer or tax administrator (Reg.17.(a)(7) at page 44).

3. The model rules incorporate general and specific provisions for reasonable approximation of the sourcing of receipts where records are not available or reliable. (See, among others, Reg.17.(a)(5), at page 43-44). These rules have proven to be essential based on MTC joint state audits. Reasonable approximation, done properly, tends not to distort the portion of income that will ultimately be taxed by the states under formulary apportionment because it determines only the in-state numerator of the sales/receipt's apportionment ratio, part of the apportionment formula. By the same token, the MTC model factor presence nexus standard, discussed in the previous

section, would use this same amount of sales in the state under this reasonable approximation approach for testing the nexus threshold.

4. Services are divided into three main categories:
    - In-person services (see Appendix B, Reg. IV.17.(d)(2), starting at page 46);
    - Professional services (see Appendix B, Reg. IV.17.(d)(4), starting at page 58); and
    - Services delivered to the customer or on behalf of the customer, or delivered electronically through the customer—which is a catch-all category of services other than in-person or professional (see Appendix B, Reg. IV.17.(d)(3), starting at page 48).

    The rules for sourcing receipts from the sale of in-person and professional services tend to be fairly straightforward. The third, catch-all category, is divided into different sub-categories. The specific rules applied in the catch-all category of services base the treatment of the receipts in question on the method of delivery of the service—whether by physical means or electronic transmission—and the nature of the seller's customer—whether an individual or business, as well as whether the seller's customer acts as an intermediary in distributing the service by reselling it to a third party. As noted above, in cases where the seller's customer acts as an intermediary, as described, the rules generally look to the location of the third party (or ultimate consumer).

5. While these comments have used the term "receipts from sales," the treatment of intangibles is broken down into two separate categories that look to the true nature of the transaction—whether it is a lease or license, or whether it is a sale of the intangible property. See Appendix B, Reg. IV.17.(e) and (f) starting at page 65. The rules also single out certain intangibles, primarily marketing intangibles, for "look-through" treatment, sourcing receipts to the location of the consumer rather than the seller's customer.

6. Software and digital goods are subject to their own separate sourcing provisions. The goal of these provisions is to make the sourcing of software compatible with the other general sourcing rules, including the sourcing of sales of similar tangible property. See Appendix B, Reg. IV.17.(g), starting at page 74.

7. Many specific sourcing provisions use a hierarchy approach—so that the seller would default to the next applicable sourcing rule in each case where it does not have information to comply with an earlier rule. Those provisions may also contain a specific method of reasonable approximation.

APPENDIX A

Factor Presence Nexus Standard for Business Activity Taxes

Approved by the Multistate Tax Commission
October 17, 2002
(Updated 2003)

The Commission adopted the following uniformity proposal as part of an amendment to MTC Policy Statement 02-02, Ensuring the Equity, Integrity and Viability of State Income Tax Systems, approved on October 17, 2002. A working group of states formulated the proposal over several months through public teleconferences and the Commission held four public hearings covering the technical, policy and constitutional aspects of the proposed provision. This factor presence nexus standard is intended to represent a simple, certain and equitable standard for the collection of state business activity taxes. Professor Charles McLure, Senior Fellow with the Hoover Institution at Stanford University, originated the idea of factor presence nexus and set forth an explanation of the concept in his December 2000 National Tax Journal article entitled, "Implementing State Corporate Income Taxes in the Digital Age." Professor McLure reiterated his concept during the Commission's July 2001 Federalism at Risk seminar.

A. (1) Individuals who are residents or domiciliaries of this State and business entities that are organized or commercially domiciled in this State have substantial nexus with this State.

(2) Nonresident individuals and business entities organized outside the State that are doing business in this State have substantial nexus and are subject to [list appropriate business activity taxes for the state, with statutory citations] when in any tax period the property, payroll or sales of the individual or business in the State, as they are defined below in Subsection C, exceeds the thresholds set forth in Subsection B.

B. (1) Substantial nexus is established if any of the following thresholds is exceeded during the tax period:

(a) a dollar amount of $50,000 of property; or

(b) a dollar amount of $50,000 of payroll; or

(c) a dollar amount of $500,000 of sales; or

(d) twenty-five percent of total property, total payroll or total sales.

(2) At the end of each year, the [tax administrator] shall review the cumulative percentage change in the consumer price index. The [tax administrator] shall adjust the thresholds set forth in paragraph (1) if the consumer price index has changed by 5% or more since January 1, 2003, or since the date that the thresholds were last adjusted under this subsection. The thresholds shall be adjusted to reflect that cumulative percentage change in the consumer price index. The adjusted thresholds shall be rounded to the nearest $1,000. As used in this subsection, “consumer price

index" means the Consumer Price Index for All Urban Consumers (CPI-U) available from the Bureau of Labor Statistics of the United States Department of Labor. Any adjustment shall apply to tax periods that begin after the adjustment is made.

C. Property, payroll and sales are defined as follows:

(1) Property counting toward the threshold is the average value of the taxpayer's real property and tangible personal property owned or rented and used in this State during the tax period. Property owned by the taxpayer is valued at its original cost basis. Property rented by the taxpayer is valued at eight times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from sub-rentals. The average value of property shall be determined by averaging the values at the beginning and ending of the tax period; but the tax administrator may require the averaging of monthly values during the tax period if reasonably required to reflect properly the average value of the taxpayer's property.

(2) Payroll counting toward the threshold is the total amount paid by the taxpayer for compensation in this State during the tax period. Compensation means wages, salaries, commissions and any other form of remuneration paid to employees and defined as gross income under Internal Revenue Code § 61. Compensation is paid in this State if (a) the individual's service is performed entirely within the State; (b) the individual's service is performed both within and without the State, but the service performed without the State is incidental to the individual's service within the State; or (c) some of the service is performed in the State and (1) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the State, or (2) the base of operations or the place from which the service is directed or controlled is not in any State in which some part of the service is performed, but the individual's residence is in this State.

(3) Sales counting toward the threshold include the total dollar value of the taxpayer's gross receipts, including receipts from entities that are part of a commonly owned enterprise as defined in D(2) of which the taxpayer is a member, from

(a) the sale, lease or license of real property located in this State;

(b) the lease or license of tangible personal property located in this State;

(c) the sale of tangible personal property received in this State as indicated by receipt at a business location of the seller in this State or by instructions, known to the seller, for delivery or shipment to a purchaser (or to another at the direction of the purchaser) in this State; and

(d) The sale, lease or license of services, intangibles, and digital products for primary use by a purchaser known to the seller to be in this State. If the seller knows that a service, intangible, or digital product will be used in multiple States because of separate charges levied for, or measured by, the use at different locations, because of other contractual provisions measuring use, or because of other information provided to the seller, the seller shall apportion the receipts according to usage in each State.

(e) If the seller does not know where a service, intangible, or digital product will be used or where a tangible will be received, the receipts shall count toward the threshold of the State indicated by an address for the purchaser that is available from the business records of the seller maintained in the ordinary course of business when such use does not constitute bad faith. If that is not known, then the receipts shall count toward the threshold of the State indicated by an address for the purchaser that is obtained during the consummation of the sale, including the address of the

purchaser's payment instrument, if no other address is available, when the use of this address does not constitute bad faith.

(4) Notwithstanding the other provisions of this Subsection C, for a taxpayer subject to the special apportionment methods under [Multistate Tax Commission Regulations IV.18.(d) through (j)], the property, payroll and sales for measuring against the nexus thresholds shall be defined as they are for apportionment purposes under those regulations. Financial institutions subject to an apportioned income or franchise tax shall determine property, payroll and sales for nexus threshold purposes the same as for apportionment purposes under the [MTC Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions]. Pass-through entities, including, but not limited to, partnerships, limited liability companies, S corporations, and trusts, shall determine threshold amounts at the entity level. If property, payroll or sales of an entity in this State exceeds the nexus threshold, members, partners, owners, shareholders or beneficiaries of that pass-through entity are subject to tax on the portion of income earned in this State and passed through to them.

D. (1) Entities that are part of a commonly owned enterprise shall determine whether they meet the threshold for nexus as follows:

(a) Commonly owned enterprises shall first aggregate the property, payroll and sales of their entities that have a minimum presence in this State of $5000 of combined property, payroll and sales, including those entities that independently exceed a threshold and separately have nexus. The aggregate number shall be reduced based on detailed disclosure of any intercompany transactions where inclusion would result in one State's double counting assets or revenue. If that aggregation of property, payroll and sales meets any threshold in Subsection B, the enterprise shall file a joint information return as specified by the [tax agency] separately listing the property, payroll and sales in this State of each entity.

(b) Those entities of the commonly owned enterprise that are listed in the joint information return and that are also part of a unitary business grouping conducting business in this State shall then aggregate the property, payroll and sales of each such unitary business grouping on the joint information return. The aggregate number shall be reduced based on detailed disclosure of any intercompany transactions where inclusion would result in one State's double counting assets or revenue. The entities shall base the unitary business groupings on the unitary combined report filed in this State. If no unitary combined report is required in this State, then the taxpayer shall use the unitary business groupings the taxpayer most commonly reports in States that require combined returns.

(c) If the aggregate property, payroll or sales in this State of the entities of any unitary business of the enterprise meets a threshold in Subsection B, then each entity that is part of that unitary business is deemed to have nexus and shall file and pay income or franchise tax as required by law.

(2) "Commonly owned enterprise" means a group of entities under common control either through a common parent that owns, or constructively owns, more than 50 percent of the voting power of the outstanding stock or ownership interests or through five or fewer individuals (individuals, estates or trusts) that own, or constructively own, more than 50 percent of the voting power of the outstanding stock or ownership interests taking into account the ownership interest of each such person only to the extent such ownership is identical with respect to each such entity.

E. A State without jurisdiction to impose tax on or measured by net income on a particular taxpayer because that taxpayer comes within the protection of Public Law 86-272 (15 U.S.C. § 381) does not gain jurisdiction to impose such a tax even if the taxpayer's property, payroll or sales in the State exceeds a threshold in Subsection B. Public Law 86-272 preempts the state's authority to tax and will therefore cause sales of each protected taxpayer to customers in the State to be thrown back to those sending States that require throwback. If Congress repeals the application of Public Law 86-272 to this State, an out-of-state business shall not have substantial nexus in this State unless its property, payroll or sales exceeds a threshold in this provision.

APPENDIX B

Note: The primary provisions of this model that are relevant to our response to the request for comments are in section Reg.IV.17 beginning on page 40 below.

Model General Allocation & Apportionment Regulations
as of July 25, 2018

PREFATORY NOTES

These prefatory notes and the drafters' notes below are provided solely as an aid to understanding the amendments. These notes do not reflect the regulatory or legislative intent of any state adopting these amendments, unless specified by that state. These notes were derived, in part, from other documents and information available on the Multistate Tax Commission's website.

The Commission and Its Uniformity Committee

One of the chief purposes of the Multistate Tax Compact (Compact) is promoting uniformity or compatibility in significant components of tax systems. See Compact, Art. I. Through its Uniformity Committee, the Multistate Tax Commission (Commission) studies state and local taxes, develops and recommends uniformity proposals, and compiles and publishes information to assist states in achieving this purpose. See Compact, Art. VI., Sec. 3, and Art. VII. Any state may participate in the Uniformity Committee's efforts. Participation by taxpayers and practitioners is also encouraged. All meetings of the Committee and its work groups are open to the public.

The Commission has no authority to require states to adopt any uniform regulations or model laws that it may develop. Rather, the Commission approves those regulations and models for recommendation to the states with the expectation that they will find them helpful and that having such models will promote uniformity or compatibility by encouraging states to consider adopting the same or similar provisions.

Background on the Model General Allocation and Apportionment Regulations

Occasionally, the Commission approves for recommendation both model statutes and related regulations to implement those statutes. Article IV of the Compact contains the Uniform Division of Income for Tax Purposes Act (UDITPA), as promulgated by the Uniform Laws Commission in 1957. UDITPA sets out provisions for the formulary apportionment of multistate business income, which have been adopted by statute, in substantially similar form, in most states. The Model General Allocation and Apportionment Regulations are the long-standing model regulations developed by the Commission to implement Article IV's UDITPA provisions. These model regulations, which date back to 1971, have been modified and amended over the years. In addition to these general regulations, the Commission has also separately adopted special model regulations under Section 18 of Article IV (and UDITPA) (related to equitable apportionment) which apply the provisions of formulary apportionment in specific circumstances or for particular industries. All of the Commission's model regulations and other information on the Commission's

uniformity process and current projects are available on the Commission website at: http://www.mtc.gov/Home.

Summary of the Statutory Changes to Which the 2017 Regulatory Amendments Relate

In July 2014 and 2015, the Commission approved recommended changes to certain provisions of Article IV (UDITPA). Those changes are as follows:

- Section 1(a) – clarifying the definition of "apportionable income" (previously "business income") and making certain changes;
- Section 1(g) – narrowing the definition of "receipts" (previously "sales");
- Section 9 – removing the requirement for equal weighting of the three-factor apportionment formula;
- Section 17 – adopting so-called market-based "sourcing" (that is, assigning to a state) receipts from transactions other than sales of tangible personal property in place of the predominant-cost-of-performance method; and
- Section 18 – making changes to the equitable apportionment authority and providing certain procedural safe-guards.

The following sections describe these changes in more detail and summarize how the 2017 amendments to the model regulations relate to the recommended changes to the Compact Article IV UDITPA provisions.[42]

Changes in Article IV, Section 1 Requiring Amended Regulations

Amendments to the model regulations were necessitated by recommended changes to the UDITPA provisions of Article IV, Section 1, and in particular, changes to the definitions of "business income" (now "apportionable income") and "sales" (now "receipts"). Throughout the document, regulatory amendments were made to conform to the new terminology and also to reflect substantive changes in the language of the definitions.

Definition of "Apportionable Income" (Previously "Business Income")
The prior and current versions of the definition of "business income," now "apportionable income" are as follows:

PRIOR DEFINITION OF "BUSINESS INCOME"
(a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the

[42] The Report of the Hearing Officer, Multistate Tax Compact Article IV [UDITPA] Proposed Amendments issued October 25, 2013, available on the Commission's website, describes these changes to Article IV in more detail.

acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

CURRENT DEFINITION OF "APPORTIONABLE INCOME"

(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:

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

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

The three most significant changes to this definition are: (1) it now explicitly references the Constitution as the standard for determining what income is subject to formulary apportionment; (2) it clarifies that the so-called transactional and functional tests (in paragraphs (A) and (B) respectively) are separate tests, an interpretation which had become the majority rule; and (3) it expands the reach of the functional test, by changing the requirement that the activity "constitute integral parts of the taxpayer's regular" business to a requirement that it be "related to the operation" of the business.

Definition of "Receipts" (Previously "Sales")

The prior and current versions of the definition of "receipts" (previously "sales") are as follows:

PRIOR DEFINITION OF "SALES"

(g) "Sales" means all gross receipts of the taxpayer not allocated under paragraphs of this Article.

CURRENT DEFINITION OF "RECEIPTS"

(g) "Receipts" means all gross receipts of the taxpayer that are not allocated under paragraphs of this article, and that are received from transactions and activity in the regular course of the taxpayer's trade or business; except that receipts of a taxpayer from hedging transactions and from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities, shall be excluded.

The definition of "receipts" determines what goes into the receipts factor (or "sales factor" as it was previously called). The new definition explicitly excludes receipts that give rise to income that would meet the functional, but not the transactional, test for apportionable income. In addition, certain specific types of receipts are explicitly excluded even if they give rise to income that would meet the transactional test.

It should be noted that, over time, provisions of the Model General Allocation and Apportionment Regulations have come to reflect interpretations that are consistent, in many ways, with some of the recommended changes in these Article IV definitions. For example, the regulations have interpreted the

definition of "business income" as containing two disjunctive tests. Also, the regulations have interpreted the term "sales," while defined more generally, as excluding certain types of receipts that are now explicitly excluded in the definition. So, while these 2017 amendments further conform the regulations to the changes to the Article IV definitions, the 2017 amendments are generally consistent with prior interpretations of UDITPA definitions.

Changes in Article IV, Section 17 Requiring Amended Regulations

The recommended changes to the UDITPA provisions of Article IV, Section 17 altered the method of sourcing (that is, assigning to a state) the receipts from transactions other than sales of tangible personal property. The old methodology sourced all such receipts to the one state with a preponderance of income-producing activity (as measured by costs of performance). The new method, which completely replaces the old one, uses a market-sourcing approach as follows:

> 17. (a) Receipts, other than receipts 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:
>
> (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 receipts 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 receipt 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 receipt shall be excluded from the denominator of the receipts factor.

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

At its December 2014 meeting, the Uniformity Committee voted to use the recently-promulgated market-based sourcing regulations in Massachusetts as the working draft for the Commission's own model regulations to implement Article IV, Section 17's market-based sourcing approach. The Section 17 work group spent over a year reviewing the Massachusetts regulations and made some changes to the working draft. In addition, the Uniformity Committee and Executive Committee made changes to the working draft before adopting a final version of the proposed amendments to the Section 17 regulations for recommendation to the Commission.

DRAFTER'S NOTES

The purpose of these drafters' notes is two-fold. First, these notes summarize the important 2017 amendments made (and a few discussed but not made) to the model regulations to implement the changes in the UDITPA provisions of Article IV. Second, these notes describe some considerations for state regulatory drafters operating under similar, but not identical, statutory apportionment provisions.

Summary of Important Amendments Made (or Discussed but not Made):

- Throughout the regulations, amendments were made to:
  - Conform terminology – including especially the substitution of the terms "apportionable income" for "business income," "non-apportionable income" for "nonbusiness income," and "receipts" for "sales."
  - Conform particular language in the regulations to related changes in the language of Article IV – including especially changes in the specific language used in the definitions of "apportionable income" and "receipts" (e.g. the removal of the requirement in the functional test that the activity be "integral," and the use of the term "related to," instead, where appropriate).
  - Remove the word "business" where it was deemed to be unnecessary or potentially confusing, and in some cases substituting the phrase "trade or business."
- In Reg. IV.1.(a)(3) and (5) – amendments eliminate the concept of "materially contributes" (or "contributes materially") as a touchstone for the functional test under the definition of "apportionable income."
- In Reg. IV.1.(a)(5) (Functional Test) – amendments made, or considered:
  - Specific amendments needed to reflect the changes made to the functional test in the

definition of "apportionable income," including especially the change in the language "constitute integral parts of the taxpayer's regular trade or business operations" in the original definition to "is or was related to the operation of the taxpayer's trade or business" in the current definition.

  - Addition of examples to show how the functional test would now be applied.
  - Changes in the so-called five-year rule for when property withdrawn from active use should be eliminated from inclusion in from the property factor were considered but not made. Based on guidance from the uniformity committee, the group decided to retain the five-year "withdrawn from service" rule as a reasonable metric.

- In Reg. IV.1.(c) (Apportionable and Non-apportionable Income: Application of Definitions) – amendments consistent with the changes in the definition of apportionable income, including especially, amendments consistent with those made to Reg.IV.1.(a)(5) having to do with the functional test.
- In Reg. IV.2.(a)(5) (Gross Receipts) – amendments clarifying this regulatory definition of a component term of the Section 1 defined term "receipts."
- In Reg. IV.2.(a)(6) (Receipts) – changes include:
  - Incorporation of examples that were previously contained in Reg. IV.15.(a). (Receipts Factor: Additional Principles) but determined to be more appropriate to include in this section of the regulations addressing the definition of receipts.
  - Amendments to reflect the explicit narrowing of the definition of receipts and the exclusions of certain items from that definition.
  - A provision clarifying that while particular receipts may give rise to apportionable income, this does not control whether those receipts are included in the receipts factor.
- In Reg. IV.15.(a) (Receipts Factor: Additional Principles) – deleting examples and other provisions which were incorporated into Reg. IV.2.(a)(6) (Receipts).
- In Reg. IV.17. (Receipts Factor: Sales Other Than Sales of Tangible Personal Property in This State) – the amendments in this section replace the regulations that had interpreted and applied the previous provisions of Article IV, Section 17's predominant-cost-of-performance sourcing method. These regulations were based on the Massachusetts regulations implementing market-based sourcing of receipts. The best summary of these regulations is included in the body of the regulations themselves at Reg. IV. 17.(a)(2) (Outline of topics.) The following should be noted about these regulations:
  - Not all receipts from transactions other than sales of tangibles are included in the receipts factor or assigned under these regulations. Receipts that do not fit the definition of "receipts" under the recommended changes to Article IV, Section 1 (see above) are not included in the receipts factor or sourced under these Section 17 regulations. Also, changes to Article IV, Section 17 now exclude certain receipts including:
    - Receipts from sales of intangible property, other than those specifically included

    (see Art. IV, Sec. 17.(a)(4)(ii)(C));

    - Receipts where the state or states of assignment cannot be reasonably determined (see Art. IV, Sec. 17(c)); and
    - Receipts that would be sourced to a jurisdiction in which the taxpayer is not taxable (see Art. IV, Sec. 17(c)).

- In general – The regulations set out different categories with specific rules for sourcing receipts and it is expected that one category will be the "best fit" for any receipts that are to be included in the receipts factor under Section 17.
- Throughout - The Uniformity Committee recommended that the examples remain in the body of the regulation under their appropriate topic. (However, an attempt was made to ensure that if an adopting state moved or omitted the examples, this would not unduly affect the operation of the regulations.)
- Reg. IV.17.(a)(3)(G): There was considerable debate in the work group as to what standard should be used to reasonably estimate the marketplace based on population data. The working group eventually decided that use of the U.S. Census Bureau's population data was an appropriate standard because of administrative ease and convenience, outweighing the benefits of using other data sources.
- Reg. IV.17.(a)(3)(H): A definition of "related party," was added (along with other provisions discussed below) in response to the concerns from representatives of separate-filing states in particular that related parties could manipulate sourcing rules and that such parties should have access to information that unrelated parties would not.
- Reg. IV.17.(d) (Sale of a Service): This is the first of three significant substantive subsections of the Section 17 regulations (the others have to do with receipts from intangible property). This subsection is divided into three main categories—in-person services (Reg. IV.17.(d)(2)), services delivered to the customer or on behalf of the customer or delivered electronically through the customer (Reg. IV.17.(d)(3)), and professional services (Reg.IV.17.(d)(4)). The first and third categories are fairly straight-forward in terms of their scope. The second category may be viewed as the "catch-all" category generally. Specific provisions addressing potential overlap are found at Reg. IV.17.(d)(4)(B).
- Reg. IV.17.(d)(3)) (services delivered to the customer or on behalf of the customer or delivered electronically through the customer): This "catch-all" category is further broken down as follows:
    - Delivery to or on behalf of a customer by physical means whether to an individual or business customer;
    - Delivery to a customer by electronic transmission to an individual customer;
    - Delivery to a customer by electronic transmission to a business customer; and
    - Services delivered electronically through or on behalf of an individual or business customer.

- Reg. IV.17.(d)(3)(B)2.b.v.: A special rule was added for related party transactions for sales of services delivered by electronic transmission to a business customer that is a related party—preventing the use of certain methods of reasonable approximation.
- Reg. IV.17.(d)(4)(A): Credit card processing services were added to the definition of "professional services." The work group rejected a proposal to adopt a separate sourcing rule for legal services.
- Reg. IV.17.(d)(4)(B): This category of professional services was further subdivided into professional services delivered to individual customers, services delivered to business customers, large volume transactions (a safe-harbor rule), architectural and engineering services, services provided by a financial institution, and related party transactions.
- Reg. IV.17.(d)(4)(B)(3) (Services provided by a financial institution): This provision notes the relationship between the model special industry regulations for financial institutions (or other similar rules which states may have adopted) and these rules—which is that where those special industry regulations direct certain miscellaneous receipts to be generally sourced pursuant to Section 17, then the rules in this subsection for professional services would apply.
- Reg. IV.17.(c) (License or lease of intangible property): This is the second of the three significant substantive subsections of the Section 17 regulations, and one of two that deal with intangible property. Under this subsection, intangible license receipts are further divided into receipts from:
  - "Marketing intangibles" (Reg. IV.17.(c)(2))
  - "Production intangibles" (Reg. IV.17.(c)(3))
  - "Mixed intangibles" (Reg. IV.17.(c)(4))
  - Licenses where the substance resembles sale of goods or services, including sublicenses (Reg. IV.17.(c)(5))
- Reg. IV.17.(f) (Sale of intangible property): This is the third of the three significant substantive subsections of the Section 17 regulations, and the second that deals with intangible property. As noted above, unless the sales of intangible property fall into two specific categories—contract rights or government licenses tied to a specific geographic area, see Art. IV, Sec. 17.(a)(4)(ii)(A)) or sales where receipts are contingent upon productivity, use or disposition (see Art. IV, Sec. 17.(a)(4)(ii)(B))—they are excluded from the receipts factor.
- Reg. IV.17.(g): This section contains special rules for sourcing receipts from software transactions and from the sale or license of digital goods and services. In general, these receipts are sourced based on the rules for the category that most closely fits the nature of the transaction, but a sale of pre-written software is always a sale of TTP.
- Reg. IV.17.(h): This section contains a mediation provision allowing states to participate in mediation to resolve multistate sourcing issues.

- In Reg. IV.18.(c) – Finally, the two regulations under Section 18 (equitable apportionment) pertaining to the receipts factor were eliminated, as these regulations were superseded by changes to the UDITPA provisions of Article IV. As explained in the Prefatory Notes above, the Commission's Uniformity Committee is working on amendments to Section 18 which may be necessary in light of changes to Sections 1, 17 and 18.

Considerations for States that Have Different Statutory Language:

These model regulations may be useful for state regulatory drafters tasked with adopting rules for market-based sourcing of receipts from the sale of services or the sale or licensing of intangibles, even if those drafters are applying somewhat different statutory language. However, the following should be noted:

- Because recommended changes to Article IV, Section 1 excludes certain receipts, in particular, receipts from transactions that meet only the functional test, and because Section 17 also excludes from the receipts factor certain categories of receipts, if a state does not also exclude those same receipts under state law, rules for sourcing those receipts will have to be added to the rules here.
- The change to Article IV, Section 17, which adopts a market-based sourcing approach for services, determines the market for services based on the location of delivery of the service. For licenses of intangibles, the approach looks to the location of use, generally. While states may use a different approaches to market-based sourcing (e.g., location of receipt or benefit of services), it is expected that in most cases the same sourcing result will be reached under any approach. This is particularly true where the marketplace is determined based upon rules for reasonable approximation.
- In general, he changes to the UDITPA provisions of Article IV, Section 17, do not require the taxpayer to determine where the service or intangible property or the benefit of the service or intangible property *is received*, but rather look to the location of delivery, for services, and the location of use, for intangibles. But in some cases, a focus on the location of delivery or use will result in receipts being sourced not to the location of the customer, but to another location. See for example, Reg. IV.17.(d)(3)(B)3.a. In addition, in the case of marketing intangibles, the provisions of Article IV, Section 17 provide that the term "used in this state" refers generally to the location where goods or services incorporating that marketing intangible are purchased. See Art. IV, Sec. 17.(a)(4)(i) and Reg. IV.17.(e)(2). These rules should be distinguished from "look-through" sourcing which is a method of assigning receipts from the sales of services or licenses of intangibles to the location of the ultimate consumers in cases where the taxpayer's customer resells or relicenses those services or intangibles. In contrast to look-through sourcing, the Section 17 regulations do not focus on the ultimate consumer except to the extent that the nature of the transaction with the seller's customer makes delivery to that ultimate consumer essential.
- The amendments assume that in some instances, the proper analog for sourcing receipts is not other sales of services or intangibles, but the sale of traditional goods (e.g. the treatment of software under Reg. IV.17.(g)). Because Article IV, Section 16 uses a market-based sourcing approach for sales of goods (as do all states using formulary apportionment generally), states may already treat such sales as being sourced to the location of the customer.
- For states that allow separate-entity filing, the Section 17 regulations dealing with related-party sales of services or licenses or sales of intangible property may be of particular interest, but it should

be noted that such related-party transactions are to be expected even in states that require combined filing.

- Another issue which may be of concern, especially for states that allow separate corporate filing, is that the narrowing of the definition of "receipts" under Section 1 and the exclusion of some receipts under Section 17 may result in taxpayers that have no receipts factor. Section 18 authority provides tax administrators with the authority to address this situation, including by regulation, and the Commission's Uniformity Committee is drafting regulations to address the situation as well.
- While the Section 17 regulations contain a number of specific examples, the goal was to set out general guidance for all taxpayers, rather than industry-specific rules, which the Commission has typically issued under the authority granted by Article IV, Section 18. The special industry regulations issued by the Commission have typically used a market-based sourcing approach for receipts, but to the extent they were adopted prior to 2014, they may not conform in every respect to the changes to Article IV, Sections 1 and 17. To the extent that the Commission has adopted special industry regulations, those regulations will take precedence over any general regulations under Section 17 (see Reg. IV.17.(a)(7)(A)). The Commissions special industry regulations are available on its website at http://www.mtc.gov/Home.

Multistate Tax Commission

Model General Allocation and Apportionment Regulations

••• Reg. IV.1.(a). Apportionable and Non-apportionable Income Defined.

(1) Apportionment and Allocation. Article IV.1(a) and (e) require that every item of income be classified either as apportionable income or non-apportionable income. Income for purposes of classification as apportionable or non-apportionable includes gains and losses. Apportionable income is apportioned among jurisdictions by use of a formula. Non-apportionable income is specifically assigned or allocated to one or more specific jurisdictions pursuant to express rules. An item of income is classified as apportionable income if it falls within the definition of apportionable income. An item of income is non-apportionable income only if it does not meet the definitional requirements for being classified as apportionable income.

(2) Apportionable Income. Apportionable income means 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

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

(C) 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.

The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, income derived from accounts receivable, operating income, non-operating income, *etc*., is of no aid in determining whether income is apportionable or non-apportionable income.

(3) "Trade or business," as used in the definition of apportionable income and in the application of that definition means the unitary business of the taxpayer, part of which is conducted within [this State].

(4) Transactional Test. Apportionable income includes income arising from transactions and activity in the regular course of the taxpayer's trade or business.

(A) If the transaction or activity is in the regular course of the taxpayer's trade or business, part of which trade or business is conducted within [this State], the resulting income of the transaction or activity is apportionable income for [this State]. Income may be apportionable income even though the actual transaction or activity that gives rise to the income does not occur in [this State].

(B) For a transaction or activity to be in the regular course of the taxpayer's trade or business, the transaction or activity need not be one that frequently occurs in the trade or business. Most, but not all, frequently occurring transactions or activities will be in the regular course of that trade or business and will, therefore, satisfy the transactional test. It is sufficient to classify a transaction or activity as being in the regular course of a trade or business, if it is reasonable to conclude

transactions of that type are customary in the kind of trade or business being conducted or are within the scope of what that kind of trade or business does. However, even if a taxpayer frequently or customarily engages in investment activities, if those activities are for the taxpayer's mere financial betterment rather than for the operations of the trade or business, such activities do not satisfy the transactional test. The transactional test includes, but is not limited to, income from sales of inventory, property held for sale to customers, and services which are commonly sold by the trade or business. The transactional test also includes, but is not limited to, income from the sale of property used in the production of apportionable income of a kind that is sold and replaced with some regularity, even if replaced less frequently than once a year.

(5) Functional test. Apportionable income also includes income from tangible and intangible property, if the acquisition, management, employment, development, or disposition of the property is or was related to the operation of the taxpayer's trade or business. "Property" includes any direct or indirect interest in, control over, or use of real property, tangible personal property and intangible property by the taxpayer

Property that is "related to the operation of the trade or business" refers to property that is or was used to contribute to the production of apportionable income directly or indirectly, without regard to the materiality of the contribution.

Property that is held merely for investment purposes is not related to the operation of the trade or business.

"Acquisition, management, employment, development or disposition" refers to a taxpayer's activities in acquiring property, exercising control and dominion over property and disposing of property, including dispositions by sale, lease or license. Income arising from the disposition or other utilization of property which was acquired or developed in the course of the taxpayer's trade or business constitutes apportionable income, even if the property was not directly employed in the operation of the taxpayer's trade or business.

Income from the disposition or other utilization of property which has been withdrawn from use in the taxpayer's trade or business and is instead held solely for unrelated investment purposes is not apportionable. Property that was related to the operation of the taxpayer's trade or business is not considered converted to investment purposes merely because it is placed for sale, but any property which has been withdrawn from use in the taxpayer's trade or business for five years or more is presumed to be held for investment purposes.

Example (i): Taxpayer purchases a chain of 100 retail stores for the purpose of merging those store operations with its existing business. Five of the retail stores are redundant under the taxpayer's business plan and are sold six months after acquisition. Even though the five stores were never integrated into the taxpayer's trade or business, the income is apportionable because the property's acquisition was related to the taxpayer's trade or business.

Example (ii): Taxpayer is in the business of developing adhesives for industrial and construction uses. In the course of its business, it accidentally creates a weak but non-toxic adhesive and patents the formula, awaiting future applications. Another manufacturer uses the formula to create temporary body tattoos. Taxpayer wins a patent infringement suit against the other manufacturer. The entire damages award, including interest and punitive damages, constitutes apportionable income.

Example (iii): Taxpayer is engaged in the oil refining business and maintains a cash reserve for buying and selling oil on the spot market as conditions warrant. The reserve is held in overnight "repurchase agreement" accounts of U.S. treasuries with a local bank. The interest on those amounts is apportionable income because the reserves are necessary for the taxpayer's business operations. Over time, the cash in the reserve account grows to the point that it exceeds any reasonably expected requirement for acquisition of oil or other short-term capital needs and is held pending subsequent business investment opportunities. The interest received on the excess amount is non-apportionable income.

Example (iv): A manufacturer decides to sell one of its redundant factories to a real estate developer and transfers the ownership of the factory to a special purpose subsidiary, SaleCo (Taxpayer) immediately prior to its sale to the real estate developer. The parties elect to treat the sale as a disposition of assets under IRC 338(h)(10), resulting in Taxpayer recognizing a capital gain on the sale. The capital gain is apportionable income. Note: although the gain is apportionable, application of the standard apportionment formula in Section 17 may not fairly reflect the taxpayer's business presence in any state, necessitating resort to equitable apportionment pursuant to Section 18.

(A) Under the functional test, income from the disposition or other utilization of property is apportionable if the property is or was related to the operation of the taxpayer's trade or business. This is true even though the transaction or activity from which the income is derived did not occur in the regular course of the taxpayer's trade or business.

(B) Income that is derived from isolated sales, leases, assignments, licenses, and other infrequently occurring dispositions, transfers, or transactions involving property, including transactions made in the full or partial liquidation or the winding-up of any portion of the trade or business, is apportionable income, if the property is or was related to the taxpayer's trade or business. Income from the licensing of an intangible asset, such as a patent, copyright, trademark, service mark, know-how, trade secrets, or the like, that was developed or acquired for use by the taxpayer in its trade or business, constitutes apportionable income whether or not the licensing itself constituted the operation of a trade or business, and whether or not the taxpayer remains in the same trade or business from or for which the intangible asset was developed or acquired.

(C) Under the functional test, income from intangible property is apportionable income when the intangible property serves an operational function as opposed to solely an investment function.

(D) If the acquisition, management, employment, development, or disposition of the property is or was related to the operation of the taxpayer's trade or business, then income from that property is apportionable income even though the actual transaction or activity involving the property that gives rise to the income does not occur in [this State].

(E) Examples.

Example (i): A manufacturer purchases raw materials to be incorporated into the product it offers for sale. The nature of the raw materials is such that the purchase price is subject to extreme price volatility. In order to protect itself from extreme price increases (or decreases), the manufacturer enters into future contracts pursuant to which the manufacturer

can either purchase a set amount of the raw materials for a fixed price, within a specified time period, or resell the future contracts. Any gain on the sale of the future contracts would be considered apportionable income, regardless of whether the contracts were either made or resold in [this State].

Example (ii): A national retailer produces substantial revenue related to the operation of its trade or business. It invests a large portion of the revenue in fixed income securities which are divided into three categories; (a) short-term securities held pending use of the funds in the taxpayer's trade or business; (b) short-term securities held pending acquisition of other companies or favorable developments in the long-term money market, and (c) long- term securities held as an investment. Interest income on the short-term securities held pending use of the funds in the taxpayer's trade or business (a) is apportionable because the funds represent working capital necessary to the operations of the taxpayer's trade or business. Interest income derived from the other investment securities ((b) and (c)) is not apportionable as those securities were not held in furtherance of the taxpayer's trade or business.

(F) If with respect to an item of property a taxpayer (i) takes a deduction from income that is apportioned to [this State] or (ii) includes the original cost in the property factor, it is presumed that the item or property is or was related to the operation of the taxpayer's trade or business. No presumption arises from the absence of any of these actions.

(G) Application of the functional test is generally unaffected by the form of the property (*e.g.*, tangible or intangible property, real or personal property). Income arising from an intangible interest, as, for example, corporate stock or other intangible interest in an entity or a group of assets, is apportionable income when the intangible itself or the property underlying or associated with the intangible is or was related to the operation of the taxpayer's trade or business. Thus, while apportionment of income derived from transactions involving intangible property may be supported by a finding that the issuer of the intangible property and the taxpayer are engaged in the same trade or business, *i.e.*, the same unitary business, establishment of such a relationship is not the exclusive basis for concluding that the income is subject to apportionment. It is sufficient to support the finding of apportionable income if the holding of the intangible interest served an operational rather than an investment function.

(6) Relationship of transactional and functional tests to U.S. Constitution. The Due Process Clause and the Commerce Clause of the U.S. Constitution restrict states from apportioning income that has no rational relationship with the taxing state. The protection against extra-territorial state taxation afforded by these Clauses is often described as the "unitary business principle." The unitary business principle requires apportionable income to be derived from the same unitary business that is being conducted at least in part in [this State]. The unitary business that is conducted in [this State] includes both a unitary business that the taxpayer alone may be conducting and a unitary business the taxpayer may conduct with any other person or persons. Satisfaction of either the transactional test or the functional test complies with the unitary business principle, because each test requires that the transaction or activity (in the case of the transactional test) or the property (in the case of the functional test) be tied to the same trade or business that is being conducted within [this State]. Determination of the scope of the unitary business being conducted in [this State] is without regard to extent to which [this State] requires or permits combined reporting.

(7) Non-apportionable income. Non-apportionable income means all income other than apportionable income.

••• Reg. IV.1.(b). Principles for Determining the Existence of a Unitary Business.

(1) Unitary Business Principle.

(A) *The Concept of a Unitary Business*. A unitary business is a single economic enterprise that is made up either of separate parts of a single entity or of a commonly controlled group of entities that are sufficiently interdependent, integrated and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts. This flow of value to an entity located in this state that comes from being part of a unitary business conducted both within and without this state is what provides the constitutional due process "definite link and minimum connection" necessary for this state to apportion apportionable income of the unitary business, even if that income arises in part from activities conducted outside the state. The apportionable income of the unitary business is then apportioned to this state using an apportionment percentage provided by [insert your state statute].

This sharing or exchange of value may also be described as requiring that the operation of one part of the business be dependent upon, or contribute to, the operation of another part of the business. Phrased in the disjunctive, the foregoing means that if the activities of one business either contributes to the activities of another business *or* are dependent upon the activities of another business, those businesses are part of a unitary business.

(B) *Constitutional Requirement for a Unitary Business.* The sharing or exchange of value described in subsection (A) that defines the scope of a unitary business requires more than the mere flow of funds arising out of a passive investment or from the financial strength contributed by a distinct business undertaking that has no *operational* relationship to the unitary business.

In this state, the unitary business principle shall be applied to the fullest extent allowed by the U.S. Constitution. The unitary business principle shall not be applied to result in the combination of business activities or entities under circumstances where, if it were adverse to the taxpayer, the combination of such activities or entities would not be allowed by the U.S. Constitution.

(C) *Separate Trades or Businesses Conducted within a Single Entity.* A single entity may have more than one unitary business. In such cases it is necessary to determine the apportionable income attributable to each separate unitary business as well as its non-apportionable income, which is specifically allocated. The apportionable income of each unitary business is then apportioned by a formula that takes into consideration the in-state and the out-of-state factors that relate to the respective unitary business whose income is being apportioned.

(D) *Unitary Business Unaffected by Formal Business Organization.* A unitary business may exist within a single entity or among a commonly controlled group of entities. The scope of what is included in a commonly controlled group of entities is set forth in Section V below.

(2) Determination of a Unitary Business

(A) A unitary business is characterized by significant flows of value evidenced by factors such as those described in *Mobil Oil Corp. v. Vermont*, 445 U.S. 425 (1980): functional integration, centralization of management, and economies of scale. These factors provide evidence of whether the business activities operate as an integrated whole or exhibit substantial mutual interdependence. Facts suggesting the presence of the factors mentioned above should be analyzed in combination for their cumulative effect and not in isolation. A particular business operation may be suggestive of one or more of the factors mentioned above.

(B) *Description and Illustration of Functional Integration, Centralization of Management and Economies of Scale*.

1. *Functional integration:* Functional integration refers to transfers between, or pooling among, business activities that significantly affect the operation of the business activities. Functional integration includes, but is not limited to, transfers or pooling with respect to the unitary business's products or services, technical information, marketing information, distribution systems, purchasing, and intangibles such as patents, trademarks, service marks, copyrights, trade secrets, know-how, formulas, and processes. There is no specific type of functional integration that must be present. The following is a list of examples of business operations that can support the finding of functional integration. The order of the list does not establish a hierarchy of importance.

a. Sales, exchanges, or transfers (collectively "sales") of products, services, and/or intangibles between business activities provide evidence of functional integration. The significance of the intercompany sales to the finding of functional integration will be affected by the character of what is sold and/or the percentage of total sales or purchases represented by the intercompany sales. For example, sales among entities that are part of a vertically integrated unitary business are indicative of functional integration. Functional integration is not negated by the use of a readily determinable market price to effect the intercompany sales, because such sales can represent an assured market for the seller or an assured source of supply for the purchaser.

b. *Common Marketing.* The sharing of common marketing features among entities is an indication of functional integration when such marketing results in significant mutual advantage. Common marketing exists when a substantial portion of the entities' products, services, or intangibles are distributed or sold to a common customer, when the entities use a common trade name or other common identification, or when the entities seek to identify themselves to their customers as a member of the same enterprise. The use of a common advertising agency or a commonly owned or controlled in-house advertising office does not by itself establish common marketing that is suggestive of functional integration. (Such activity, however, is relevant to determining the existence of economies of scale and/or centralization of management.)

c. *Transfer or Pooling of Technical Information or Intellectual Property.* Transfers or pooling of technical information or intellectual property, such as patents, copyrights, trademarks and service marks, trade secrets, processes or formulas, know-how,

research, or development, provide evidence of functional integration when the matter transferred is significant to the businesses' operations.

d. *Common Distribution System*. Use of a common distribution system by the entities, under which inventory control and accounting, storage, trafficking, and/or transportation are controlled through a common network provides evidence of functional integration.

e. *Common Purchasing*. Common purchasing of substantial quantities of products, services, or intangibles from the same source by the entities, particularly where the purchasing results in significant cost savings or where the products, services or intangibles are not readily available from other sources and are significant to each entity's operations or sales, provides evidence of functional integration.

f. *Common or Intercompany Financing*. Significant common or intercompany financing, including the guarantee by, or the pledging of the credit of, one or more entities for the benefit of another entity or entities provides evidence of functional integration, if the financing activity serves an operational purpose of both borrower and lender. Lending which serves an investment purpose of the lender does not necessarily provide evidence of functional integration. (See below for discussion of centralization of management.)

2. *Centralization of Management.* Centralization of management exists when directors, officers, and/or other management employees jointly participate in the management decisions that affect the respective business activities and that may also operate to the benefit of the entire economic enterprise. Centralization of management can exist whether the centralization is effected from a parent entity to a subsidiary entity, from a subsidiary entity to a parent entity, from one subsidiary entity to another, from one division within a single entity to another division within an entity, or from any combination of the foregoing. Centralization of management may exist even when day-to-day management responsibility and accountability has been decentralized, so long as the management has an ongoing operational role with respect to the business activities. An operational role can be effected through mandates, consensus building, or an overall operational strategy of the business, or any other mechanism that establishes joint management.

a. *Facts Providing Evidence of Centralization of Management*. Evidence of centralization of management is provided when common officers participate in the decisions relating to the business operations of the different segments. Centralization of management may exist when management shares or applies knowledge and expertise among the parts of the business. Existence of common officers and directors, while relevant to a showing of centralization of management, does not alone provide evidence of centralization of management. Common officers are more likely to provide evidence of centralization of management than are common directors.

b. *Stewardship Distinguished.* Centralized efforts to fulfill stewardship oversight are not evidence of centralization of management. Stewardship oversight consists of those activities that any owner would take to review the performance of or safeguard an investment. Stewardship oversight is distinguished from those activities that an owner may take to enhance value by integrating one or more significant operating aspects of one business activity with the other business activities of the owner. For example, implementing reporting requirements or mere approval of capital expenditures may evidence only stewardship oversight.

3. *Economies of Scale.* Economies of scale refer to a relation among and between business activities resulting in a significant decrease in the average per unit cost of operational or administrative functions due to the increase in operational size. Economies of scale may exist from the inherent cost savings that arise from the presence of functional integration or centralization of management. The following are examples of business operations that can support the finding of economies of scale. The order of the list does not establish a hierarchy of importance.

a*. Centralized Purchasing.* Centralized purchasing designed to achieve savings due to the volume of purchases, the timing of purchases, or the interchangeability of purchased items among the parts of the business engaging in the purchasing provides evidence of economies of scale.

b. *Centralized Administrative Functions.* The performance of traditional corporate administrative functions, such as legal services, payroll services, pension and other employee benefit administration, in common among the parts of the business may result in some degree of economies of scale. An entity that secures savings in the performance of corporate administrative services due to its affiliation with other entities that it would not otherwise reasonably be able to secure on its own because of its size, financial resources, or available market, provides evidence of economies of scale.

(3) Indicators of a Unitary Business.

(A) *Same Type of Business.* Business activities that are in the same general line of business generally constitute a single unitary business, as, for example, a multistate grocery chain.

(B) *Steps in a Vertical Process.* Business activities that are part of different steps in a vertically structured business almost always constitute a single unitary business. For example, a business engaged in the exploration, development, extraction, and processing of a natural resource and the subsequent sale of a product based upon the extracted natural resource, is engaged in a single unitary business, regardless of the fact that the various steps in the process are operated substantially independently of each other with only general supervision from the business's executive offices.

(C) *Strong Centralized Management.* Business activities which might otherwise be considered as part of more than one unitary business may constitute one unitary business when there is a strong central management, coupled with the existence of centralized departments for such functions as financing, advertising, research, or purchasing. Strong centralized management exists when a central

manager or group of managers makes substantially all of the operational decisions of the business. For example, some businesses conducting diverse lines of business may properly be considered as engaged in only one unitary business when the central executive officers are actively involved in the operations of the various business activities and there are centralized offices which perform for the business activities the normal matters which a truly independent business would perform for itself, such as personnel, purchasing, advertising, or financing.

(4) Commonly Controlled Group of Entities.

(A) Separate corporations can be part of a unitary business only if they are members of a commonly controlled group.

(B) A "commonly controlled group" means any of the following:

1. A parent corporation and any one or more corporations or chains of corporations, connected through stock ownership (or constructive ownership) with the parent, but only if—

a. The parent owns stock possessing more than 50 percent of the voting power of at least one corporation, and, if applicable,

b. Stock cumulatively possessing more than 50 percent of the voting power of each of the corporations, except the parent, is owned by the parent, one or more corporations described in subparagraph a, or one or more other corporations that satisfy the conditions of this subparagraph.

2. Any two or more corporations, if stock possessing more than 50 percent of the voting power of the corporations is owned, or constructively owned, by the same person.

3. Any two or more corporations that constitute stapled entities.

a. For purposes of this paragraph, "stapled entities" means any group of two or more corporations if more than 50 percent of the ownership or beneficial ownership of the stock possessing voting power in each corporation consists of stapled interests.

b. Two or more interests are stapled interests if, by reason of form of ownership, restrictions on transfer, or other terms or conditions, in connection with the transfer of one of the interests the other interest or interests are also transferred or required to be transferred.

4. Any two or more corporations, if stock possessing more than 50 percent of the voting power of the corporations is cumulatively owned (without regard to the constructive ownership rules of paragraph 1 of subsection (E)) by, or for the benefit of, members of the same family. Members of the same family are limited to an individual, his or her spouse, parents, brothers or sisters, grandparents, children and grandchildren, and their respective spouses.

(C) 1. If, in the application of subsection (B), a corporation is a member of more than one commonly controlled group of corporations, the corporation shall elect to be treated as a member of only the commonly controlled group (or part thereof) with respect to which it has a unitary business relationship. If the corporation has a unitary business relationship with more

than one of those groups, it shall elect to be treated as a member of only one of the commonly controlled groups with respect to which it has a unitary business relationship. This election shall remain in effect until the unitary business relationship between the corporation and the rest of the members of its elected commonly controlled group is discontinued, or unless revoked with the approval of the [state tax agency].

2. Membership in a commonly controlled group shall be treated as terminated in any year, or fraction thereof, in which the conditions of subsection (B) are not met, except as follows:

a. When stock of a corporation is sold, exchanged, or otherwise disposed of, the membership of a corporation in a commonly controlled group shall not be terminated, if the requirements of subsection (B) are again met immediately after the sale, exchange, or disposition.

b. The [state tax agency] may treat the commonly controlled group as remaining in place if the conditions of subsection B are again met within a period not to exceed two years.

(D) A taxpayer may exclude some or all corporations included in a "commonly controlled group" by reason of paragraph 4 of subsection (B) by showing that those members of the group are not controlled directly or indirectly by the same interests, within the meaning of the same phrase in Section 482 of the Internal Revenue Code. For purposes of this subsection, the term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised.

(E) Except as otherwise provided, stock is "owned" when title to the stock is directly held or if the stock is constructively owned.

1. An individual constructively owns stock that is owned by any of the following:

a. His or her spouse.

b. Children, including adopted children, of that individual or the individual's spouse, who have not attained the age of 21 years.

c. An estate or trust, of which the individual is an executor, trustee, or grantor, to the extent that the estate or trust is for the benefit of that individual's spouse or children.

2. Stock owned by a corporation, or a member of a controlled group of which the corporation is the parent corporation, is constructively owned by any shareholder owning stock that represents more than 50 percent of the voting power of the corporation.

3. In the application of paragraph 4 of subsection (B) (dealing with stock possessing voting power held by members of the same family), if more than 50% of the stock possessing voting power of a corporation is, in the aggregate, owned by or for the benefit of members of the same family, stock owned by that corporation shall be treated as constructively owned by members of that family in the same ratio as the proportion of their respective ownership of stock possessing voting power in that corporation to all of such stock of that corporation.

4. Except as otherwise provided, stock owned by a partnership is constructively owned by any partner, other than a limited partner, in proportion to the partner's capital interest in the partnership. For this purpose, a partnership is treated as owning proportionately the stock owned by any other partnership in which it has a tiered interest, other than as a limited partner.

5. In any case where a member of a commonly controlled group, or shareholders, officers, directors, or employees of a member of a commonly controlled group, is a general partner in a limited partnership, stock held by the limited partnership is constructively owned by a limited partner to the extent of its capital interest in the limited partnership.

6. In the application of paragraph 4 of subsection (B) (dealing with stock possessing voting power held by members of the same family), stock held by a limited partnership is constructively owned by a limited partner to the extent of the limited partner's capital interest in the limited partnership.

(F) For purposes of the definition of a commonly controlled group, each of the following shall apply:

1. "Corporation" means a subchapter S corporation, any other incorporated entity, or any entity defined or treated as a corporation (including but not limited to a limited liability company) pursuant to [insert your State statute].

2. "Person" means an individual, a trust, an estate, a qualified employee benefit plan, a limited partnership, or a corporation. 3. "Voting power" means the power of all classes of stock entitled to vote that possess the power to elect the membership of the board of directors of the corporation.

4. "More than 50 percent of the voting power" means voting power sufficient to elect a majority of the membership of the board of directors of the corporation.

5. "Stock possessing voting power" includes stock where ownership is retained but the actual voting power is transferred in either of the following manners:

a. For one year or less.

b. By proxy, voting trust, written shareholder agreement, or by similar device, where the transfer is revocable by the transferor.

6. In the case of an entity treated as a corporation under paragraph 1 of subsection (F), "stock possessing voting power" refers to an instrument, contract, or similar document demonstrating an ownership interest in that entity that confers power in the owner to cast a vote in the selection of the management of that entity.

7. In the general application of this section, if an entity may elect to be treated as a partnership or as a corporation under the laws of this state (or under Section 7701 of the Internal Revenue Code), and elects to be treated as a partnership, that entity shall be treated as a general partnership. If, however, contractual agreements, member agreements, or other restrictions limit the power of some or all of the members to participate in the vote of stock possessing voting power owned by that entity (similar to the restrictions of limited partners in

a limited partnership), the [state tax agency] may permit or require that entity to be treated as a limited partnership.

(G) The [state tax agency] may prescribe any regulations as may be necessary or appropriate to carry out the purposes of this section, including, but not limited to, regulations that do the following:

1. Prescribe terms and conditions relating to the election described by subsection (C), and the revocation thereof.

2. Disregard transfers of voting power not described by paragraph 5 of subsection (F).

3. Treat entities not described by paragraph 2 of subsection (F) as a person.

4. Treat warrants, obligations convertible into stock, options to acquire or sell stock, and similar instruments as stock.

5. Treat holders of a beneficial interest in, or executor or trustee powers over, stock held by an estate or trust as constructively owned by the holder.

6. Prescribe rules relating to the treatment of partnership agreements which authorize a particular partner or partners to exercise voting power of stock held by the partnership.

7. Treat limited partners as constructive owners of stock possessing voting power held by the limited partnership, in proportion to their interest in the partnership.

••• Reg. IV.1.(c). Apportionable and Non-apportionable Income: Application of Definitions. The following applies the foregoing principles for purposes of determining whether particular income is apportionable or non-apportionable income. The examples used throughout these regulations are illustrative only and are limited to the facts they contain.

(1) Rents from real and tangible personal property. Rental income from real and tangible property is apportionable income if the property with respect to which the rental income was received is or was used in the taxpayer's trade or business and therefore is includable in the property factor under Regulation IV.10.

Example (i): The taxpayer operates a multistate car rental business. The income from car rentals is apportionable income.

Example (ii): The taxpayer is engaged in the heavy construction business in which it uses equipment such as cranes, tractors, and earth-moving vehicles. The taxpayer makes short-term leases of the equipment when particular pieces of equipment are not needed on any particular project. The rental income is apportionable income.

Example (iii): The taxpayer operates a multistate chain of men's clothing stores. The taxpayer purchases a five-story office building for use in connection with its trade or business. It uses the street floor as one of its retail stores and the second and third floors for its general corporate headquarters. The remaining two floors are held for future use in the trade or business and are leased to tenants on a sort-term basis in the meantime. The rental income is apportionable income.

Example (iv): The taxpayer operates a multistate chain of grocery stores. It purchases as an investment an office building in another state with surplus funds and leases the entire building to others. The net rental income is not apportionable income of the grocery store trade or business. Therefore, the net rental income is non-apportionable income.

Example (v): The taxpayer operates a multistate chain of men's clothing stores. The taxpayer invests in a 20-story office building and uses the street floor as one of its retail stores and the second floor for its general corporate headquarters. The remaining 18 floors are leased to others. The rental of the eighteen floors is not done in furtherance of but rather is separate from the operation of the taxpayer's trade or business. The net rental income is not apportionable income of the clothing store trade or business. Therefore, the net rental income is non-apportionable income.

Example (vi): The taxpayer constructed a plant for use in its multistate manufacturing business and 20 years later the plant was closed and put up for sale. The plant was rented for a temporary period from the time it was closed by the taxpayer until it was sold 18 months later. The rental income is apportionable income and the gain on the sale of the plant is apportionable income.

(2) Gains or losses from sales of assets. Gain or loss from the sale, exchange or other disposition of real property or of tangible or intangible personal property constitutes apportionable income if the property while owned by the taxpayer was related to the operation of the taxpayer’s trade or business, or was otherwise properly included in the property factor of the taxpayer's trade or business.

Example (i): In conducting its multistate manufacturing business, the taxpayer systematically replaces automobiles, machines, and other equipment used in the trade or business. The gains or losses resulting from those sales constitute apportionable income.

Example (ii): The taxpayer constructed a plant for use in its multistate manufacturing business and 20 years later sold the property at a gain while it was in operation by the taxpayer. The gain is apportionable income.

Example (iii): Same as (ii) except that the plant was closed and put up for sale but was not in fact sold until a buyer was found 18 months later. The gain is apportionable income.

Example (iv): Same as (ii) except that the plant was rented while being held for sale. The rental income is apportionable income and the gain on the sale of the plant is apportionable income.

(3) Interest. Interest income is apportionable income where the intangible with respect to which the interest was received arose out of or was created in the regular course of the taxpayer's trade or business, or the purpose of acquiring and holding the intangible is related to the operation of the taxpayer's trade or business.

Example (i): The taxpayer operates a multistate chain of department stores, selling for cash and on credit. Service charges, interest, or time-price differentials and the like are received with respect to installment sales and revolving charge accounts. These amounts are apportionable income.

Example (ii): The taxpayer conducts a multistate manufacturing business. During the year the taxpayer receives a federal income tax refund pertaining to the taxpayer’s trade or business and collects a judgment against a debtor of the business. Both the tax refund and the judgment bear interest. The interest income is apportionable income.

Example (iii): The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business, the taxpayer maintains special accounts to cover such items as workmen's compensation claims, rain and storm damage, machinery replacement, etc. The funds in those accounts earned interest. Similarly, the taxpayer temporarily invests funds intended for payment of federal, state and local tax obligations pertaining to the taxpayer's trade or business. The interest income is apportionable income.

Example (iv): The taxpayer is engaged in a multistate money order and traveler's check business. In addition to the fees received in connection with the sale of the money orders and traveler's checks, the taxpayer earns interest income by the investment of the funds pending their redemption. The interest income is apportionable income.

Example (v): The taxpayer is engaged in a multistate manufacturing and selling business. The taxpayer usually has working capital and extra cash totaling $200,000 which it regularly invests in short-term interest bearing securities. The interest income is apportionable income.

Example (vi): In January, the taxpayer sold all of the stock of a subsidiary for $20,000,000. The funds are placed in an interest-bearing account pending a decision by management as to how the funds are to be utilized. The funds are not pledged for use in the business. The interest income for the entire period between the receipt of the funds and their subsequent utilization or distribution to shareholders is non-apportionable income.

(4) Dividends. Dividends are apportionable income where the stock with respect to which the dividends was received arose out of or was acquired in the regular course of the taxpayer's trade or business or where the acquiring and holding the stock is or was related to the operation of the taxpayer's trade or business, or contributes to the production of apportionable income of the trade or business.

Example (i): The taxpayer operates a multistate chain of stock brokerage houses. During the year, the taxpayer receives dividends on stock that it owns. The dividends are apportionable income.

Example (ii): The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business, the taxpayer maintains special accounts to cover such items as workmen's compensation claims, etc. A portion of the moneys in those accounts is invested in interest-bearing bonds. The remainder is invested in various common stocks listed on national stock exchanges. Both the interest income and any dividends are apportionable income.

Example (iii): The taxpayer and several unrelated corporations own all of the stock of a corporation whose business consists solely of acquiring and processing materials for delivery to the corporate owners. The taxpayer acquired the stock in order to obtain a source of supply of materials used in its manufacturing trade or business. The dividends are apportionable income.

Example (iv): The taxpayer is engaged in a multistate heavy construction business. Much of its construction work is performed for agencies of the federal government and various state governments. Under state and federal laws applicable to contracts for these agencies, a contractor must have adequate bonding capacity, as measured by the ratio of its current assets (cash and marketable securities) to current liabilities. In order to maintain an adequate bonding capacity the taxpayer holds various stocks and interest-bearing securities. Both the interest income and any dividends received are apportionable income.

Example (v): The taxpayer receives dividends from the stock of its subsidiary or affiliate which acts as the marketing agency for products manufactured by the taxpayer. The dividends are apportionable income.

Example (vi): The taxpayer is engaged in a multistate glass manufacturing business. It also holds a portfolio of stock and interest-bearing securities, the acquisition and holding of which are unrelated to the manufacturing business. The dividends and interest income received are non-apportionable income.

(5) Patent and copyright royalties. Patent and copyright royalties are apportionable income where the patent or copyright with respect to which the royalties were received arose out of or was created in the regular course of the taxpayer's trade or business or where the acquiring and holding the patent or copyright is or was related to the operation of the taxpayer's trade or business, or contributes to the production of apportionable income of the trade or business.

Example (i): The taxpayer is engaged in the multistate business of manufacturing and selling industrial chemicals. In connection with that business, the taxpayer obtained patents on certain of its products. The taxpayer licensed the production of the chemicals in foreign countries, in return for which the taxpayer receives royalties. The royalties received by the taxpayer are apportionable income.

Example (ii): The taxpayer is engaged in the music publishing trade or business and holds copyrights on numerous songs. The taxpayer acquires the assets of a smaller publishing company, including music copyrights. These acquired copyrights are thereafter used by the taxpayer in its trade or business. Any royalties received on these copyrights are apportionable income.

••• Reg. IV.1.(d). Proration of Deductions. In most cases, an allowable deduction of a taxpayer will be applicable to only the apportionable income arising from a particular trade or business or to a particular item of non-apportionable income. In some cases, an allowable deduction may be applicable to the apportionable incomes of more than one trade or business and to items of non-apportionable income. In such cases, the deduction shall be prorated among those trades or businesses and those items of non-apportionable income in a manner which fairly distributes the deduction among the classes of income to which it is applicable.

(1) Year to year consistency. In filing returns with this state, if the taxpayer departs from or modifies the manner of prorating any such deduction used in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.

(2) State to state consistency. If the returns or reports filed by a taxpayer with all states to which the taxpayer reports under Article IV of this Compact or the Uniform Division of Income for Tax Purposes Act are not uniform in the application or proration of any deduction, the taxpayer shall disclose in its return to this state the nature and extent of the variance.

••• Reg. IV.2.(a). Definitions.

(1) "Taxpayer" means [each state should insert the definition in Article II.3. or the definition in its own tax laws].

(2) "Apportionment" refers to the division of apportionable income between states by the use of a formula containing apportionment factors.

(3) "Allocation" refers to the assignment of non-apportionable income to a particular state.

(4) "Business activity" refers to the transactions and activities occurring in the regular course of a particular trade or business of a taxpayer and includes the acquisition, employment, development, management, or disposition of property that is or was related to the operation of the taxpayer's trade or business.

(5) "Gross receipts" are the gross amounts realized (the sum of money and the fair market value of other property or services received) on the sale or exchange of property, the performance of services, or the use of property or capital in a transaction which produces apportionable income in which the income or loss is recognized under the Internal Revenue Code, and, where the income of foreign entities is included in apportionable income, amounts which would have been recognized under the Internal Revenue Code if the relevant transactions or entities were in the United States. Amounts realized on the sale or exchange of property are not reduced for the cost of goods sold or the basis of property sold.

(6) "Receipts" means all gross receipts of the taxpayer that are not allocated under paragraphs of Article IV, and that are received from transactions and activity in the regular course of the taxpayer's trade or business. The following are additional rules for determining "receipts" in various situations:

(A) In the case of a taxpayer engaged in manufacturing and selling or purchasing and reselling goods or products, "receipts" includes all gross receipts from the sales of such goods or products (or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the tax period) held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. Gross receipts for this purpose means gross sales less returns and allowances.

(B) In the case of cost plus fixed fee contracts, such as the operation of a government-owned plant for a fee, "receipts" includes the entire reimbursed cost plus the fee.

(C) In the case of a taxpayer engaged in providing services, such as the operation of an advertising agency or the performance of equipment service contracts or research and development contracts, "receipts" includes the gross receipts from the performance of such services, including fees, commissions, and similar items.

(D) In the case of a taxpayer engaged in the sale of equipment used in the taxpayer's trade or business, where the taxpayer disposes of the equipment under a regular replacement program, "receipts" includes the gross receipts from the sale of this equipment. For example, a truck express company that owns a fleet of trucks and sells its trucks under a regular replacement program the gross receipts from the sale of the trucks would be included in "receipts."

(E) In the case of a taxpayer with insubstantial amounts of gross receipts arising from sales in the ordinary course of business, the insubstantial amounts may be excluded from the receipts factor unless their exclusion would materially affect the amount of income apportioned to this state.

(F) Receipts of a taxpayer from hedging transactions, or from holding cash or securities, or from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities, shall be excluded. Receipts arising from a business activity are receipts from hedging, if the primary purpose of engaging in the business activity is to reduce the exposure to risk caused by other business activities. Whether events or transactions not involving cash or securities are hedging transactions shall be determined based on the primary purpose of the taxpayer engaging in the activity giving rise to the receipts, including the acquisition or holding of the underlying asset. Receipts from the holding of cash or securities, or maturity, redemption, sale, exchange, loan or other disposition of cash or securities are excluded from the definition of receipts whether or not those events or transactions are engaged in for the purpose of hedging. The taxpayer's treatment of the receipts as hedging receipts for accounting or federal tax purposes may serve as indicia of the taxpayer's primary purpose, but shall not be determinative.

(G) Receipts, even if apportionable income, are presumed not to include such items as, for example:

1) damages and other amounts received as the result of litigation;

2) property acquired by an agent on behalf of another;

3) tax refunds and other tax benefit recoveries;

4) contributions to capital;

5) income from forgiveness of indebtedness;

6) amounts realized from exchanges of inventory that are not recognized by the Internal Revenue Code; or

7) Amounts realized as a result of factoring accounts receivable recorded on an accrual basis.

Exclusion of an item from the definition of "receipts" is not determinative of its character as apportionable or non-apportionable income. Certain gross receipts that are "receipts" under the definition are excluded from the "receipts factor" under Section IV.17. Nothing in this definition shall be construed to modify, impair or supersede any provision of Section IV.18.

(7) "Security'' means any interest or instrument commonly treated as a security as well as other instruments which are customarily sold in the open market or on a recognized exchange, including, but not limited to, transferable shares of a beneficial interest in any corporation or other entity, bonds, debentures, notes, and other evidences of indebtedness, accounts receivable and notes receivable, cash and cash equivalents including foreign currencies, and repurchase and futures contracts.

••• Reg. IV.2.(b)(1). Application of Article IV: Apportionment. If the business activity in respect to any trade or business of a taxpayer occurs both within and without this state, and if by reason of such business activity the taxpayer is taxable in another state, the portion of the net income (or net loss) arising from such trade or business which is derived from sources within this state shall be determined by apportionment in accordance with Article IV.9. to IV.17.

••• Reg. IV.2.(b)(2). Application of Article IV: Combined Report. If a particular trade or business is carried on by a taxpayer and one or more affiliated corporations, nothing in Article IV or in these regulations shall preclude the use of a "combined report" whereby the entire apportionable income of such trade or business is apportioned in accordance with Article IV.9. to IV.17.

••• Reg. IV.2.(b)(3). Application of Article IV: Allocation. Any taxpayer subject to the taxing jurisdiction of this state shall allocate all of its non-apportionable income or loss within or without this state in accordance with Article IV.4. to IV.8.

••• Reg. IV.2.(c). Consistency and Uniformity in Reporting.

(1) Year to year consistency. In filing returns with this state, if the taxpayer departs from or modifies the manner in which income has been classified as apportionable income or non-apportionable income in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification. [State should insert its requirements]

(2) State to state consistency. If the returns or reports filed by a taxpayer for all states to which the taxpayer reports under Article IV of this Compact or the Uniform Division of Income for Tax Purposes Act are not uniform in the classification of income as apportionable or non-apportionable income, the taxpayer shall disclose in its return to this state the nature and extent of the variance. [State should insert its requirements]

••• Reg. IV.3.(a). Taxable in Another State: In General. Under Article IV.2. the taxpayer is subject to the allocation and apportionment provisions of Article IV if it has income from business activity that is taxable both within and without this state. A taxpayer's income from business activity is taxable without this state if the taxpayer, by reason of such business activity (i.e., the transactions and activity occurring in the regular course of a particular trade or business), is taxable in another state within the meaning of Article IV.3.

(1) Applicable tests. A taxpayer is taxable within another state if it meets either one of two tests: (1) By reason of business activity in another state, the taxpayer is subject to one of the types of taxes specified in Article IV.3.(1), namely: A net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; or (2) By reason of such business activity, another state has jurisdiction to subject the taxpayer to a net income tax, regardless of whether or not the state imposes such a tax on the taxpayer.

(2) Producing non-apportionable income. A taxpayer is not taxable in another state with respect to a particular trade or business merely because the taxpayer conducts activities in that other state pertaining to the production of non-apportionable income or business activities relating to a separate trade or business.

••• Reg. IV.3.(b).Taxable in Another State: When a Corporation Is "Subject to" a Tax under Article IV.3.(1).

(1) A taxpayer is "subject to" one of the taxes specified in Article IV.3.(1) if it carries on business activities in a state and the state imposes such a tax thereon. Any taxpayer which asserts that it is subject to one of the taxes specified in Article IV.3.(1) in another state shall furnish to [the tax administrator] of this state upon his/her request evidence to support that assertion. [The tax administrator] of this state may request that such evidence include proof that the taxpayer has filed the requisite tax return in the other state and has paid any taxes imposed under the law of the other state; the taxpayer's failure to produce such proof may be taken into account in determining whether the taxpayer in fact is subject to one of the taxes specified in Article IV.3.(1) in the other state.

Voluntary tax payment. If the taxpayer voluntarily files and pays one or more of such taxes when not required to do so by the laws of that state or pays a minimal fee for qualification, organization or for the privilege of doing business in that state, but

(A) does not actually engage in business activity in that state, or

(B) does actually engage in some business activity not sufficient for nexus and the minimum tax bears no relationship to the taxpayer's business activity within such state, the taxpayer is not "subject to" one of the taxes specified within the meaning of Article IV.3.(1).

Example: State A has a corporation franchise tax measured by net income for the privilege of doing business in that state. Corporation X files a return and pays the $50 minimum tax, although it carries on no business activity in State A. Corporation X is not taxable in State A.

(2) The concept of taxability in another state is based upon the premise that every state in which the taxpayer is engaged in business activity may impose an income tax even though every state does not do so. In states which do not, other types of taxes may be imposed as a substitute for an income tax. Therefore, only those taxes enumerated in Article IV.3.(1) which may be considered as basically revenue raising rather than regulatory measures shall be considered in determining whether the taxpayer is "subject to" one of the taxes specified in Article IV.3.(1) in another state.

Example (i): State A requires all nonresident corporations which qualify or register in State A to pay to the Secretary of State an annual license fee or tax for the privilege of doing business in the state regardless of whether the privilege is in fact exercised. The amount paid is determined according to the total authorized capital stock of the corporation; the rates are progressively higher by bracketed amounts. The statute sets a minimum fee of $50 and a maximum fee of $500. Failure to pay the tax bars a corporation from utilizing the state courts for enforcement of its rights. State A also imposes a corporation income tax. Nonresident Corporation X is qualified in State A and pays the required fee to the Secretary of State but does not carry on any business activity in State A (although it may utilize the courts of State A). Corporation X is not "taxable" in State A.

Example (ii): Same facts as Example (i) except that Corporation X is subject to and pays the corporation income tax. Payment is prima facie evidence that Corporation X is "subject to" the net income tax of State A and is "taxable" in State A.

Example (iii): State B requires all nonresident corporations qualified or registered in State B to pay to the Secretary of State an annual permit fee or tax for doing business in the state. The base of the fee or tax is the sum of (1) outstanding capital stock, and (2) surplus and undivided profits. The fee or tax base attributable to State B is determined by a three factor apportionment formula.

Nonresident Corporation X which operates a plant in State B, pays the required fee or tax to the Secretary of State. Corporation X is "taxable" in State B.

Example (iv): State A has a corporation franchise tax measured by net income for the privilege of doing business in that state. Corporation X files a return based upon its business activity in the state but the amount of computed liability is less than the minimum tax. Corporation X pays the minimum tax. Corporation X is subject to State A's corporation franchise tax.

••• Reg. IV.3.(c). Taxable in Another State: When a State Has Jurisdiction to Subject a Taxpayer to a Net Income Tax. The second test, that of Article IV.3.(2), applies if the taxpayer's business activity is sufficient to give the state jurisdiction to impose a net income tax by reason of such business activity under the Constitution and statutes of the United States. Jurisdiction to tax is not present where the state is prohibited from imposing the tax by reason of the provisions of Public Law 86-272, 15 U.S.C.A. §§ 381-385. In the case of any "state" as defined in Article IV.1.(h), other than a state of the United States or political subdivision thereof, the determination of whether the "state" has jurisdiction to subject the taxpayer to a net income tax shall be made as though the jurisdictional standards applicable to a state of the United States applied in that "state." If jurisdiction is otherwise present, that "state" is not considered as being without jurisdiction by reason of the provisions of a treaty between that "state" and the United States.

Example: Corporation X is actively engaged in manufacturing farm equipment in State A and in foreign country B. Both State A and foreign country B impose a net income tax but foreign country B exempts corporations engaged in manufacturing farm equipment. Corporation X is subject to the jurisdiction of State A and foreign country B.

••• Reg. IV.9. Apportionment Formula. All apportionable income of each trade or business of the taxpayer shall be apportioned to this state by use of the apportionment formula set forth in Article IV.9. The elements of the apportionment formula are the property factor (see Regulation IV.10.), the payroll factor (see Regulation IV.13.) and the receipts factor (see Regulation IV.15.) of the trade or business of the taxpayer.

••• Reg. IV.10.(a). Property Factor: In General. The property factor of the apportionment formula for each trade or business of the taxpayer shall include all real and tangible personal property owned or rented by the taxpayer and used during the tax period in the regular course of the trade or business. The 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. Property used in connection with the production of non-apportionable income shall be excluded from the property factor. Property used both in the regular course of the taxpayer's trade or business and in the production of non-apportionable income shall be included in the factor only to the extent that the property is used in the regular course of the taxpayer's trade or business. The method of determining that portion of the value to be included in the factor will depend upon the facts of each case. The property factor shall include the average value of property includable in the factor. See Regulation IV.12.

••• Reg. IV.10.(b). Property Factor: Property Used for the Production of Apportionable Income. Property shall be included in the property factor if it is actually used or is available for or capable of being used during the tax period in the regular course of the trade or business of the taxpayer. Property held as reserves or standby facilities or property held as a reserve source of materials shall be included in the factor. For example, a plant temporarily idle or raw material reserves not currently being processed are includable in the factor. Property or equipment under construction during the tax period (except inventoriable goods in process) shall be excluded from the factor until such property is actually used in the regular course of the trade or business of the taxpayer. If the property is partially used in the regular course of the trade or business of the taxpayer while under construction, the value of the property to the extent used shall be included in the property factor. Property used in the regular course of the trade or business of the taxpayer shall remain in the property factor until its permanent withdrawal is established by an identifiable event that results in its conversion to the production of non-apportionable income, its sale, or the lapse of an extended period of time (normally, five years) during which the property is no longer held for use in the trade or business.

Example (i): Taxpayer closed its manufacturing plant in State X and held the property for sale. The property remained vacant until its sale one year later. The value of the manufacturing plant is included in the property factor until the plant is sold.

Example (ii): Same as above except that the property was rented until the plant was sold. The plant is included in the property factor until the plant is sold.

••• Reg. IV.10.(c). Property Factor: Consistency in Reporting.

(1) Year to year consistency. In filing returns with this state, if the taxpayer departs from or modifies the manner of valuing property or of excluding property from or including property in the property factor used in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.

(2) State to state consistency. If the returns or reports filed by the taxpayer with all states to which the taxpayer reports under Article IV of this Compact or the Uniform Division of Income for Tax Purposes Act are not uniform in the valuation of property and in the exclusion of property from or the inclusion of property in the property factor, the taxpayer shall disclose in its return to this state the nature and extent of the variance.

••• Reg. IV.10.(d). Property Factor: Numerator. The numerator of the property factor shall include the average value of the real and tangible personal property owned or rented by the taxpayer and used in this state during the tax period in the regular course of the trade or business of the taxpayer. Property in transit between locations of the taxpayer to which it belongs shall be considered to be at the destination for purposes of the property factor. Property in transit between a buyer and seller which is included by a taxpayer in the denominator of its property factor in accordance with its regular accounting practices shall be included in the numerator according to the state of destination. The value of mobile or movable property such as construction equipment, trucks or leased electronic equipment which are located within and without this state during the tax period shall be determined for purposes of the numerator of the factor on the basis of total time within the state during the tax period. An automobile assigned to a traveling employee shall

be included in the numerator of the factor of the state to which the employee's compensation is assigned under the payroll factor or in the numerator of the state in which the automobile is licensed.

••• Reg. IV.11.(a). Property Factor: Valuation of Owned Property.

(1) Property owned by the taxpayer shall be valued at its original cost. As a general rule, "original cost" is deemed to be the basis of the property for federal income tax purposes (prior to any federal adjustments) at the time of acquisition by the taxpayer and adjusted by subsequent capital additions or improvements thereto and partial disposition thereof, by reason of sale, exchange, abandonment, etc. However, capitalized intangible drilling and development costs shall be included in the property factor whether or not they have been expensed for either federal or state tax purposes. [This last sentence was added on July 14, 1988.]

> *Example (i):* The taxpayer acquired a factory building in this state at a cost of $500,000 and, 18 months later, expended $100,000 for major remodeling of the building. Taxpayer files its return for the current taxable year on the calendar-year basis. Depreciation deduction in the amount of $22,000 was claimed with respect to the building on the return for the current taxable year. The value of the building includable in the numerator and denominator of the property factor is $600,000; the depreciation deduction is not taken into account in determining the value of the building for purposes of the factor.
>
> *Example (ii):* During the current taxable year, Corporation X merges into Corporation Y in a tax-free reorganization under the Internal Revenue Code. At the time of the merger, Corporation X owns a factory which X built five years earlier at a cost of $1,000,000. X has been depreciating the factory at the rate of two percent per year, and its basis in X's hands at the time of the merger is $900,000. Since the property is acquired by Y in a transaction in which, under the Internal Revenue Code, its basis in Y's hands is the same as its basis in X's hands, Y includes the property in Y's property factor at X's original cost, without adjustment for depreciation, i.e. $1,000,000.
>
> *Example (iii):* Corporation Y acquires the assets of Corporation X in a liquidation by which Y is entitled to use its stock cost as the basis of the X assets under Section 334(b)(2) of the 1954 Internal Revenue Code (i.e. stock possessing 80 percent control is purchased and liquidated within two years). Under these circumstances, Y's cost of the assets is the purchase price of the X stock, prorated over the X assets.
>
> If the original cost of property is unascertainable, the property is included in the factor at its fair market value as of the date of acquisition by the taxpayer.

(2) Inventory of stock of goods shall be included in the factor in accordance with the valuation method used for federal income tax purposes.

(3) Property acquired by gift or inheritance shall be included in the factor at its basis for determining depreciation for federal income tax purposes.

••• Reg. IV.11.(b). Property Factor: Valuation of Rented Property.

(1) Multiplier and subrentals. Property rented by the taxpayer is valued at eight times its net annual rental rate. The net annual rental rate for any item of rented property is the annual rental rate paid by the taxpayer for the property less the aggregate annual subrental rates paid by subtenants of the taxpayer. (See Regulation IV.18.(b) for special rules when the use of such net annual rental rate produces a negative or clearly inaccurate value or when property is used by the taxpayer at no charge or is rented at a nominal rental rate.) Subrents are not deducted when they constitute apportionable income because the property which produces the subrents is used in the regular course of a trade or business of the taxpayer when it is producing such income. Accordingly there is no reduction in its value.

Example (i): The taxpayer receives subrents from a bakery concession in a food market operated by the taxpayer. Since the subrents are apportionable income, they are not deducted from rent paid by the taxpayer for the food market.

Example (ii): The taxpayer rents a 5-story office building primarily for use in its multistate business, uses three floors for its offices and subleases two floors to various other businesses on a short-term basis because it anticipates it will need those two floors for future expansion of its multistate business. The rental of all five floors is related to the operation of the taxpayer's trade or business. Since the subrents are apportionable income, they are not deducted from the rent paid by the taxpayer.

Example (iii): The taxpayer rents a 20-story office building and uses the lower two stories for its general corporation headquarters. The remaining 18 floors are subleased to others. The rental of the eighteen floors is not incidental to but rather is separate from the operation of the taxpayer's trade or business. Since the subrents are non-apportionable income they are not included in the taxpayer's property factor.

(2) "Annual rental rate" is the amount paid as rental for property for a 12-month period (i.e., the amount of the annual rent). Where property is rented for less than a 12-month period, the rent paid for the actual period of rental shall constitute the "annual rental rate" for the tax period. However, where a taxpayer has rented property for a term of 12 or more months and the current tax period covers a period of less than 12 months (due, for example, to a reorganization or change of accounting period), the rent paid for the short tax period shall be annualized. If the rental term is for less than 12 months, the rent shall not be annualized beyond its term. Rent shall not be annualized because of the uncertain duration when the rental term is on a month-to-month basis.

Example (i): Taxpayer A, which *ordinarily* files its returns based on a calendar year, is merged into Taxpayer B on April 30. The net rent paid under a lease with 5 years remaining is $2,500 a month. The rent for the tax period January 1 to April 30 is $10,000. After the rent is annualized the net rent is

$30,000 ($2,500 x 12).

Example (ii): Same facts as in *Example (i)* except that the lease would have terminated on August 31. In this case, the annualized rent is $20,000 ($2,500 x 8).

(3) "Annual rent" is the actual sum of money or other consideration payable, directly or indirectly, by the taxpayer or for its benefit for the use of the property and includes:

(A) Any amount payable for the use of real or tangible personal property, or any part thereof, whether designated as a fixed sum of money or as a percentage of sales, profits or otherwise.

Example: A taxpayer, pursuant to the terms of a lease, pays a lessor $1,000 per month as a base rental and at the end of the year pays the lessor one percent of its gross sales of $400,000. The annual rent is $16,000 ($12,000 plus one percent of $400,000 or $4,000).

(B) Any amount payable as additional rent or in lieu of rents, such as interest, taxes, insurance, repairs or any other items which are required to be paid by the terms of the lease or other arrangement, not including amounts paid as service charges, such as utilities, janitor services, etc. If a payment includes rent and other charges unsegregated, the amount of rent shall be determined by consideration of the relative values of the rent and other items.

Example (i): A taxpayer, pursuant to the terms of a lease, pays the lessor $12,000 a year rent plus taxes in the amount of $2,000 and interest on a mortgage in the amount of $1,000. The annual rent is $15,000.

Example (ii): A taxpayer stores *part* of its inventory in a public warehouse. The total charge for the year was $1,000 of which $700 was for the use of storage space and $300 for inventory insurance, handling and shipping charges, and C.O.D. collections. The annual rent is $700.

(4) Exclusions. "Annual rent" does not include:

(A) Incidental day-to-day expenses such as hotel or motel accommodations, daily rental of automobiles, etc.; and

(B) Royalties based on extraction of natural resources, whether represented by delivery or purchase. For this purpose, a royalty includes any consideration conveyed or credited to a holder of an interest in property which constitutes a sharing of current or future production of natural resources from such property, irrespective of the method of payment or how such consideration may be characterized, whether as a royalty, advance royalty, rental or otherwise.

(5) Leasehold improvements shall, for the purposes of the property factor, be treated as property owned by the taxpayer regardless of whether the taxpayer is entitled to remove the improvements or the improvements revert to the lessor upon expiration of the lease. Hence, the original cost of leasehold improvements shall be included in the factor.

••• Reg. IV.12. Property Factor: Averaging Property Values. As a general rule, the average value of property owned by the taxpayer shall be determined by averaging the values at the beginning and ending of the tax period. However, [the tax administrator] may require or allow averaging by monthly values if that method of averaging is required to properly reflect the average value of the taxpayer's property for the tax period.

Averaging by monthly values will generally be applied if substantial fluctuations in the values of the property exist during the tax period or if property is acquired after the beginning of the tax period or disposed of before the end of the tax period.

Example: The monthly value of the taxpayer's property was as follows:

January	$2,000	July	$15,000
February	2,000	August	17,000
March	3,000	September	23,000
April	3,500	October	25,000
May	4,500	November	13,000
June	10,000	December	2,000
	$25,000		$95,000
		Total	$120,000

The average value of the taxpayer's property includable in the property factor for the income year is determined as follows:

$$\frac{\$120{,}000}{12} = \$10{,}000$$

Averaging with respect to rented property is achieved automatically by the method of determining the net annual rental rate of such property as set forth in Reg. IV.11.(b).

••• Reg. IV.13.(a). Payroll Factor: In General.

(1) The payroll factor of the apportionment formula for each trade or business of the taxpayer shall include the total amount paid by the taxpayer in the regular course of its trade or business for compensation during the tax period.

(2) The total amount "paid" to employees is determined upon the basis of the taxpayer's accounting method. If the taxpayer has adopted the accrual method of accounting, all compensation properly accrued shall be deemed to have been paid. Notwithstanding the taxpayer's method of accounting, compensation paid to employees may, at the election of the taxpayer, be included in the payroll factor by use of the cash method if the taxpayer is required to report such compensation under that method for unemployment compensation purposes. The compensation of any employee on account of activities which are connected with the production of non-apportionable income shall be excluded from the factor.

Example (i): The taxpayer uses some of its employees in the construction of a storage building which, upon completion, is used in the regular course of the taxpayer's trade or business. The wages paid to those employees are treated as a capital expenditure by the taxpayer. The amount of those wages is included in the payroll factor.

Example (ii): The taxpayer owns various securities which it holds as an investment separate and apart from its trade or business. The management of the taxpayer's investment portfolio is the only duty of Mr. X, an employee. The salary paid to Mr. X is excluded from the payroll factor.

••• Reg. IV.13.(b). Payroll Factor: Denominator. The denominator of the payroll factor is the total compensation paid everywhere during the tax period. Accordingly, compensation paid to employees whose

services are performed entirely in a state where the taxpayer is immune from taxation, for example, by Public Law 86-272, is included in the denominator of the payroll factor.

Example: A taxpayer has employees in its state of legal domicile (State A) and is taxable in State B. In *addition* the taxpayer has other employees whose services are performed entirely in State C where the taxpayer is immune from taxation under the provisions of Public Law 86-272. As to these latter employees, the compensation will be assigned to State C where their services are performed (i.e., included in the denominator but not the numerator of the payroll factor) even though the taxpayer is not taxable in State C.

••• Reg. IV.13.(c). Payroll Factor: Numerator. The numerator of the payroll factor is the total amount paid in this state during the tax period by the taxpayer for compensation. The tests in Article IV.14. to be applied in determining whether compensation is paid in this state are derived from the Model Unemployment Compensation Act. Accordingly, if compensation paid to employees is included in the payroll factor by use of the cash method of accounting or if the taxpayer is required to report such compensation under that method for unemployment compensation purposes, it shall be presumed that the total wages reported by the taxpayer to this state for unemployment compensation purposes constitute compensation paid in this state except for compensation excluded under Regulation IV.13.(a). to IV.14. The presumption may be overcome by satisfactory evidence that an employee's compensation is not properly reportable to this state for unemployment compensation purposes.

••• Reg. IV.14. Payroll Factor: Compensation Paid in This State. Compensation is paid in this state if any one of the following tests, applied consecutively, are met:

(1) The employee's service is performed entirely within the state.

(2) The employee's service is performed both within and without the state, but the service performed without the state is incidental to the employee's service within the state. The word "incidental" means any service which is temporary or transitory in nature, or which is rendered in connection with an isolated transaction.

(3) If the employee's services are performed both within and without this state, the employee's compensation will be attributed to this state:

(A) if the employee's base of operations is in this state; or

(B) if there is no base of operations in any state in which some part of the service is performed, but the place from which the service is directed or controlled is in this state; or

(C) if the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed but the employee's residence is in this state.

The term "place from which the service is directed or controlled" refers to the place from which the power to direct or control is exercised by the taxpayer.

The term "base of operations" is the place of more or less permanent nature from which the employee starts his work and to which he customarily returns in order to receive instructions from the taxpayer or communications from his customers or other persons or to replenish stock or other materials, repair equipment, or perform any other functions necessary to the exercise of his trade or profession at some other point or points.

••• Reg. IV.15.(a). Receipts Factor: Additional Principles.

(1) Exceptions. In some cases certain gross receipts should be disregarded in determining the receipts factor in order that the apportionment formula will operate fairly to apportion to this state the income of the taxpayer's trade or business. See Regulation IV.18.(c).

(2) Year to year consistency. In filing returns with this state, if the taxpayer departs from or modifies the basis for excluding or including gross receipts in the receipts factor used in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification. [Each state should insert its own reporting requirement].

(3) State to state consistency. If the returns or reports filed by the taxpayer with all states to which the taxpayer reports under Article IV of this Compact or the Uniform Division of Income for Tax Purposes Act are not uniform in the inclusion or exclusion of gross receipts, the taxpayer shall disclose in its return to this state the nature and extent of the variance. [Each state should insert its own reporting requirement].

••• Reg. IV.15.(b). Receipts Factor: Denominator. The denominator of the receipts factor shall include the gross receipts derived by the taxpayer from transactions and activity in the regular course of its trade or business, except gross receipts excluded under these regulations.

••• Reg. IV.15.(c). Receipts Factor: Numerator. The numerator of the receipts factor shall include gross receipts attributable to this state and derived by the taxpayer from transactions and activity in the regular course of its trade or business, except gross receipts excluded under these regulations.

••• Reg. IV.16.(a). Receipts Factor: Sales of Tangible Personal Property in This State.

(1) Gross receipts from sales of tangible personal property (except sales to the United States Government; see Regulation IV.16.(b)) are in this state:

(A) if the property is delivered or shipped to a purchaser within this state regardless of the f.o.b. point or other conditions of sale; or

(B) if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and the taxpayer is not taxable in the state of the purchaser.

(2) Property shall be deemed to be delivered or shipped to a purchaser within this state if the recipient is located in this state, even though the property is ordered from outside this state.

Example: The taxpayer, with inventory in State A, sold $100,000 of its products to a purchaser having branch stores in several states, including this state. The order for the purchase was placed by the purchaser's central purchasing department located in State B. $25,000 of the purchase order was shipped directly to purchaser's branch store in this state. The branch store in this state is the purchaser within this state with respect to $25,000 of the taxpayer's sales.

(3) Property is delivered or shipped to a purchaser within this state if the shipment terminates in this state, even though the property is subsequently transferred by the purchaser to another state.

Example: The taxpayer makes a sale to a purchaser who maintains a central warehouse in this state at which all merchandise purchases are received. The purchaser reships the goods to its branch stores in other states for sale. All of the taxpayer's products shipped to the purchaser's warehouse in this state constitute property delivered or shipped to a purchaser within this state.

(4) The term "purchaser within this state" shall include the ultimate recipient of the property if the taxpayer in this state, at the designation of the purchaser, delivers to or has the property shipped to the ultimate recipient within this state.

Example: A taxpayer in this state sold merchandise to a purchaser in State A. Taxpayer directed the manufacturer or supplier of the merchandise in State B to ship the merchandise to the purchaser's customer in this state pursuant to purchaser's instructions. The sale by the taxpayer is in this state.

(5) When property being shipped by a seller from the state of origin to a consignee in another state is diverted while en-route to a purchaser in this state, the sales are in this state.

Example: The taxpayer, a produce grower in State A, begins shipment of perishable produce to the purchaser's place of business in State B. While en-route, the produce is diverted to the purchaser's place of business in this state in which state the taxpayer is subject to tax. The sale by the taxpayer is attributed to this state.

(6) If the taxpayer is not taxable in the state of the purchaser, the sale is attributed to this state if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state.

Example: The taxpayer has its head office and factory in State A. It maintains a branch office and inventory in this state. Taxpayer's only activity in State B is the solicitation of orders by a resident salesman. All orders by the State B salesman are sent to the branch office in this state for approval and are filled by shipment from the inventory in this state. Since the taxpayer is immune under Public Law 86-272 from tax in State B, all sales of merchandise to purchasers in State B are attributed to this state, the state from which the merchandise was shipped.

(7) If a taxpayer whose salesman operates from an office located in this state makes a sale to a purchaser in another state in which the taxpayer is not taxable and the property is shipped directly by a third party to the purchaser, the following rules apply:

(A) If the taxpayer is taxable in the state from which the third party ships the property, then the sale is in that state.

(B) If the taxpayer is not taxable in the state from which the property is shipped, then the sale is in this state.

Example: The taxpayer in this state sold merchandise to a purchaser in State A. Taxpayer is not taxable in State A. Upon direction of the taxpayer, the merchandise was shipped directly to the purchaser by the manufacturer in State B. If the taxpayer is taxable in State B, the sale is in State B. If the taxpayer is not taxable in State B, the sale is in this state.

••• Reg. IV.16.(b). Receipts Factor: Sales of Tangible Personal Property to the United States Government in This State. Gross receipts from sales of tangible personal property to the United States Government are in this state if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state. For the purposes of this regulation, only sales for which the United States Government makes direct payment to the seller pursuant to the terms of a contract constitute sales to the United States Government. Thus, as a general rule, sales by a subcontractor to the prime contractor, the party to the contract with the United States Government, do not constitute sales to the United States Government.

Example (i): A taxpayer contracts with General Services Administration to deliver X number of trucks which were paid for by the United States Government. The sale is a sale to the United States Government.

Example (ii): The taxpayer, as a subcontractor to a prime contractor with the National Aeronautics and Space Administration, contracts to build a component of a rocket for $1,000,000. The sale by the subcontractor to the prime contractor is not a sale to the United States Government.

The former Section 17 Regulations are repealed; in their place is the following:

••• Reg. IV.17.(a). Receipts Factor: Sales Other Than Sales of Tangible Personal Property in This State: General Rules.

In general. Article IV.17. provides for the inclusion in the numerator of the receipts factor of gross receipts arising from transactions other than sales of tangible personal property.

(1) Market-Based Sourcing.

Receipts, other than receipts described in Article IV.16 (from sales of tangible personal property) are in [state] within the meaning of Article IV.17 and this Reg. IV.17 if and to the extent that the taxpayer's market for the sales is in [state]. In general, the provisions in this section establish uniform rules for (1) determining whether and to what extent the market for a sale other than the sale of tangible personal property is in [state], (2) reasonably approximating the state or states of assignment where the state or states cannot be determined, (3) excluding receipts from the sale of intangible property from the numerator and denominator of the receipts factor pursuant to Article IV.17(a)(4)(ii)(c), and (4) excluding receipts from the denominator of the receipts factor, pursuant to Article IV.17(c) where the state or states of assignment cannot be determined or reasonably approximated, or where the taxpayer is not taxable in the state to which the receipts are assigned as determined under Article IV.3 and applicable regulations,

(2) Outline of topics.

The provisions in this Reg. IV.17 are organized as follows:

(a) General Rules

(1) Market-Based Sourcing

(2) Outline of Topics

(3) Definitions

(4) General Principles of Application; Contemporaneous Records

(5) Rules of Reasonable Approximation

(6) Rules with respect to Exclusion of Receipts from the Receipts Factor

(7) Changes in Methodology; [tax administrator] Review

(8) Further Guidance

(b) Sale, Rental, Lease or License of Real Property

(c) Rental, Lease or License of Tangible Personal Property

(d) Sale of a Service

(1) General Rule

(2) In-Person Services

(3) Services Delivered to the Customer or on Behalf of the Customer, or Delivered Electronically Through the Customer

(4) Professional Services

(e) License or Lease of Intangible Property

(1) General Rules

(2) License of a Marketing Intangible

(3) License of a Production Intangible

(4) License of a Mixed Intangible

(5) License of Intangible Property where Substance of the Transaction Resembles a Sale of Goods or Services

(f) Sale of Intangible Property

(1) Assignment of Receipts

(g) Special Rules

(1) Software Transactions

(2) Sales or Licenses of Digital Goods and Services

(3) Definitions.

(3) For the purposes of this Reg. IV.17 these terms have the following meanings:

(A) "Billing address" means the location indicated in the books and records of the taxpayer as the primary mailing address relating to a customer's account as of the time of the transaction as kept in good faith in the normal course of business and not for tax avoidance purposes.

(B) "Business customer" means a customer that is a business operating in any form, including a sole proprietorship. Sales to a non-profit organization, to a trust, to the U.S. Government, to a foreign, state or local government, or to an agency or instrumentality of that government are treated as sales to a business customer and must be assigned consistent with the rules for those sales.

(C) "Code" means the Internal Revenue Code as currently written and subsequently amended.

(D) "Individual customer" means a customer that is not a business customer.

(E) "Intangible property" generally means property that is not physical or whose representation by physical means is merely incidental and includes, without limitation, copyrights; patents; trademarks; trade names; brand names; franchises; licenses; trade secrets; trade dress; information; know-how; methods; programs; procedures; systems; formulae; processes; technical data; designs; licenses; literary, musical, or artistic compositions; information; ideas; contract rights including broadcast rights; agreements not to compete; goodwill and going concern value; securities; and, except as otherwise provided in Reg. IV.17, computer software. Receipts from the sale of intangible property may be excluded from the numerator and denominator of the taxpayer's receipts factor pursuant to Article IV.17 and Reg. IV.17.(f).(1)(D).

(F) "Place of order," means the physical location from which a customer places an order for a sale other than a sale of tangible personal property from a taxpayer, resulting in a contract with the taxpayer.

(G) "Population" means the most recent population data maintained by the U.S. Census Bureau for the year in question as of the close of the taxable period.

(H) "Related party" means:

(1) a stockholder who is an individual, or a member of the stockholder's family set forth in section 318 of the Code if the stockholder and the members of the stockholder's family own, directly, indirectly, beneficially or constructively, in the aggregate, at least 50 per cent of the value of the taxpayer's outstanding stock;

(2) a stockholder, or a stockholder's partnership, limited liability company, estate, trust or corporation, if the stockholder and the stockholder's partnerships, limited liability companies, estates, trusts and corporations own directly, indirectly, beneficially or constructively, in the aggregate, at least 50 per cent of the value of the taxpayer's outstanding stock; or

(3) a corporation, or a party related to the corporation in a manner that would require an attribution of stock from the corporation to the party or from the party to the corporation under the attribution rules of the Code if the taxpayer owns, directly, indirectly, beneficially or constructively, at least 50 per cent of the value of the corporation's outstanding stock. The attribution rules of the Code shall apply for purposes of determining whether the ownership requirements of this definition have been met. [or insert state definition]

(I) "State where a contract of sale is principally managed by the customer," means 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.

(4) General Principles of Application; Contemporaneous Records.

In order to satisfy the requirements of Reg. IV.17, a taxpayer's assignment of receipts from sales of other than tangible personal property must be consistent with the following principles:

(A) A taxpayer shall apply the rules set forth in Reg. IV.17 based on objective criteria and shall consider all sources of information reasonably available to the taxpayer at the time of its tax filing including, without limitation, the taxpayer's books and records kept in the normal course of business. A taxpayer shall determine its method of assigning receipts in good faith, and apply it consistently with respect to similar transactions and year to year. A taxpayer shall retain contemporaneous records that explain the determination and application of its method of assigning its receipts, including its underlying assumptions, and shall provide those records to the [Agency] upon request.

(B) Reg. IV.17 provides various assignment rules that apply sequentially in a hierarchy. For each sale to which a hierarchical rule applies, a taxpayer must make a reasonable effort to apply the primary rule applicable to the sale before seeking to apply the next rule in the hierarchy (and must continue to do so with each succeeding rule in the hierarchy, where applicable). For example, in some cases, the applicable rule first requires a taxpayer to determine the state or states of assignment, and if the taxpayer cannot do so, the rule requires the taxpayer to reasonably approximate the state or states. In these cases, the taxpayer must attempt to determine the state or states of assignment (i.e., apply the primary rule in the hierarchy) in good faith and with reasonable effort before it may reasonably approximate the state or states.

(C) A taxpayer's method of assigning its receipts, including the use of a method of approximation, where applicable, must reflect an attempt to obtain the most accurate assignment of receipts consistent with the regulatory standards set forth in Reg. IV.17, rather than an attempt to lower the taxpayer's tax liability. A method of assignment that is reasonable for one taxpayer may not necessarily be reasonable for another taxpayer, depending upon the applicable facts.

(5) Rules of Reasonable Approximation.

(A) In General. In general, Reg. IV.17 establishes uniform rules for determining whether and to what extent the market for a sale other than the sale of tangible personal property is in [state]. The regulation also sets forth rules of reasonable approximation, which apply if the state or states of assignment cannot be determined. In some instances, the reasonable approximation must be made in accordance with specific rules of approximation prescribed in Reg. IV.17. In other cases, the applicable rule in Reg. IV.17 permits a taxpayer to reasonably approximate the state or states of assignment, 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.

(B) Approximation Based Upon Known Sales. In an instance where, applying the applicable rules set forth in Reg. IV.17.(d). (Sale of a Service), a taxpayer can ascertain the state or states of assignment of a substantial portion of its receipts from sales of substantially similar services ("assigned receipts"), but not all of those sales, and the taxpayer reasonably believes, based on all available information, that the geographic distribution of some or all of the remainder of those sales

generally tracks that of the assigned receipts, it shall include receipts from those sales which it believes tracks the geographic distribution of the assigned receipts in its receipts factor in the same proportion as its assigned receipts. This rule also applies in the context of licenses and sales of intangible property where the substance of the transaction resembles a sale of goods or services. *See* Reg.s IV.17.(e).(5) and (f).(1)(C).

(C) Related-Party Transactions – Information Imputed from Customer to Taxpayer. Where a taxpayer has receipts subject to this Reg. IV.17 from transactions with a related-party customer, information that the customer has that is relevant to the sourcing of receipts from these transactions is imputed to the taxpayer.

(6) Rules with Respect to Exclusion of Receipts from the Receipts Factor

(A) The receipts factor only includes those amounts defined as receipts under Article IV.1(g) and applicable regulations.

(B) Certain receipts arising from the sale of intangibles are excluded from the numerator and denominator of the sales factor pursuant to Article IV.17(a)(4)(ii)(C). *See* Reg. IV.17.(f).(1)(D).

(C) In a case in which a taxpayer cannot ascertain the state or states to which receipts of a sale are to be assigned pursuant to the applicable rules set forth in Reg. IV.17 (including through the use of a method of reasonable approximation, where relevant) using a reasonable amount of effort undertaken in good faith, the receipts must be excluded from the denominator of the taxpayer's receipts factor pursuant to Article IV. 17.(c). and these regulations.

(D) In a case in which a taxpayer can ascertain the state or states to which receipts from a sale are to be assigned pursuant to the applicable rules set forth in Reg. IV.17, but the taxpayer is not taxable in one or more of those states, pursuant to Article IV.3 and applicable regulations, the receipts that would otherwise be assigned to those states where the taxpayer is not taxable must be excluded from the denominator of the taxpayer's receipts factor pursuant to Article IV.17.(c).

(E) Receipts of a taxpayer from hedging transactions, or from holding cash or securities, or from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities, shall be excluded pursuant to Article IV.1.(g) and Art. IV.17.

(7) Changes in Methodology; [tax administrator] Review

(A) No Limitation on Article IV.18 or Reg. IV.18. Nothing in the regulations adopted here pursuant to Article IV.17 is intended to limit the application of Article IV.18 or the authority granted to [the tax administrator] under Section 18. To the extent that regulations adopted pursuant to Section 18 conflict with provisions of these regulations adopted pursuant to Section 17, the regulations adopted pursuant to Section 18 control. If the application of Section 17 or the regulations adopted pursuant thereto result in the attribution of receipts to the taxpayer's receipts factor that does not fairly represent the extent of the taxpayer's business activity in [state], the taxpayer may petition for or [the tax administrator] may require the use of a different method for attributing those receipts.

(B) General Rules Applicable to Original Returns. In any case in which a taxpayer files an original return for a taxable year in which it properly assigns its receipts using a method of assignment,

including a method of reasonable approximation, in accordance with the rules stated in Reg. IV.17., the application of such method of assignment shall be deemed to be a correct determination by the taxpayer of the state or states of assignment to which the method is properly applied. In those cases, neither [the tax administrator] nor the taxpayer (through the form of an audit adjustment, amended return, abatement application or otherwise) may modify the taxpayer's methodology as applied for assigning those receipts for the taxable year. However, [the tax administrator] and the taxpayer may each subsequently, through the applicable administrative process, correct factual errors or calculation errors with respect to the taxpayer's application of its filing methodology.

(C) [Tax Administrator] Authority to Adjust a Taxpayer's Return. The provisions contained in this Reg. IV.17.(a)(7)(C) are subject to Reg. IV. 17.(a)(7)(B). The [tax administrator's] ability to review and adjust a taxpayer's assignment of receipts on a return to more accurately assign receipts consistently with the rules or standards of Reg. IV.17, includes, but is not limited to, each of the following potential actions.

1. In a case in which a taxpayer fails to properly assign receipts from a sale in accordance with the rules set forth in Reg. IV.17, including the failure to properly apply a hierarchy of rules consistent with the principles of Reg. IV.17.(a).(4)(B), [the tax administrator] may adjust the assignment of the receipts in accordance with the applicable rules in Reg. IV.17.

2. In a case in which a taxpayer uses a method of approximation to assign its receipts and [the tax administrator] determines that the method of approximation employed by the taxpayer is not reasonable, the [tax administrator] may substitute a method of approximation that the [tax administrator] determines is appropriate or may exclude the receipts from the taxpayer's numerator and denominator, as appropriate.

3. In a case in which [the tax administrator] determines that a taxpayer's method of approximation is reasonable, but has not been applied in a consistent manner with respect to similar transactions or year to year, the [tax administrator] may require that the taxpayer apply its method of approximation in a consistent manner.

4. In a case in which a taxpayer excludes receipts from the denominator of its receipts factor on the theory that the assignment of the receipts cannot be reasonably approximated, the [tax administrator] may determine that the exclusion of those receipts is not appropriate, and may instead substitute a method of approximation that the [tax administrator] determines is appropriate.

5. In a case in which a taxpayer fails to retain contemporaneous records that explain the determination and application of its method of assigning its receipts, including its underlying assumptions, or fails to provide those records to [the tax administrator] upon request, the [tax administrator] may treat the taxpayer's assignment of receipts as unsubstantiated, and may adjust the assignment of the receipts in a manner consistent with the applicable rules in Reg. IV.17.

6. In a case in which the [tax administrator] concludes that a customer's billing address was selected by the taxpayer for tax avoidance purposes, the [tax administrator] may adjust

the assignment of receipts from sales to that customer in a manner consistent with the applicable rules in Reg. IV.17.

(D) Taxpayer Authority to Change a Method of Assignment on a Prospective Basis. A taxpayer that seeks to change its method of assigning its receipts under Reg. IV.17 must disclose, in the original return filed for the year of the change, the fact that it has made the change. If a taxpayer fails to adequately disclose the change, the [tax administrator] may disregard the taxpayer's change and substitute an assignment method that the [tax administrator] determines is appropriate.".

(E) [Tax administrator] Authority to Change a Method of Assignment on a Prospective Basis. The [tax administrator] may direct a taxpayer to change its method of assigning its receipts in tax returns that have not yet been filed, including changing the taxpayer's method of approximation, if upon reviewing the taxpayer's filing methodology applied for a prior tax year, [the tax administrator] determines that the change is appropriate to reflect a more accurate assignment of the taxpayer's receipts within the meaning of Reg. IV.17, and determines that the change can be reasonably adopted by the taxpayer. [the tax administrator] will provide the taxpayer with a written explanation as to the reason for making the change. In a case in which a taxpayer fails to comply with [the tax administrator]'s direction on subsequently filed returns, [the tax administrator] may deem the taxpayer's method of assigning its receipts on those returns to be unreasonable, and may substitute an assignment method that the [tax administrator] determines is appropriate.

(8) Further Guidance.

The [tax administrator] may issue further public written statements with respect to the rules set forth in Reg. IV.17. These statements may, among other things, include guidance with respect to: (1) what constitutes a reasonable method of approximation within the meaning of the rules, and (2) the circumstances in which a filing change with respect to a taxpayer's method of reasonable approximation will be deemed appropriate.

••• Reg. IV.17.(b). Sale, Rental, Lease or License of Real Property.

In the case of a sale, rental, lease or license of real property, the receipts from the sale are in [state] if and to the extent that the property is in [state].

••• Reg. IV.17.(c). Rental, Lease or License of Tangible Personal Property.

In the case of a rental, lease or license of tangible personal property, the receipts from the sale are in [state] if and to the extent that the property is in [state]. If property is mobile property that is located both within and without [state] during the period of the lease or other contract, the receipts assigned to [state] are the receipts from the contract period multiplied by the fraction computed under Reg. IV.10.(d). (as adjusted when necessary to reflect differences between usage during the contract period and usage during the taxable year).

••• Reg. IV.17.(d). Sale of a Service.

(1) General Rule.

The receipts from a sale of a service are in [state] if and to the extent that the service is delivered to a location in [state]. In general, 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. The rules to determine the location of the delivery of a service in the context of several specific types of service transactions are set forth at Reg.s IV.17.(d).(2)-(4).

(2) In-Person Services.

(A) In General.

Except as otherwise provided in this Reg. IV.17.(d).(2), in-person services are services that are physically provided in person by the taxpayer, where the customer or the customer's real or tangible property upon which the services are performed is in the same location as the service provider at the time the services are performed. This rule includes situations where the services are provided on behalf of the taxpayer by a third-party contractor. Examples of in-person services include, without limitation, warranty and repair services; cleaning services; plumbing services; carpentry; construction contractor services; pest control; landscape services; medical and dental services, including medical testing, x-rays and mental health care and treatment; child care; hair cutting and salon services; live entertainment and athletic performances; and in-person training or lessons. In-person services include services within the description above that are performed at (1) a location that is owned or operated by the service provider or (2) a location of the customer, including the location of the customer's real or tangible personal property. Various professional services, including legal, accounting, financial and consulting services, and other similar services as described in Reg. IV.17.(d).(4), although they may involve some amount of in-person contact, are not treated as in-person services within the meaning of this Reg. IV.17.(d).(2).

(B) Assignment of Receipts.

(1) Rule of Determination. Except as otherwise provided in this Reg. IV.17.(d).(2)(B), if the service provided by the taxpayer is an in-person service, the service is delivered to the location where the service is received. Therefore, the receipts from a sale are in [state] if and to the extent the customer receives the in-person service in [state]. In assigning its receipts from sales of in-person services, a taxpayer must first attempt to determine the location where a service is received, as follows:

a. If the service is performed with respect to the body of an individual customer in [state] (e.g. hair cutting or x-ray services) or in the physical presence of the customer in [state] (e.g. live entertainment or athletic performances), the service is received in [state].

b. If the service is performed with respect to the customer's real estate in [state] or if the service is performed with respect to the customer's tangible personal property at the customer's residence or in the customer's possession in [state], the service is received in [state].

c. If the service is performed with respect to the customer's tangible personal property and the tangible personal property is to be shipped or delivered to the

customer, whether the service is performed within or outside [state], the service is received in [state] if the property is shipped or delivered to the customer in [state].

(C) Rule of Reasonable Approximation. In an instance in which the state or states where a 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. If the state to which the receipts are to be assigned can be determined or reasonably approximated, but the taxpayer is not taxable in that state, the receipts that would otherwise be assigned to the state are excluded from the denominator of the taxpayer's receipts factor pursuant to Article IV.17.(c). and Reg. IV.17.(a).(6)(D).

(D) Examples.

In these examples assume, unless otherwise stated, that the taxpayer is taxable in each state to which its receipts would be assigned, so that there is no requirement that the receipts from the sale or sales be eliminated from the denominator of the taxpayer's receipts factor. *See* Article IV.17.(c). and Reg. IV.17.(a).(6)(D). Note that for purposes of the examples it is irrelevant whether the services are performed by an employee of the taxpayer or by an independent contractor acting on the taxpayer's behalf.

Example (i). Salon Corp has retail locations in [state] and in other states where it provides hair cutting services to individual and business customers, the latter of whom are paid for through the means of a company account. The receipts from sales of services provided at Salon Corp's in-state locations are in [state]. The receipts from sales of services provided at Salon Corp's locations outside [state], even when provided to residents of [state], are not receipts from in-state sales.

Example (ii). Landscape Corp provides landscaping and gardening services in [state] and in neighboring states. Landscape Corp provides landscaping services at the in-state vacation home of an individual who is a resident of another state and who is located outside [state] at the time the services are performed. The receipts from sale of services provided at the in-state location are in [state].

Example (iii). Same facts as in Example (ii), except that Landscape Corp provides the landscaping services to Retail Corp, a corporation with retail locations in several states, and the services are with respect to those locations of Retail Corp that are in [state] and in other states. The receipts from the sale of services provided to Retail Corp are in [state] to the extent the services are provided in [state].

Example (iv). Camera Corp provides camera repair services at an in-state retail location to walk-in individual and business customers. In some cases, Camera Corp actually repairs a camera that is brought to its in-state location at a facility that is in another state. In these cases, the repaired camera is then returned to the customer at Camera Corp's in-state location. The receipts from sale of these services are in [state].

Example (v). Same facts as in Example (iv), except that a customer located in [state] mails the camera directly to the out-of-state facility owned by Camera Corp to be fixed, and receives the repaired camera back in [state] by mail. The receipts from sale of the service are in [state].

Example (vi). Teaching Corp provides seminars in [state] to individual and business customers. The seminars and the materials used in connection with the seminars are prepared outside the state, the teachers who teach the seminars include teachers that are resident outside the state, and the students who attend the seminars include students that are resident outside the state. Because the seminars are taught in [state] the receipts from sales of the services are in [state].

(3) Services Delivered to the Customer or on Behalf of the Customer, or Delivered Electronically Through the Customer.

(A) In General.

If the service provided by the taxpayer is not an in-person service within the meaning of Reg. IV.17.(d).(2) or a professional service within the meaning of Reg. IV.17(d)(4), and the service is delivered to or on behalf of the customer, or delivered electronically through the customer, the receipts from a sale are in [state] if and to the extent that the service is delivered in [state]. For purposes of this Reg. IV.17.(d).(3), a service that is delivered "to" a customer is a service in which the customer and not a third party is the recipient of the service. A service that is delivered "on behalf of" a customer is one in which a customer contracts for a service but one or more third parties, rather than the customer, is the recipient of the service, such as fulfillment services, or the direct or indirect delivery of advertising to the customer's intended audience (see Reg. IV.17.(d).(3)(B)1 and Example (iv) under (d).(3)(B)1.c.). A service can be delivered to or on behalf of a customer by physical means or through electronic transmission. A service that is delivered electronically "through" a customer is a service that is delivered electronically to a customer for purposes of resale and subsequent electronic delivery in substantially identical form to an end user or other third-party recipient.

(B) Assignment of Receipts.

The assignment of receipts to a state or states in the instance of a sale of a service that is delivered to the customer or on behalf of the customer, or delivered electronically through the customer, depends upon the method of delivery of the service and the nature of the customer. Separate rules of assignment apply to services delivered by physical means and services delivered by electronic transmission. (For purposes of this Reg. IV.17.(d).(3), a service delivered by an electronic transmission is not a delivery by a physical means). If a rule of assignment set forth in this Reg. IV.17.(d).(3), depends on whether the customer is an individual or a business customer, and the taxpayer acting in good faith cannot reasonably determine whether the customer is an individual or business customer, the taxpayer shall treat the customer as a business customer. If the state to which the receipts from a sale are to be assigned can be determined or reasonably approximated, but the taxpayer is not taxable in that state, the receipts that would otherwise be assigned to that state are excluded from the denominator of the taxpayer's receipts factor. *See* Article IV.17(c) and Reg. IV.17.(a).(6)(D).

1. Delivery to or on Behalf of a Customer by Physical Means Whether to an Individual or Business Customer. Services delivered to a customer or on behalf of a customer through a physical means include, for example, product delivery services where property is delivered to the customer or to a third party on behalf of the customer; the delivery of brochures, fliers or other direct mail services; the delivery of advertising or advertising-related services to the customer's intended audience in the form of a physical medium; and the sale of custom software (e.g., where software is developed for a specific customer in a case where the transaction is properly treated as a service transaction for purposes of corporate taxation) where the taxpayer installs the custom software at the customer's site. The rules in this Reg. IV.17.(d).(3)(B)1. apply whether the taxpayer's customer is an individual customer or a business customer.

a. Rule of Determination. In assigning the receipts from a sale of a service delivered to a customer or on behalf of a customer through a physical means, a taxpayer must first attempt to determine the state or states where the service is delivered. If the taxpayer is able to determine the state or states where the service is delivered, it shall assign the receipts to that state or states.

b. Rule of Reasonable Approximation. If the taxpayer cannot determine the state or states where the service is actually delivered, but has sufficient information regarding the place of delivery from which it can reasonably approximate the state or states where the service is delivered, it shall reasonably approximate the state or states.

Examples:

In these examples assume, unless otherwise stated, that the taxpayer is taxable in each state to which its receipts would be assigned, so that there is no requirement in these examples that the receipts must be eliminated from the denominator of the taxpayer's receipts factor. *See* Article IV.17.(c). and Reg. IV.17.(a).(6)(D).

Example (i). Direct Mail Corp, a corporation based outside [state], provides direct mail services to its customer, Business Corp. Business Corp contracts with Direct Mail Corp to deliver printed fliers to a list of customers that is provided to it by Business Corp. Some of Business Corp's customers are in [state] and some of those customers are in other states. Direct Mail Corp will use the postal service to deliver the printed fliers to Business Corp's customers. The receipts from the sale of Direct Mail Corp's services to Business Corp are assigned to [state] to the extent that the services are delivered on behalf of Business Corp to [state] customers (i.e., to the extent that the fliers are delivered on behalf of Business Corp to Business Corp's intended audience in [state]).

Example (ii). Ad Corp is a corporation based outside [state] that provides advertising and advertising-related services in [state] and in neighboring states. Ad Corp enters into a contract at a location outside [state] with an individual customer who is not a [state] resident to design advertisements for billboards to be displayed in [state], and to design fliers to be mailed to [state] residents. All of the design work is performed outside [state]. The receipts from the sale of the design services are in [state] because

the service is physically delivered on behalf of the customer to the customer's intended audience in [state].

Example (iii). Same facts as example (ii), except that the contract is with a business customer that is based outside [state]. The receipts from the sale of the design services are in [state] because the services are physically delivered on behalf of the customer to the customer's intended audience in [state].

Example (iv). Fulfillment Corp, a corporation based outside [state], provides product delivery fulfillment services in [state] and in neighboring states to Sales Corp, a corporation located outside [state] that sells tangible personal property through a mail order catalog and over the Internet to customers. In some cases when a customer purchases tangible personal property from Sales Corp to be delivered in [state], Fulfillment Corp will, pursuant to its contract with Sales Corp, deliver that property from its fulfillment warehouse located outside [state]. The receipts from the sale of the fulfillment services of Fulfillment Corp to Sales Corp are assigned to [state] to the extent that Fulfillment Corp's deliveries on behalf of Sales Corp are to recipients in [state].

Example (v). Software Corp, a software development corporation, enters into a contract with a business customer, Buyer Corp, which is physically located in [state], to develop custom software to be used in Buyer Corp's business. Software Corp develops the custom software outside [state], and then physically installs the software on Buyer Corp's computer hardware located in [state]. The development and sale of the custom software is properly characterized as a service transaction, and the receipts from the sale are assigned to [state] because the software is physically delivered to the customer in [state].

Example (vi). Same facts as Example (v), except that Buyer Corp has offices in [state] and several other states, but is commercially domiciled outside [state] and orders the software from a location outside [state]. The receipts from the development and sale of the custom software service are assigned to [state] because the software is physically delivered to the customer in [state].

2. Delivery to a Customer by Electronic Transmission. Services delivered by electronic transmission include, without limitation, services that are transmitted through the means of wire, lines, cable, fiber optics, electronic signals, satellite transmission, audio or radio waves, or other similar means, whether or not the service provider owns, leases or otherwise controls the transmission equipment. In the case of the delivery of a service by electronic transmission to a customer, the following rules apply.

a. Services Delivered By Electronic Transmission to an Individual Customer.

i. Rule of Determination. In the case of the delivery of a service to an individual customer by electronic transmission, the service is delivered in [state] if and to the extent that the taxpayer's customer receives the service in [state]. If the taxpayer can determine the state or states where the service is received, it shall assign the receipts from that sale to that state or states.

ii. Rules of Reasonable Approximation. If the taxpayer cannot determine the state or states where the customer actually receives the service, but has sufficient information regarding the place of receipt from which it can reasonably approximate the state or states where the service is received, it shall reasonably approximate the state or states. If a taxpayer does not have sufficient information from which it can determine or reasonably approximate the state or states in which the service is received, it shall reasonably approximate the state or states using the customer's billing address.

b. Services Delivered By Electronic Transmission to a Business Customer.

i. Rule of Determination. In the case of the delivery of a service to a business customer by electronic transmission, the service is delivered in [state] if and to the extent that the taxpayer's customer receives the service in [state]. If the taxpayer can determine the state or states where the service is received, it shall assign the receipts from that sale to the state or states. For purposes of this Reg. IV.17.(d.)(3)(B)2.b., it is intended that the state or states where the service is received reflect the location at which the service is directly used by the employees or designees of the customer.

ii. Rule of Reasonable Approximation. If the taxpayer cannot determine the state or states where the customer actually receives the service, but has sufficient information regarding the place of receipt from which it can reasonably approximate the state or states where the service is received, it shall reasonably approximate the state or states.

iii. Secondary Rule of Reasonable Approximation. In the case of the delivery of a service to a business customer by electronic transmission where a taxpayer does not have sufficient information from which it can determine or reasonably approximate the state or states in which the service is received, the taxpayer shall reasonably approximate the state or states as set forth in this regulation. In these cases, unless the taxpayer can apply the safe harbor set forth in Reg.IV.17.(d).(3)(B)2.b.iv., the taxpayer shall reasonably approximate the state or states in which the service is received as follows: first, by assigning the receipts from the sale to the state where the contract of sale is principally managed by the customer; second, if the state where the customer principally manages the contract is not reasonably determinable, by assigning the receipts from the sale to the customer's place of order; and third, if the customer's place of order is not reasonably determinable, by assigning the receipts from the sale using the customer's billing address; provided, however, if the taxpayer derives more than 5% of its receipts from sales of services from any single customer, the taxpayer is required to identify the state in which the contract of sale is principally managed by that customer.

iv. Safe Harbor. In the case of the delivery of a service to a business customer by electronic transmission a taxpayer may not be able to determine, or

reasonably approximate under Reg. IV.17.(d).(3)(B)2.b.ii., the state or states in which the service is received. In these cases, the taxpayer may, in lieu of the rule stated at Reg. IV.17.(d).(3)(B)2.b.iii., apply the safe harbor stated in this subsection. Under this safe harbor, a taxpayer may assign its receipts from sales to a particular customer based upon the customer's billing address in a taxable year in which the taxpayer (1) engages in substantially similar service transactions with more than 250 customers, whether business or individual, and (2) does not derive more than 5% of its receipts from sales of all services from that customer. This safe harbor applies only for purposes of [omitted reference] services delivered by electronic transmission to a business customer, and not otherwise.

v. Related Party Transactions. In the case of a sale of a service by electronic transmission to a business customer that is a related party, the taxpayer may not use the secondary rule of reasonable approximation in Reg. IV.17.(d).(3)(B)2.b.iii but may use the rule of reasonable approximation in Reg. IV.17.(d).(3)(B)2.b.ii, and the safe harbor in Reg. IV.17.(d).(3)(B)2.b.iv, provided that [the tax administrator] may aggregate sales to related parties in determining whether the sales exceed 5% of receipts from sales of all services under that safe harbor provision if necessary or appropriate to prevent distortion.

c. Examples:

In these examples, unless otherwise stated, assume that the taxpayer is not related to either the customer to which the service is delivered. Also, unless otherwise stated, assume that the taxpayer is taxable in each state to which its receipts would be assigned, so that there is no requirement in these examples that the receipts must be eliminated from the denominator of the taxpayer's receipts factor. *See* Article IV.17.(c). and Reg. IV.17.(a).(6)(D). Further, assume if relevant, unless otherwise stated, that the safe harbor set forth at Reg. IV.17.(d).(3)(B)2.b.iv does not apply.

Example (i). Support Corp, a corporation that is based outside [state], provides software support and diagnostic services to individual and business customers that have previously purchased certain software from third-party vendors. These individual and business customers are located in [state] and other states. Support Corp supplies its services on a case by case basis when directly contacted by its customer. Support Corp generally provides these services through the Internet but sometimes provides these services by phone. In all cases, Support Corp verifies the customer's account information before providing any service. Using the information that Support Corp verifies before performing a service, Support Corp can determine where its services are received, and therefore must assign its receipts to these locations. The receipts from sales made to Support Corp's individual and business customers are in [state] to the extent that Support Corp's services are received in [state]. *See* Reg. IV.17.(d).(3)(B)2.a. and b.

Example (ii). Online Corp, a corporation based outside [state], provides web-based services through the means of the Internet to individual customers who are resident in [state] and in other states. These customers access Online Corp's web

services primarily in their states of residence, and sometimes, while traveling, in other states. For a substantial portion of its receipts from the sale of services, Online Corp can either determine the state or states where the services are received, or, where it cannot determine the state or states, it has sufficient information regarding the place of receipt to reasonably approximate the state or states. However, Online Corp cannot determine or reasonably approximate the state or states of receipt for all of the sales of its services. Assuming that Online Corp reasonably believes, based on all available information, that the geographic distribution of the receipts from sales for which it cannot determine or reasonably approximate the location of the receipt of its services generally tracks those for which it does have this information, Online Corp must assign to [state] the receipts from sales for which it does not know the customers' location in the same proportion as those receipts for which it has this information. *See* Reg. IV.17.(a).(5)(B).

Example (iii). Same facts as in Example (ii), except that Online Corp reasonably believes that the geographic distribution of the receipts from sales for which it cannot determine or reasonably approximate the location of the receipt of its web-based services do not generally track the sales for which it does have this information. Online Corp must assign the receipts from sales of its services for which it lacks information as provided to its individual customers using the customers' billing addresses. *See* Reg. IV.17.(d).(3)(B)2.a.

Example (iv). Same facts as in Example (iii), except that Online Corp is not taxable in one state to which some of its receipts from sales would be otherwise assigned. The receipts that would be otherwise assigned to that state are to be excluded from the denominator of Online Corp's receipts factor. *See* Reg. IV.17.(d).(3)(B).

Example (v). Net Corp, a corporation based outside [state], provides web-based services to a business customer, Business Corp, a company with offices in [state] and two neighboring states. Particular employees of Business Corp access the services from computers in each Business Corp office. Assume that Net Corp determines that Business Corp employees in [state] were responsible for 75% of Business Corp's use of Net Corp's services, and Business Corp employees in other states were responsible for 25% of Business Corp's use of Net Corp's services. In this case, 75% of the receipts from the sale are received in [state]. *See* Reg. IV.17.(d).(3)(B)2.a.i. Assume alternatively that Net Corp lacks sufficient information regarding the location or locations where Business Corp's employees used the services to determine or reasonably approximate the location or locations. Under these circumstances, if Net Corp derives 5% or less of its receipts from sales to Business Corp, Net Corp must assign the receipts under Reg. IV.17.(d).(3)(B)2.b.iii. to the state where Business Corp principally managed the contract, or if that state is not reasonably determinable, to the state where Business Corp placed the order for the services, or if that state is not reasonably determinable, to the state of Business Corp's billing address. If Net Corp derives more than 5% of its receipts from sales of services to Business Corp, Net Corp is required to identify the state in which its contract of sale is principally managed by Business Corp and must assign the receipts to that state.

Example (vi). Net Corp, a corporation based outside [state], provides web-based services through the means of the Internet to more than 250 individual and business customers in [state] and in other states. Assume that for each customer Net Corp cannot determine the state or states where its web services are actually received, and lacks sufficient information regarding the place of receipt to reasonably approximate the state or states. Also assume that Net Corp does not derive more than 5% of its receipts from sales of services to a single customer. Net Corp may apply the safe harbor stated in Reg. IV.17.(d).(3)(B)2.b.iv., and may assign its receipts using each customer's billing address. If Net Corp is not taxable in one or more states to which some of its receipts would be otherwise assigned, it must exclude those receipts from the denominator of its receipts factor. *See* Article IV.17.(c). and Reg. IV.17.(a).(6)(D).

4. Services Delivered Electronically Through or on Behalf of an Individual or Business Customer. A service delivered electronically "on behalf of" the customer is one 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, such as the direct or indirect delivery of advertising on behalf of a customer to the customer's intended audience. A service delivered electronically "through" a customer to third-party recipients is 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.

a. Rule of Determination. In the case of the delivery of a service by electronic transmission, where the service is delivered electronically to end users or other third-party recipients through or on behalf of the customer, the service is delivered in [state] if and to the extent that the end users or other third-party recipients are in [state]. For example, in the case of the direct or indirect delivery of advertising on behalf of a customer to the customer's intended audience by electronic means, the service is delivered in [state] to the extent that the audience for the advertising is in [state]. In the case of the delivery of a service to a customer that acts as an intermediary in reselling the service in substantially identical form to third-party recipients, the service is delivered in [state] to the extent that the end users or other third-party recipients receive the services in [state]. The rules in this subsection Reg. IV.17(d).(3)(B)3.a. apply whether the taxpayer's customer is an individual customer or a business customer and whether the end users or other third-party recipients to which the services are delivered through or on behalf of the customer are individuals or businesses.

b. Rule of Reasonable Approximation. If the taxpayer cannot determine the state or states where the services are actually delivered to the end users or other third-party recipients either through or on behalf of the customer, but has sufficient information regarding the place of delivery from which it can reasonably approximate the state or states where the services are delivered, it shall reasonably approximate the state or states.

c. Select Secondary Rules of Reasonable Approximation.

i. If a taxpayer's service is the direct or indirect electronic delivery of advertising on behalf of its customer to the customer's intended audience, and if the taxpayer lacks sufficient information regarding the location of the audience from which it can determine or reasonably approximate that location, the taxpayer shall reasonably approximate the audience in a state for the advertising using the following secondary rules of reasonable approximation. If a taxpayer is delivering advertising directly or indirectly to a known list of subscribers, the taxpayer shall reasonably approximate the audience for advertising in a state using a percentage that reflects the ratio of the state's subscribers in the specific geographic area in which the advertising is delivered relative to the total subscribers in that area. For a taxpayer with less information about its audience, the taxpayer shall reasonably approximate the audience in a state using the percentage that reflects the ratio of the state's population in the specific geographic area in which the advertising is delivered relative to the total population in that area.

ii. If a taxpayer's service is the delivery of a service to a customer that then acts as the taxpayer's intermediary in reselling that service to end users or other third party recipients, if the taxpayer lacks sufficient information regarding the location of the end users or other third party recipients from which it can determine or reasonably approximate that location, the taxpayer shall reasonably approximate the extent to which the service is received in a state by using the percentage that reflects the ratio of the state's population in the specific geographic area in which the taxpayer's intermediary resells the services, relative to the total population in that area.

iii. When using the secondary reasonable approximation methods provided above, the relevant specific geographic area [of delivery] include only the areas where the service was substantially and materially delivered or resold. Unless the taxpayer demonstrates the contrary, it will be presumed that the area where the service was substantially and materially delivered or resold does not include areas outside the United States.

d. Examples:

In these examples, unless otherwise stated, assume that the taxpayer is taxable in each state to which its receipts would be assigned, so that there is no requirement in these examples that the receipts must be eliminated from the denominator of the taxpayer's receipts factor. *See* Article IV.17.(c). and Reg. IV.17.(a).(6)(D).

Example (i). Cable TV Corp, a corporation that is based outside of [state], has two revenue streams. First, Cable TV Corp sells advertising time to business customers pursuant to which the business customers' advertisements will run as commercials during Cable TV Corp's televised programming. Some of these business customers, though not all of them, have a physical presence in [state].

Second, Cable TV Corp sells monthly subscriptions to individual customers in [state] and in other states. The receipts from Cable TV Corp's sale of advertising time to its business customers are assigned to [state] to the extent that the audience for Cable TV Corp's televised programming during which the advertisements run is in [state]. *See* Reg. IV.17.(d).(3)(B)3.a. If Cable TV Corp is unable to determine the actual location of its audience for the programming, and lacks sufficient information regarding audience location to reasonably approximate the location, Cable TV Corp must approximate its [state] audience using the percentage that reflects the ratio of its [state] subscribers in the geographic area in which Cable TV Corp's televised programming featuring the advertisements is delivered relative to its total number of subscribers in that area. *See* Reg. IV.17.(d).(3)(B)3.c.i. To the extent that Cable TV Corp's sales of monthly subscriptions represent the sale of a service, the receipts from these sales are properly assigned to [state] in any case in which the programming is received by a customer in [state]. *See* Reg. IV.17.(d).(3)(B)2.a. In any case in which Cable TV Corp cannot determine the actual location where the programming is received, and lacks sufficient information regarding the location of receipt to reasonably approximate the location, the receipts from these sales of Cable TV Corp's monthly subscriptions are assigned to [state] where its customer's billing address is in [state]. *See* Reg. IV.17.(d).(3)(B)2.a.ii. Note that whether and to the extent that the monthly subscription fee represents a fee for a service or for a license of intangible property does not affect the analysis or result as to the state or states to which the receipts are properly assigned. *See* Reg. IV.17.(e).(5).

Example (ii). Network Corp, a corporation that is based outside of [state], sells advertising time to business customers pursuant to which the customers' advertisements will run as commercials during Network Corp's televised programming as distributed by unrelated cable television and satellite television transmission companies. The receipts from Network Corp's sale of advertising time to its business customers are assigned to [state] to the extent that the audience for Network Corp's televised programming during which the advertisements will run is in [state]. *See* Reg. IV.17.(d).(3)(B)3.a. If Network Corp cannot determine the actual location of the audience for its programming during which the advertisements will run, and lacks sufficient information regarding audience location to reasonably approximate the location, Network Corp must approximate the receipts from sales of advertising that constitute [state] sales by multiplying the amount of advertising receipts by a percentage that reflects the ratio of the [state] population in the specific geographic area in which the televised programming containing the advertising is run relative to the total population in that area. *See* Reg. IV.17.(d).(3)(B)3.c.ii. and iii. In any case in which Network Corp's receipts would be assigned to a state in which Network Corp is not taxable, the receipts must be excluded from the denominator of Network Corp's receipts factor. *See* Article IV.17(c) and Reg. IV.17.(a).(6)(D).

Example (iii). Web Corp, a corporation that is based outside [state], provides Internet content to viewers in [state] and other states. Web Corp sells advertising space to business customers pursuant to which the customers' advertisements will appear in connection with Web Corp's Internet content. Web Corp receives a fee for running the advertisements that is determined by reference to the number of times the advertisement is viewed or clicked upon by the viewers of its website. The receipts from Web Corp's sale of advertising space to its business customers are assigned to [state] to the extent that the viewers of the Internet content are in [state], as measured by viewings or clicks. *See* Reg. IV.17.(d).(3)(B)3.a. If Web Corp is unable to determine the actual location of its viewers, and lacks sufficient information regarding the location of its viewers to reasonably approximate the location, Web Corp must approximate the amount of its [state] receipts by multiplying the amount of receipts from sales of advertising by a percentage that reflects the [state] population in the specific geographic area in which the content containing the advertising is delivered relative to the total population in that area. *See* Reg. IV.17.(d).(3)(B)3.c. In any case in which Web Corp's receipts would be assigned to a state in which Web Corp is not taxable, those receipts must be excluded from the denominator of Web Corp's receipts factor. *See* Article IV.17.(c). and Reg. IV.17.(a).(6)(D).

Example (iv). Retail Corp, a corporation that is based outside of [state], sells tangible property through its retail stores located in [state] and other states, and through a mail order catalog. Answer Co, a corporation that operates call centers in multiple states, contracts with Retail Corp to answer telephone calls from individuals placing orders for products found in Retail Corp's catalogs. In this case, the phone answering services of Answer Co are being delivered to Retail Corp's customers and prospective customers. Therefore, Answer Co is delivering a service electronically to Retail Corp's customers or prospective customers on behalf of Retail Corp, and must assign the proceeds from this service to the state or states from which the phone calls are placed by the customers or prospective customers. If Answer Co cannot determine the actual locations from which phone calls are placed, and lacks sufficient information regarding the locations to reasonably approximate the locations, Answer Co must approximate the amount of its [state] receipts by multiplying the amount of its fee from Retail Corp by a percentage that reflects the [state] population in the specific geographic area from which the calls are placed relative to the total population in that area. *See* Reg. IV.17.(d).(3)(B)3.c.i. Answer Co's receipts must also be excluded from the denominator of its receipts factor in any case in which the receipts would be assigned to a state in which Answer Co is not taxable. *See* Article IV.17(c) and Reg. IV.17.(a).(6)(D).

Example (v). Web Corp, a corporation that is based outside of [state], sells tangible property to customers via its Internet website. Design Co. designed and maintains Web Corp's website, including making changes to the site based on

customer feedback received through the site. Design Co.'s services are delivered to Web Corp, the proceeds from which are assigned pursuant to Reg. IV.17.(d).(3)(B)2. The fact that Web Corp's customers and prospective customers incidentally benefit from Design Co.'s services, and may even interact with Design Co in the course of providing feedback, does not transform the service into one delivered "on behalf of" Web Corp to Web Corp's customers and prospective customers.

Example (vi). Wholesale Corp, a corporation that is based outside [state], develops an Internet-based information database outside [state] and enters into a contract with Retail Corp whereby Retail Corp will market and sell access to this database to end users. Depending on the facts, the provision of database access may be either the sale of a service or the license of intangible property or may have elements of both, but for purposes of analysis it does not matter. *See* Reg. IV.17.(e).(5)Assume that on the particular facts applicable in this example Wholesale Corp is selling database access in transactions properly characterized as involving the performance of a service. When an end user purchases access to Wholesale Corp's database from Retail Corp, Retail Corp in turn compensates Wholesale Corp in connection with that transaction. In this case, Wholesale Corp's services are being delivered through Retail Corp to the end user. Wholesale Corp must assign its receipts from sales to Retail Corp to the state or states in which the end users receive access to Wholesale Corp's database. If Wholesale Corp cannot determine the state or states where the end users actually receive access to Wholesale Corp's database, and lacks sufficient information regarding the location from which the end users access the database to reasonably approximate the location, Wholesale Corp must approximate the extent to which its services are received by end users in [state] by using a percentage that reflects the ratio of the [state] population in the specific geographic area in which Retail Corp regularly markets and sells Wholesale Corp's database relative to the total population in that area. *See* Reg. IV.17(d).(3)(B)3.c.ii. Note that it does not matter for purposes of the analysis whether Wholesale Corp's sale of database access constitutes a service or a license of intangible property, or some combination of both. *See* Reg. IV.17.(e).(5). In any case in which Wholesale Corp's receipts would be assigned to a state in which Wholesale Corp is not taxable, the receipts must be excluded from the denominator of Wholesale Corp's receipts factor. *See* Article IV.17(c) and Reg. IV.17.(a).(6)(D).

(4) Professional Services.

(A) In General.

Except as otherwise provided in this Reg. IV.17.(d).(4), professional services are services that require specialized knowledge and in some cases require a professional certification, license or degree. These services include the performance of technical services that require the application of specialized knowledge. Professional services include, without limitation, management services, bank

and financial services, financial custodial services, investment and brokerage services, fiduciary services, tax preparation, payroll and accounting services, lending services, credit card services (including credit card processing services), data processing services, legal services, consulting services, video production services, graphic and other design services, engineering services, and architectural services.

(B) Overlap with Other Categories of Services.

1. Certain services that fall within the definition of "professional services" set forth in this Reg. IV.17.(d).(4) are nevertheless treated as "in-person services" within the meaning of Reg. IV.17.(d).(2), and are assigned under the rules of that subsection. Specifically, professional services that are physically provided in person by the taxpayer such as carpentry, certain medical and dental services or child care services, where the customer or the customer's real or tangible property upon which the services are provided is in the same location as the service provider at the time the services are performed, are "in-person services" and are assigned as such, notwithstanding that they may also be considered to be "professional services." However, professional services where the service is of an intellectual or intangible nature, such as legal, accounting, financial and consulting services, are assigned as professional services under the rules of this Reg. IV.17(d)(4), notwithstanding the fact that these services may involve some amount of in-person contact.

2. Professional services may in some cases include the transmission of one or more documents or other communications by mail or by electronic means. In some cases, all or most communications between the service provider and the service recipient may be by mail or by electronic means. However, in these cases, despite this transmission, the assignment rules that apply are those set forth in this Reg. IV.17(d)(4), and not those set forth in Reg. IV.17.(d).(3), pertaining to services delivered to a customer or through or on behalf of a customer.

(C) Assignment of Receipts.

In the case of a professional service, it is generally possible to characterize the location of delivery in multiple ways by emphasizing different elements of the service provided, no one of which will consistently represent the market for the services. Therefore, the location of delivery in the case of professional services is not susceptible to a general rule of determination, and must be reasonably approximated. The assignment of receipts from a sale of a professional service depends in many cases upon whether the customer is an individual or business customer. In any instance in which the taxpayer, acting in good faith, cannot reasonably determine whether the customer is an individual or business customer, the taxpayer shall treat the customer as a business customer. For purposes of assigning the receipts from a sale of a professional service, a taxpayer's customer is the person that contracts for the service, irrespective of whether another person pays for or also benefits from the taxpayer's services. In any instance in which the taxpayer is not taxable in the state to which receipts from a sale is assigned, the receipts are excluded from the denominator of the taxpayer's receipts factor. *See* Article IV.17(c) and Reg. IV.17.(a).(6)(D).

1. General Rule. Receipts from sales of professional services other than those services described in Reg. IV.17.(d).(4)(C)2. (architectural and engineering services), Reg.

IV.17(d).(4)(C)3. (services provided by a financial institution) and Reg. IV.17(d).(4)(C)4. (transactions with related parties) are assigned in accordance with this Reg. IV.17.(d).(4)(C)1.

a. Professional Services Delivered to Individual Customers. Except as otherwise provided in Reg. IV.17(d)(4) (see in particular Reg. IV.17.(d).(4)(C)4, in any instance in which the service provided is a professional service and the taxpayer's customer is an individual customer, the state or states in which the service is delivered must be reasonably approximated as set forth in this Reg. IV.17.(d).(4)(C)1.a. In particular, the taxpayer shall assign the receipts from a sale to the customer's state of primary residence, or, if the taxpayer cannot reasonably identify the customer's state of primary residence, to the state of the customer's billing address; provided, however, in any instance in which the taxpayer derives more than 5% of its receipts from sales of all services from an individual customer, the taxpayer shall identify the customer's state of primary residence and assign the receipts from the service or services provided to that customer to that state.

b. Professional Services Delivered to Business Customers. Except as otherwise provided in Reg. IV.17.(d).(4), in any instance in which the service provided is a professional service and the taxpayer's customer is a business customer, the state or states in which the service is delivered must be reasonably approximated as set forth in this section. In particular, unless the taxpayer may use the safe harbor set forth at Reg. IV.17.(d).(4)(C)1.c., the taxpayer shall assign the receipts from the sale as follows: first, by assigning the receipts to the state where the contract of sale is principally managed by the customer; second, if the place of customer management is not reasonably determinable, to the customer's place of order; and third, if the customer place of order is not reasonably determinable, to the customer's billing address; provided, however, in any instance in which the taxpayer derives more than 5% of its receipts from sales of all services from a customer, the taxpayer is required to identify the state in which the contract of sale is principally managed by the customer.

c. Safe Harbor; Large Volume of Transactions. Notwithstanding the rules set forth in Reg. IV.17.(d).(4)(C)1.a. and b., a taxpayer may assign its receipts from sales to a particular customer based on the customer's billing address in any taxable year in which the taxpayer (1) engages in substantially similar service transactions with more than 250 customers, whether individual or business, and (2) does not derive more than 5% of its receipts from sales of all services from that customer. This safe harbor applies only for purposes of Reg. IV.17.(d).(4)(C)1. and not otherwise.

2. Architectural and Engineering Services with respect to Real or Tangible Personal Property. Architectural and engineering services with respect to real or tangible personal property are professional services within the meaning of this Reg. IV.17.(d)(4). However, unlike in the case of the general rule that applies to professional services, (1) the receipts from a sale of an architectural service are assigned to a state or states if and to the extent that the services are with respect to real estate improvements located, or expected to be located, in the state or states; and (2) the receipts from a sale of an engineering service are assigned to a state or

states if and to the extent that the services are with respect to tangible or real property located in the state or states, including real estate improvements located in, or expected to be located in, the state or states. These rules apply whether or not the customer is an individual or business customer. In any instance in which architectural or engineering services are not described in Reg. IV.17(d)(4)(C)2, the receipts from a sale of these services must be assigned under the general rule for professional services. *See* Reg. IV.17.(d).(4)(C)1.

3. Services Provided by a Financial Institution. The apportionment rules that apply to financial institutions are set forth at [financial institutions special apportionment statute or regulation]. [Drafter's Note: not all states have special industry rules or statutes for sourcing financial institution income.] That [financial institutions special apportionment statute or regulation] includes specific rules to determine a financial institution's receipts factor. However, [the statute or regulation] also provides that receipts from sales, other than sales of tangible personal property, including service transactions, that are not otherwise apportioned under [the statute or regulation], are to be assigned pursuant to Article IV.17. and these regulations. In any instance in which a financial institution performs services that are to be assigned pursuant to Article IV.17. and these regulations including, for example, financial custodial services, those services are considered professional services within the meaning of this Reg. IV.17(d)(4), and are assigned according to the general rule for professional service transactions as set forth at Reg. IV.17.(d).(4)(C)1.

4. Related Party Transactions. In any instance in which the professional service is sold to a related party, rather than applying the rule for professional services delivered to business customers in Reg. IV.17.(d).(4)(C)1.b, the state or states to which the service is assigned is the place of receipt by the related party as reasonably approximated using the following hierarchy: (1) if the service primarily relates to specific operations or activities of a related party conducted in one or more locations, then to the state or states in which those operations or activities are conducted in proportion to the related party's payroll at the locations to which the service relates in the state or states; or (2) if the service does not relate primarily to operations or activities of a related party conducted in particular locations, but instead relates to the operations of the related party generally, then to the state or states in which the related party has employees, in proportion to the related party's payroll in those states. The taxpayer may use the safe harbor provided by Reg. IV.17.(d).(4)(C)1.c provided that [the tax administrator] may aggregate the receipts from sales to related parties in applying the 5% rule if necessary or appropriate to avoid distortion.

5. Examples:

Unless otherwise stated, assume in each of these examples, where relevant, that the taxpayer is taxable in each state to which its receipts would be assigned, so that there is no requirement in the examples that the receipts must be excluded from the denominator of the taxpayer's receipts factor, *see* Article IV.17(c) and Reg. IV.17.(a).(6)(D). Assume also that the customer is not a related party and that the safe harbor set forth at Reg. IV.17.(d).(4)(C)1.c. does not apply.

Example (i). Broker Corp provides securities brokerage services to individual customers who are resident in [state] and in other states. Assume that Broker Corp knows the state of primary residence for many of its customers, and where it does not know this state of primary residence, it knows the customer's billing address. Also assume that Broker Corp does not derive more than 5% of its receipts from sales of all services from any one individual customer. If Broker Corp knows its customer's state of primary residence, it shall assign the receipts to that state. If Broker Corp does not know its customer's state of primary residence, but rather knows the customer's billing address, it shall assign the receipts to that state. *See* Reg. IV.17.(d).(4)(C)1.a.

Example (ii). Same facts as in Example (i), except that Broker Corp has several individual customers from whom it derives, in each instance, more than 5% of its receipts from sales of all services. Receipts from sales to customers from whom Broker Corp derives 5% or less of its receipts from sales of all services must be assigned as described in example 1. For each customer from whom it derives more than 5% of its receipts from sales of all services, Broker Corp is required to determine the customer's state of primary residence and must assign the receipts from the services provided to that customer to that state. In any case in which a 5% customer's state of primary residence is [state], receipts from a sale made to that customer must be assigned to [state]; in any case in which a 5% customer's state of primary residence is not [state] receipts from a sale made to that customer are not assigned to [state]. Where receipts from a sale are assigned to a state other than [state], if the state of assignment (i.e., the state of primary residence of the individual customer) is a state in which Broker Corp is not taxable, receipts from the sales must be excluded from the denominator of Broker Corp's receipts factor. *See* Reg. IV.17.(d).(4)(C)1, Article IV.17(c) and Reg. IV.17.(a).(6)(D).

Example (iii). Architecture Corp provides building design services as to buildings located, or expected to be located, in [state] to individual customers who are resident in [state] and other states, and to business customers that are based in [state] and other states. The receipts from Architecture Corp's sales are assigned to [state] because the locations of the buildings to which its design services relate are in [state], or are expected to be in [state]. For purposes of assigning these receipts, it is not relevant where, in the case of an individual customer, the customer primarily resides or is billed for the services, and it is not relevant where, in the case of a business customer, the customer principally manages the contract, placed the order for the services, or is billed for the services. Further, these receipts are assigned to [state] even if Architecture Corp's designs are either physically delivered to its customer in paper form in a state other than [state] or are electronically delivered to its customer in a state other than [state]. *See* Reg. IV.17.(d).(4)(B)2. and (C)2.

Example (iv). Law Corp provides legal services to individual clients who are resident in [state] and in other states. In some cases, Law Corp may prepare one or more legal documents for its client as a result of these services and/or the legal work may be related to litigation or a legal matter that is ongoing in a state other than where the client is resident. Assume that Law Corp knows the state of primary residence for many

of its clients, and where it does not know this state of primary residence, it knows the client's billing address. Also assume that Law Corp does not derive more than 5% of its receipts from sales of all services from any one individual client. If Law Corp knows its client's state of primary residence, it shall assign the receipts to that state. If Law Corp does not know its client's state of primary residence, but rather knows the client's billing address, it shall assign the receipts to that state. For purposes of the analysis it is irrelevant whether the legal documents relating to the service are mailed or otherwise delivered to a location in another state, or the litigation or other legal matter that is the underlying predicate for the services is in another state. *See* Reg. IV.17.(d).(4)(B)2. and (C)1.

Example (v). Same facts as in Example (iv), except that Law Corp provides legal services to several individual clients who it knows have a primary residence in a state where Law Corp is not taxable. Receipts from these services are excluded from the denominator of Law Corp's receipts factor even if the billing address of one or more of these clients is in a state in which Law Corp is taxable, including [state]. *See* Reg. IV.17.(d).(4)(C), Article IV.17(c) and Reg. IV.17.(a).(6)(D).

Example (vi). Law Corp provides legal services to several multistate business clients. In each case, Law Corp knows the state in which the agreement for legal services that governs the client relationship is principally managed by the client. In one case, the agreement is principally managed in [state]; in the other cases, the agreement is principally managed in a state other than [state]. If the agreement for legal services is principally managed by the client in [state] the receipts from sale of the services are assigned to [state]; in the other cases, the receipts are not assigned to [state]. In the case of receipts that are assigned to [state], the receipts are so assigned even if (1) the legal documents relating to the service are mailed or otherwise delivered to a location in another state, or (2) the litigation or other legal matter that is the underlying predicate for the services is in another state. *See* Reg. IV.17.(d).(4)(B)2. and (C)1.

Example (vii). Same facts as in example 6, except that Law Corp is not taxable in one of the states other than [state] in which Law Corp's agreement for legal services that governs the client relationship is principally managed by the business client. Receipts from these latter services are excluded from the denominator of Law Corp's receipts factor. *See* Reg. IV.17.(d).(4)(C); (C)1.b. and Article IV.17(c) and Reg. IV.17.(a).(6)(D).

Example (viii). Consulting Corp, a company that provides consulting services to law firms and other customers, is hired by Law Corp in connection with legal representation that Law Corp provides to Client Co. Specifically, Consulting Corp is hired to provide expert testimony at a trial being conducted by Law Corp on behalf of Client Co. Client Co pays for Consulting Corp's services directly. Assuming that Consulting Corp knows that its agreement with Law Co is principally managed by Law Corp in [state], the receipts from the sale of Consulting Corp's services are assigned to [state]. It is not relevant for purposes of the analysis that Client Co is the ultimate beneficiary

of Consulting Corp's services, or that Client Co pays for Consulting Corp's services directly. *See* Reg. IV.17.(d).(4)(C)1.b.

Example (ix).[43] Bank Corp provides financial custodial services to 100 individual customers who are resident in [state] and in other states, including the safekeeping of some of its customers' financial assets. Assume for purposes of this example that Bank Corp knows the state of primary residence for many of its customers, and where it does not know this state of primary residence, it knows the customer's billing address. Also assume that Bank Corp does not derive more than 5% of its receipts from sales of all of its services from any single customer. Note that because Bank Corp does not have more than 250 customers, it may not apply the safe harbor for professional services stated in Reg. IV.17.(d).(4)(C)1.c. If Bank Corp knows its customer's state of primary residence, it must assign the receipts to that state. If Bank Corp does not know its customer's state of primary residence, but rather knows the customer's billing address, it must assign the receipts to that state. Bank Corp's receipts are assigned to [state] if the customer's state of primary residence (or billing address, in cases where it does not know the customer's state of primary residence) is in [state], even if Bank Corp's financial custodial work, including the safekeeping of the customer's financial assets, takes place in a state other than [state]. *See* Reg. IV.17.(d).(4)(C)1.a.

Example (x).[44] Same facts as Example (ix), except that Bank Corp has more than 250 customers, individual or business. Bank Corp may apply the safe harbor for professional services stated in Reg. IV.17.(d).(4)(C)1.c., and may assign its receipts from sales to a state or states using each customer's billing address.

Example (xi).[45] Same facts as Example (x), except that Bank Corp derives more than 5% of its receipts from sales from a single individual customer. As to the sales made to this customer, Bank Corp is required to determine the individual customer's state of primary residence and must assign the receipts from the service or services provided to that customer to that state. *See* Reg. IV.17.(d).(4)(C)1.a. and (C)3. Receipts from sales to all other customers are assigned as described in Example (x).

Example (xii). Advisor Corp, a corporation that provides investment advisory services, provides these advisory services to Investment Co. Investment Co is a multistate business client of Advisor Corp that uses Advisor Corp's services in connection with investment accounts that it manages for individual clients, who are the ultimate beneficiaries of Advisor Corp's services. Assume that Investment Co's individual clients are persons that are resident in numerous states, which may or may not include [state]. Assuming that Advisor Corp knows that its agreement with Investment Co is principally managed by Investment Co in [state], receipts from the sale of Advisor Corp's services are assigned to [state]. It is not relevant for purposes of the analysis that the

[43] See Rule re: Financial Institutions, Reg. IV.17.(d).(4)(C)3, p. 26.
[44] See Rule re: Financial Institutions, Reg. IV.17.(d).(4)(C)3, p. 26.
[45] See Rule re: Financial Institutions, Reg. IV.17.(d).(4)(C)3, p. 26.

ultimate beneficiaries of Advisor Corp's services may be Investment Co's clients, who are residents of numerous states. *See* Reg. IV.17.(d.)(4)(C)1.b.

Example (xiii). Advisor Corp provides investment advisory services to Investment Fund LP, a partnership that invests in securities and other assets. Assuming that Advisor Corp knows that its agreement with Investment Fund LP is principally managed by Investment Fund LP in [state], receipts from the sale of Advisor Corp's services are assigned to [state]. *See* Reg. IV.17.(d).(4)(C)1.b. Note that it is not relevant for purposes of the analysis that the partners in Investment Fund LP are residents of numerous states.

Example (xiv). Design Corp is a corporation based outside [state] that provides graphic design and similar services in [state] and in neighboring states. Design Corp enters into a contract at a location outside [state] with an individual customer to design fliers for the customer. Assume that Design Corp does not know the individual customer's state of primary residence and does not derive more than 5% of its receipts from sales of services from the individual customer. All of the design work is performed outside [state]. Receipts from the sale are in [state] if the customer's billing address is in [state]. *See* Reg. IV.17.(d).(4)(C)1.a.

••• Reg. IV.17.(e). License or Lease of Intangible Property.

(1) General Rules.

(A) The receipts from the license of intangible property are in [state] if and to the extent the intangible is used in [state]. In general, the term "use" is construed to refer to the location of the taxpayer's market for the use of the intangible property that is being licensed and is not to be construed to refer to the location of the property or payroll of the taxpayer. The rules that apply to determine the location of the use of intangible property in the context of several specific types of licensing transactions are set forth at Reg. IV.17.(e).(2)-(5). For purposes of the rules set forth in this Reg. IV.17.(e)., a lease of intangible property is to be treated the same as a license of intangible property.

(B) In general, a license of intangible property that conveys all substantial rights in that property is treated as a sale of intangible property for purposes of Reg. IV.17. *See* Reg. IV.17.(f). Note, however, that for purposes of Reg.s IV.17.(e). and (f)., a sale or exchange of intangible property is treated as a license of that property where the receipts from the sale or exchange derive from payments that are contingent on the productivity, use or disposition of the property.

(C) Intangible property licensed as part of the sale or lease of tangible property is treated under Reg. IV.17 as the sale or lease of tangible property.

(D) In any instance in which the taxpayer is not taxable in the state to which the receipts from the license of intangible property are assigned, the receipts are excluded from the denominator of the taxpayer's receipts factor. *See* Article IV.17(c) and Reg. IV.17.(a).(6)(D).

(E) Nothing in this Reg. IV.17.(e). shall be construed to allow or require inclusion of receipts in the receipts factor that are not included in the definition of "receipts" pursuant to Article IV.1.(g). or

related regulations, or that are excluded from the numerator and the denominator of the receipts factor pursuant to Article IV.17.(a).(4)(ii)(C). For examples of the types of intangibles that are excluded pursuant to Article IV.1(g), see Reg. IV [insert cross-reference]. For examples of the types of intangibles that are excluded pursuant to Article IV.17.(a).(4)(ii)(C), see Reg. IV.17.(f).(1)(D). So, to the extent that the transfer of either a security, as defined in [cross-reference], or business "goodwill" or similar intangible value, including, without limitation, "going concern value" or "workforce in place," may be characterized as a license or lease of intangible property, receipts from such transaction shall be excluded from the numerator and the denominator of the taxpayer's receipts factor.

(2) License of a Marketing Intangible.

Where a license is granted for the right to use intangible property in connection with the sale, lease, license, or other marketing of goods, services, or other items (i.e., a marketing intangible) to a consumer, the royalties or other licensing fees paid by the licensee for that marketing intangible are assigned to [state] to the extent that those fees are attributable to the sale or other provision of goods, services, or other items purchased or otherwise acquired by consumers or other ultimate customers in [state]. Examples of a license of a marketing intangible include, without limitation, the license of a service mark, trademark, or trade name; certain copyrights; the license of a film, television or multimedia production or event for commercial distribution; and a franchise agreement. In each of these instances the license of the marketing intangible is intended to promote consumer sales. In the case of the license of a marketing intangible, where a taxpayer has actual evidence of the amount or proportion of its receipts that is attributable to [state], it shall assign that amount or proportion to [state]. In the absence of actual evidence of the amount or proportion of the licensee's receipts that are derived from [state] consumers, the portion of the licensing fee to be assigned to [state] must be reasonably approximated by multiplying the total fee by a percentage that reflects the ratio of the [state] population in the specific geographic area in which the licensee makes material use of the intangible property to regularly market its goods, services or other items relative to the total population in that area. If the license of a marketing intangible is for the right to use the intangible property in connection with sales or other transfers at wholesale rather than directly to retail customers, the portion of the licensing fee to be assigned to [state] must be reasonably approximated by multiplying the total fee by a percentage that reflects the ratio of the [state] population in the specific geographic area in which the licensee's goods, services, or other items are ultimately and materially marketed using the intangible property relative to the total population of that area. Unless the taxpayer demonstrates that the marketing intangible is materially used in the marketing of items outside the United States, the fees from licensing that marketing intangible will be presumed to be derived from within the United States.

(3) License of a Production Intangible.

If a license is granted for the right to use intangible property other than in connection with the sale, lease, license, or other marketing of goods, services, or other items, and the license is to be used in a production capacity (a "production intangible"), the licensing fees paid by the licensee for that right are assigned to [state] to the extent that the use for which the fees are paid takes place in [state]. Examples of a license of a production intangible include, without limitation, the license of a patent, a copyright, or trade secrets to be used in a manufacturing process, where the value of the intangible lies predominately in its use in that process. In the case of a license of a production intangible to a party other than a related party where the location of actual use is unknown, it is presumed that the use of the intangible property takes

place in the state of the licensee's commercial domicile (where the licensee is a business) or the licensee’s state of primary residence (where the licensee is an individual). If the [tax administrator] can reasonably establish that the actual use of intangible property pursuant to a license of a production intangible takes place in part in [state], it is presumed that the entire use is in this state except to the extent that the taxpayer can demonstrate that the actual location of a portion of the use takes place outside [state]. In the case of a license of a production intangible to a related party, the taxpayer must assign the receipts to where the intangible property is actually used.

(4) License of a Mixed Intangible.

If a license of intangible property includes both a license of a marketing intangible and a license of a production intangible (a “mixed intangible”) and the fees to be paid in each instance are separately and reasonably stated in the licensing contract, the [tax administrator] will accept that separate statement for purposes of Reg. IV.17. If a license of intangible property includes both a license of a marketing intangible and a license of a production intangible and the fees to be paid in each instance are not separately and reasonably stated in the contract, it is presumed that the licensing fees are paid entirely for the license of the marketing intangible except to the extent that the taxpayer or the [tax administrator] can reasonably establish otherwise.

(5) License of Intangible Property where Substance of Transaction Resembles a Sale of Goods or Services.

(A) In general.

In some cases, the license of intangible property will resemble the sale of an electronically-delivered good or service rather than the license of a marketing intangible or a production intangible. In these cases, the receipts from the licensing transaction are assigned by applying the rules set forth in Reg. IV.17.(d).(3)(B)2 and 3, as if the transaction were a service delivered to an individual or business customer or delivered electronically through an individual or business customer, as applicable. Examples of transactions to be assigned under this Reg. IV.17.(e).(5) include, without limitation, the license of database access, the license of access to information, the license of digital goods (*see* Reg. IV.17.(g).(2)), and the license of certain software (*e.g.*, where the transaction is not the license of pre-written software that is treated as the sale of tangible personal property, *see* Reg. IV.17.(g).(1)).

(B) Sublicenses.

Pursuant to Reg. IV.17.(e).(5)(A), the rules of Reg. IV.17.(d).(3)(B)3. may apply where a taxpayer licenses intangible property to a customer that in turn sublicenses the intangible property to end users as if the transaction were a service delivered electronically through a customer to end users. In particular, the rules set forth at Reg. IV.17.(d).(3)(B)3. that apply to services delivered electronically to a customer for purposes of resale and subsequent electronic delivery in substantially identical form to end users or other recipients may also apply with respect to licenses of intangible property for purposes of sublicense to end users. For this purpose, the intangible property sublicensed to an end user shall not fail to be substantially identical to the property that was licensed to the sublicensor merely because the sublicense transfers a reduced bundle of rights with respect to that property (e.g., because the sublicensee’s rights are limited to its own use of the property and do not include the

ability to grant a further sublicense), or because that property is bundled with additional services or items of property.

(C) Examples:

In these examples, unless otherwise stated, assume that the taxpayer is taxable in each state to which its receipts would be assigned, so that there is no requirement in these examples that the receipts must be eliminated from the denominator of the taxpayer's receipts factor. *See* Article IV.17.(c). and Reg. IV.17.(a).(6)(D). Also assume that the customer is not a related party.

> *Example (i)*. Crayon Corp and Dealer Co enter into a license contract under which Dealer Co as licensee is permitted to use trademarks that are owned by Crayon Corp in connection with Dealer Co's sale of certain products to retail customers. Under the contract, Dealer Co is required to pay Crayon Corp a licensing fee that is a fixed percentage of the total volume of monthly sales made by Dealer Co of products using the Crayon Corp trademarks. Under the contract, Dealer Co is permitted to sell the products at multiple store locations, including store locations that are both within and without [state]. Further, the licensing fees that are paid by Dealer Co are broken out on a per-store basis. The licensing fees paid to Crayon Corp by Dealer Co represent fees from the license of a marketing intangible. The portion of the fees to be assigned to [state] are determined by multiplying the fees by a percentage that reflects the ratio of Dealer Co's receipts that are derived from its [state] stores relative to Dealer Co's total receipts. *See* Reg. IV.17.(e).(2).

> *Example (ii)*. Program Corp, a corporation that is based outside [state], licenses programming that it owns to licensees, such as cable networks, that in turn will offer the programming to their customers on television or other media outlets in [state] and in all other U.S. states. Each of these licensing contracts constitutes the license of a marketing intangible. For each licensee, assuming that Program Corp lacks evidence of the actual number of viewers of the programming in [state], the component of the licensing fee paid to Program Corp by the licensee that constitutes Program Corp's [state] receipts is determined by multiplying the amount of the licensing fee by a percentage that reflects the ratio of the [state] audience of the licensee for the programming relative to the licensee's total U.S. audience for the programming. *See* Reg. IV.17.(e).(5). If Program Corp is not taxable in any state in which the licensee's audience is located, the receipts are excluded from the denominator of Program Corp's receipts factor. *See* Article IV.17(c) and Reg. IV.17.(a).(6)(D). Note that the analysis and result as to the state or states to which receipts are properly assigned would be the same to the extent that the substance of Program Corp's licensing transactions may be determined to resemble a sale of goods or services, instead of the license of a marketing intangible. *See* Reg. IV.17.(e).(5).

> *Example (iii)*. Moniker Corp enters into a license contract with Wholesale Co. Pursuant to the contract Wholesale Co is granted the right to use trademarks owned by Moniker Corp to brand sports equipment that is to be manufactured by Wholesale Co or an unrelated entity, and to sell the manufactured equipment to unrelated companies that will ultimately market the equipment to consumers in a specific geographic region, including a foreign country. The license agreement confers a license of a marketing intangible, even though the trademarks in

question will be affixed to property to be manufactured. In addition, the license of the marketing intangible is for the right to use the intangible property in connection with sales to be made at wholesale rather than directly to retail customers. The component of the licensing fee that constitutes the [state] receipts of Moniker Corp is determined by multiplying the amount of the fee by a percentage that reflects the ratio of the [state] population in the specific geographic region relative to the total population in that region. *See* Reg. IV.17.(e).(2). If Moniker Corp is able to reasonably establish that the marketing intangible was materially used throughout a foreign country, then the population of that country will be included in the population ratio calculation. However, if Moniker Corp is unable to reasonably establish that the marketing intangible was materially used in the foreign country in areas outside a particular major city; then none of the foreign country's population beyond the population of the major city is include in the population ratio calculation. If Moniker Corp is not taxable in any state (including a foreign country) in which Wholesale Co's ultimate consumers are located, the receipts that would be assigned to that state are excluded from the denominator of Moniker Corp's receipts factor. *See* Article IV.17(c) and Reg. IV.17.(a).(6)(D).

Example (iv). Formula, Inc and Appliance Co enter into a license contract under which Appliance Co is permitted to use a patent owned by Formula, Inc to manufacture appliances. The license contract specifies that Appliance Co is to pay Formula, Inc a royalty that is a fixed percentage of the gross receipts from the products that are later sold. The contract does not specify any other fees. The appliances are both manufactured and sold in [state] and several other states. Assume the licensing fees are paid for the license of a production intangible, even though the royalty is to be paid based upon the sales of a manufactured product (i.e., the license is not one that includes a marketing intangible). Because the [tax administrator] can reasonably establish that the actual use of the intangible property takes place in part in [state], the royalty is assigned based to the location of that use rather than to location of the licensee's commercial domicile, in accordance with Reg. IV.17.(e).(1). It is presumed that the entire use is in [state] except to the extent that the taxpayer can demonstrate that the actual location of some or all of the use takes place outside [state]. Assuming that Formula, Inc can demonstrate the percentage of manufacturing that takes place in [state] using the patent relative to the manufacturing in other states, that percentage of the total licensing fee paid to Formula, Inc under the contract will constitute Formula, Inc's [state] receipts. *See* Reg. IV.17.(e).(5).

Example (v). Axel Corp enters into a license agreement with Biker Co in which Biker Co is granted the right to produce motor scooters using patented technology owned by Axel Corp, and also to sell the scooters by marketing the fact that the scooters were manufactured using the special technology. The contract is a license of both a marketing and production intangible, i.e., a mixed intangible. The scooters are manufactured outside [state]. Assume that Axel Corp lacks actual information regarding the proportion of Biker Co.'s receipts that are derived from [state] customers. Also assume that Biker Co is granted the right to sell the scooters in a U.S. geographic region in which the [state] population constitutes 25% of the total population during the period in question. The licensing contract requires an upfront licensing fee to be paid by Biker Co to Axel Corp and does not specify what percentage of the fee derives from Biker Co's right to use Axel Corp's patented technology. Because the fees for

the license of the marketing and production intangible are not separately and reasonably stated in the contract, it is presumed that the licensing fees are paid entirely for the license of a marketing intangible, unless either the taxpayer or [tax administrator] reasonably establishes otherwise. Assuming that neither party establishes otherwise, 25% of the licensing fee constitutes [state] receipts. *See* Reg. IV.17.(e).(2), (e).(4).

Example (vi). Same facts as Example 5, except that the license contract specifies separate fees to be paid for the right to produce the motor scooters and for the right to sell the scooters by marketing the fact that the scooters were manufactured using the special technology. The licensing contract constitutes both the license of a marketing intangible and the license of a production intangible. Assuming that the separately stated fees are reasonable, [the tax administrator] will: (1) assign no part of the licensing fee paid for the production intangible to [state], and (2) assign 25% of the licensing fee paid for the marketing intangible to [state]. *See* Reg. IV.17.(e).(4).

Example (vii). Better Burger Corp, which is based outside [state], enters into franchise contracts with franchisees that agree to operate Better Burger restaurants as franchisees in various states. Several of the Better Burger Corp franchises are in [state]. In each case, the franchise contract between the individual and Better Burger provides that the franchisee is to pay Better Burger Corp an upfront fee for the receipt of the franchise and monthly franchise fees, which cover, among other things, the right to use the Better Burger name and service marks, food processes and cooking know-how, as well as fees for management services. The upfront fees for the receipt of the [state] franchises constitute fees paid for the licensing of a marketing intangible. These fees constitute [state] receipts because the franchises are for the right to make [state] sales. The monthly franchise fees paid by [state] franchisees constitute fees paid for (1) the license of marketing intangibles (the Better Burger name and service marks), (2) the license of production intangibles (food processes and know-how) and (3) personal services (management fees). The fees paid for the license of the marketing intangibles and the production intangibles constitute [state] receipts because in each case the use of the intangibles is to take place in [state]. *See* Reg. IV.17.(e).(2)-(3). The fees paid for the personal services are to be assigned pursuant to Reg. IV.17.(d).

Example (viii). Online Corp, a corporation based outside [state], licenses an information database through the means of the Internet to individual customers that are resident in [state] and in other states. These customers access Online Corp's information database primarily in their states of residence, and sometimes, while traveling, in other states. The license is a license of intangible property that resembles a sale of goods or services and are assigned in accordance with Reg. IV.17.(e).(5). If Online Corp can determine or reasonably approximate the state or states where its database is accessed, it must do so. Assuming that Online Corp cannot determine or reasonably approximate the location where its database is accessed, Online Corp must assign the receipts made to the individual customers using the customers' billing addresses to the extent known. Assume for purposes of this example that Online Corp knows the billing address for each of its customers. In this case, Online Corp's receipts from sales made to its individual customers are in [state] in any case in which the customer's billing address is in [state]. *See* Reg. IV.17.(d).(3)(B)2.a.

Example (ix). Net Corp, a corporation based outside [state], licenses an information database through the means of the Internet to a business customer, Business Corp, a company with offices in [state] and two neighboring states. The license is a license of intangible property that resembles a sale of goods or services and are assigned in accordance with Reg. IV.17.(e).(5). Assume that Net Corp cannot determine where its database is accessed but reasonably approximates that 75% of Business Corp's database access took place in [state], and 25% of Business Corp's database access took place in other states. In that case, 75% of the receipts from database access is in [state]. Assume alternatively that Net Corp lacks sufficient information regarding the location where its database is accessed to reasonably approximate the location. Under these circumstances, if Net Corp derives 5% or less of its receipts from database access from Business Corp, Net Corp must assign the receipts under Reg. IV.17.(d).(3)(B)2.b. to the state where Business Corp principally managed the contract, or if that state is not reasonably determinable to the state where Business Corp placed the order for the services, or if that state is not reasonably determinable to the state of Business Corp's billing address. If Net Corp derives more than 5% of its receipts from database access from Business Corp, Net Corp is required to identify the state in which its contract of sale is principally managed by Business Corp and must assign the receipts to that state. *See* Reg. IV.17.(d).(3)(B)2.b.

Example (x). Net Corp, a corporation based outside [state], licenses an information database through the means of the Internet to more than 250 individual and business customers in [state] and in other states. The license is a license of intangible property that resembles a sale of goods or services and receipts from that license are assigned in accordance with Reg. IV.17.(e).(5). Assume that Net Corp cannot determine or reasonably approximate the location where its information database is accessed. Also assume that Net Corp does not derive more than 5% of its receipts from sales of database access from any single customer. Net Corp may apply the safe harbor stated in Reg. IV.17.(d).(3)(B)2.b.iv., and may assign its receipts to a state or states using each customer's billing address. If Net Corp is not taxable in one or more states to which some of its receipts would be otherwise assigned, it must exclude those receipts from the denominator of its receipts factor. *See* Article IV.17(c) and Reg. IV.17.(a).(6)(D).

Example (xi). Web Corp, a corporation based outside of [state], licenses an Internet-based information database to business customers who then sublicense the database to individual end users that are resident in [state] and in other states. These end users access Web Corp's information database primarily in their states of residence, and sometimes, while traveling, in other states. Web Corp's license of the database to its customers includes the right to sublicense the database to end users, while the sublicenses provide that the rights to access and use the database are limited to the end users' own use and prohibit the individual end users from further sublicensing the database. Web Corp receives a fee from each customer based upon the number of sublicenses issued to end users. The license is a license of intangible property that resembles a sale of goods or services and are assigned by applying the rules set forth in Reg. IV.17.(d).(3)(B)3. *See* Reg. IV.17.(e).(5). If Web Corp can determine or reasonably approximate the state or states where its database is accessed by end users, it must do so.

Assuming that Web Corp lacks sufficient information from which it can determine or reasonably approximate the location where its database is accessed by end users, Web Corp must approximate the extent to which its database is accessed in [state] using a percentage that represents the ratio of the [state] population in the specific geographic area in which Web Corp's customer sublicenses the database access relative to the total population in that area. *See* Reg. IV.17.(d).(3)(B)3.c.

••• Reg. IV.17.(f). Sale of Intangible Property.

(1) Assignment of Receipts.

The assignment of receipts to a state or states in the instance of a sale or exchange of intangible property depends upon the nature of the intangible property sold. For purposes of this Reg. IV.17(f), a sale or exchange of intangible property includes a license of that property where the transaction is treated for tax purposes as a sale of all substantial rights in the property and the receipts from transaction are not contingent on the productivity, use or disposition of the property. For the rules that apply where the consideration for the transfer of rights is contingent on the productivity, use or disposition of the property, *see* Reg. IV.17.(e).(1).

(A) Contract Right or Government License that Authorizes Business Activity in Specific Geographic Area.

In the case of a sale or exchange of intangible property where the property sold or exchanged is a contract right, government license or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area, the receipts from the sale are assigned to a state if and to the extent that the intangible property is used or is authorized to be used within the state. If the intangible property is used or may be used only in this state the taxpayer shall assign the receipts from the sale to [state]. If the intangible property is used or is authorized to be used in [state] and one or more other states, the taxpayer shall assign the receipts from the sale to [state] to the extent that the intangible property is used in or authorized for use in [state], through the means of a reasonable approximation.

(B) Sale that Resembles a License (Receipts are Contingent on Productivity, Use or Disposition of the Intangible Property).

In the case of a sale or exchange of intangible property where the receipts from the sale or exchange are contingent on the productivity, use or disposition of the property, the receipts from the sale are assigned by applying the rules set forth in Reg. IV.17.(e). (pertaining to the license or lease of intangible property).

(C) Sale that Resembles a Sale of Goods and Services.

In the case of a sale or exchange of intangible property where the substance of the transaction resembles a sale of goods or services and where the receipts from the sale or exchange do not derive from payments contingent on the productivity, use or disposition of the property, the receipts from the sale are assigned by applying the rules set forth in Reg. IV.17.(e).(5) (relating to licenses of

intangible property that resemble sales of goods and services). Examples of these transactions include those that are analogous to the license transactions cited as examples in Reg. IV.17.(e).(5).

(D) Excluded Receipts.

Receipts from the sale of intangible property are not included in the receipts factor in any case in which the sale does not give rise to receipts within the meaning of Article IV.1(g). In addition, in any case in which the sale of intangible property does result in receipts within the meaning of Article IV.1(g), those receipts are excluded from the numerator and the denominator of the taxpayer's receipts factor if the receipts are not referenced in Article IV.17(a)(4)(i), (ii)(A) or (ii)(B). *See* Article IV.17(a)(4)(ii)(C). The sale of intangible property that is excluded from the numerator and denominator of the taxpayer's receipts factor under this provision includes, without limitation, the sale of a partnership interest, the sale of business "goodwill," the sale of an agreement not to compete, or similar intangible value. Also, in any instance in which, the state to which the receipts from a sale is to be assigned can be determined or reasonably approximated, but where the taxpayer is not taxable in such state, the receipts that would otherwise be assigned to such state shall be excluded from the numerator and denominator of the taxpayer's receipts factor. *See* Reg. IV.17.(a).(6)(D).

(E) Examples.

In these examples, unless otherwise stated, assume that the taxpayer is taxable in each state to which some of its receipts would be assigned, so that there is no requirement in these examples that the receipts to other states must be excluded from the taxpayer's denominator. *See* Article IV.17(c) and Reg. IV.17.(a).(6)(D).

Example (i). Airline Corp, a corporation based outside [state], sells its rights to use several gates at an airport located in [state] to Buyer Corp, a corporation that is based outside [state]. The contract of sale is negotiated and signed outside of [state]. The receipts from the sale are in [state] because the intangible property sold is a contract right that authorizes the holder to conduct a business activity solely in [state]. *See* Reg. IV.17.(f).(1).

Example (ii). Wireless Corp, a corporation based outside [state], sells a license issued by the Federal Communications Commission (FCC) to operate wireless telecommunications services in a designated area in [state] to Buyer Corp, a corporation that is based outside [state]. The contract of sale is negotiated and signed outside of [state]. The receipts from the sale are in [state] because the intangible property sold is a government license that authorizes the holder to conduct business activity solely in [state]. *See* Reg. IV.17.(f).(1)(A).

Example (iii). Same facts as in Example 2 except that Wireless Corp sells to Buyer Corp an FCC license to operate wireless telecommunications services in a designated area in [state] and an adjacent state. Wireless Corp must attempt to reasonably approximate the extent to which the intangible property is used in or may be used in [state]. For purposes of making this reasonable approximation, Wireless Corp may rely upon credible data that identifies the percentage of persons that use wireless telecommunications in the two states covered by the license. *See* Reg. IV.17.(f).(1)(A).

Example (iv). Same facts as in Example 3 except that Wireless Corp is not taxable in the adjacent state in which the FCC license authorizes it to operate wireless telecommunications services. The receipts paid to Wireless Corp that would be assigned to the adjacent state must be excluded from the denominator of Wireless Corp's receipts factor. *See* Article IV.17(c) and Reg. IV.17.(a).(6)(D).

Example (v). Sports League Corp, a corporation that is based outside [state], sells the rights to broadcast the sporting events played by the teams in its league in all 50 U.S. states to Network Corp. Although the games played by Sports League Corp will be broadcast in all 50 states, the games are of greater interest in the northeast region of the country, including [state]. Because the intangible property sold is a contract right that authorizes the holder to conduct a business activity in a specified geographic area, Sports League Corp must attempt to reasonably approximate the extent to which the intangible property is used in or may be used in [state]. For purposes of making this reasonable approximation, Sports League Corp may rely upon audience measurement information that identifies the percentage of the audience for its sporting events in [state] and the other states. *See* Reg. IV.17.(f).(1)(A).

Example (vi). Same facts as in Example 5, except that Sports League Corp is not taxable in one state. The receipts paid to Sports League Corp that would be assigned to that state must be excluded from the denominator of Sports League Corp's receipts factor. *See* Article IV.17(c) and Reg. IV.17.(a).(6)(D).

Example (vii). Inventor Corp, a corporation that is based outside [state], sells patented technology that it has developed to Buyer Corp, a business customer that is based in [state]. Assume that the sale is not one in which the receipts derive from payments that are contingent on the productivity, use or disposition of the property. *See* Reg. IV.17.(f).(1)(A). Inventor Corp understands that Buyer Corp is likely to use the patented technology in [state], but the patented technology can be used anywhere (i.e., the rights sold are not rights that authorize the holder to conduct a business activity in a specific geographic area). The receipts from the sale of the patented technology are excluded from the numerator and denominator of Inventor Corp's receipts factor. *See* Article IV.17.(a).(4)(ii)(C), Reg. IV.17.(f).(1)(D).

••• Reg. IV.17.(g). Special Rules.

(1) Software Transactions.

A license or sale of pre-written software for purposes other than commercial reproduction (or other exploitation of the intellectual property rights) transferred on a tangible medium is treated as the sale of tangible personal property, rather than as either the license or sale of intangible property or the performance of a service. In these cases, the receipts are in [state] as determined under the rules for the sale of tangible personal property set forth under Article IV.16. and related regulations. In all other cases, the receipts from a license or sale of software are to be assigned to [state] as determined otherwise under Reg. IV.17. (e.g., depending on the facts, as the development and sale of custom software, *see* Reg. IV.17.(d).(3), as a license of a marketing intangible, *see* Reg. IV.17.(e).(2), as a license of a production intangible, *see* Reg. IV.17.(e).(3), as a license of intangible property where the substance of the transaction

resembles a sale of goods or services, *see* Reg. IV.17.(e).(5), or as a sale of intangible property, *see* Reg. IV.17.(f).

(2) Sales or Licenses of Digital Goods or Services.

(A) In general.

In the case of a sale or license of digital goods or services, including, among other things, the sale of various video, audio and software products or similar transactions, the receipts from the sale or license are assigned by applying the same rules as are set forth in Reg. IV.17.(d).(3)(B)2. or 3., as if the transaction were a service delivered to an individual or business customer or delivered through or on behalf of an individual or business customer. For purposes of the analysis, it is not relevant what the terms of the contractual relationship are or whether the sale or license might be characterized, depending upon the particular facts, as, for example, the sale or license of intangible property or the performance of a service. *See* Regs IV.17.(e).(5) and (f).(1)(C).

(B) Telecommunications Companies.

In the case of a taxpayer that provides telecommunications or ancillary services and that is thereby subject to Reg. IV.18(i), receipts from the sale or license of digital goods or services not otherwise assigned for apportionment purposes pursuant to that regulation are assigned pursuant to this Reg. IV.17(g)(2)(B), by applying the rules set forth in Reg. IV.17.(d).(3)(B)2. or 3. as if the transaction were a service delivered to an individual or business customer or delivered through or on behalf of an individual or business customer. However, in applying these rules, if the taxpayer cannot determine the state or states where a customer receives the purchased product it may reasonably approximate this location using the customer's place of "primary use" of the purchased product, applying the definition of "primary use" set forth in [MTC Model Regulation for Sourcing Sales of Telecommunications and Ancillary Services].

••• Reg. IV.17.(h). Mediation.

Whenever a taxpayer is subjected to different sourcing methodologies regarding intangibles or services, by the [State Tax Agency] and one or more other state taxing authorities, the taxpayer may petition for, and the [State Tax Agency] may participate in, and encourage the other state taxing authorities to participate in, non-binding mediation in accordance with the alternative dispute resolution rules promulgated by the Multistate Tax Commission from time to time, regardless of whether all the state taxing authorities are members of the Multistate Tax Compact.

••• Reg. IV.18.(a). Special Rules: In General. Article IV.18. provides that if the allocation and apportionment provisions of Article IV 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.

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.

In 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.

••• Reg. IV.18.(b). Special Rules: Property Factor. The following special rules are established in respect to the property factor of the apportionment formula:

(1) If the subrents taken into account in determining the net annual rental rate under Regulation IV.11.(b) produce a negative or clearly inaccurate value for any item of property, another method which will properly reflect the value of rented property may be required by [the tax administrator] or requested by the taxpayer.

In no case, however, shall the value be less than an amount which bears the same ratio to the annual rental rate paid by the taxpayer for the property as the fair market value of that portion of the property used by the taxpayer bears to the total fair market value of the rented property.

Example: The taxpayer rents a 10-story building at an annual rental rate of $1,000,000. Taxpayer occupies two stories and sublets eight stories for $1,000,000 a year. The net annual rental rate of the taxpayer must not be less than two-tenths of the taxpayer's annual rental rate for the entire year, or $200,000.

(2) If property owned by others is used by the taxpayer at no charge or rented by the taxpayer for a nominal rate, the net annual rental rate for the property shall be determined on the basis of a reasonable market rental rate for the property.

••• Reg. IV.18.(c). Receipts Factor.

(1) Definitions. As used in this Reg. IV.18(c):

(A) “Receipts” means receipts as defined in [reference to Compact Article IV.1.g MTC Model Allocation and Apportionment Regulation IV.2.(a)(6) or other similar state law];

(B) "Gross receipts" means gross receipts as defined in [reference to MTC Model Allocation and Apportionment Regulation IV.2.(a)(5) or similar state regulation] that give rise to apportionable income included in the tax base;

(C) "MTC Financial Institutions Apportionment Model" means the Multistate Tax Commission's Recommended Formula for the Apportionment and Allocation of the Net Income of Financial Institutions, as amended July 29, 2015;

DRAFTER'S NOTE: IF YOUR STATE HAS ITS OWN FINANCIAL INSTITUTIONS APPORTIONMENT RULES, YOUR STATE MAY WISH TO REFERENCE THE SPECIFIC RULES OF ASSIGNMENT IN THOSE RULES FOR THESE TYPES OF GROSS RECEIPTS. SEE SUBPARAGRAPH (3)(c)(3).

(D) "Gross receipts from lending activities" means interest income and other gross receipts arising from the activities described in subsections 3(d) through 3(j) of the MTC Financial Institutions Apportionment Model; and,

(E) An entity's apportionment factor is "*de minimis*" if the denominator is less than 3.33 percent of the entity's apportionable gross receipts or if the factor is insignificant in producing income.

DRAFTER'S NOTE: SUBPARAGRAPH (1)(E) DOES NOT APPLY TO THE CALCULATION OF THE TAXPAYER'S RECEIPTS FACTOR UNDER PARAGRAPH (2), BELOW.

(2) This Reg. IV.18.(c) applies to the determination of the receipts factor if the taxpayer's receipts are less than 3.33 percent of the taxpayer's gross receipts. A taxpayer's receipts subject to assignment under Compact Art. IV, Sections 16 and 17 are assigned under those sections and are not assigned by this Regulation IV.18.(c).

(3) The following gross receipts are included in the receipts factor denominator and are assigned to the receipts factor numerator in this state as follows:

(A) Dividends paid by a related party, as defined in [reference to applicable state law], are assigned to the receipts factor numerator in this state as follows:

1. If paid from earnings that can be reasonably attributed to a particular year, the dividends are assigned to the receipts factor numerator in this state in a proportion equal to the dividend payor's apportionment factors in this state for that year as determined pursuant to [reference to state law].

2. If the dividends were paid from earnings that cannot reasonably be attributed to a particular year, the dividends are assigned to the receipts factor numerator in this state in a proportion equal to the dividend payor's average apportionment factors in this state for the current and preceding year as determined pursuant to [reference to state law].

EXAMPLE:

DRAFTER'S NOTE: TREATMENT OF DIVIDEND INCOME VARIES WIDELY AMONG THE STATES. STATES SHOULD CHECK THEIR TAX BASE WHEN ADOPTING THIS EXAMPLE TO AVOID CONFUSION.

Taxpayer Bigbox Holding, Inc. (Holding) is a domestic corporation, domiciled in Delaware, with numerous foreign and domestic subsidiaries. Holding has no "receipts," as

defined under this state's apportionment statutes. Holding is the corporate parent of Bigbox Retailing, Inc. (Retailing), a domestic corporation with its commercial domicile in State X. During the tax year, Holding receives $100 million in dividends from Retailing and $100 million in dividends from Holding's foreign subsidiaries. Because the foreign-source dividends are excluded from this state's tax base pursuant to this state's laws, they are not "gross receipts" subject to apportionment and are not included in the receipts factor. In both the current tax year and the prior tax year, Retailing conducted operations in ten states, including this state. Retailing's apportionment factor in this state in the current year is 20%, and the factor was 18% in the prior year. The dividends received from Retailing cannot be reasonably attributed to that entity's earnings in any specific year. Therefore, pursuant to subparagraph (3)(A)(2), Holding's receipts factor in this state is calculated by including the $100 million of apportionable dividends received from Retailing in the denominator, and $19 million in the receipts factor numerator in this state, based on the average of Retailing's apportionment factors in this state in the current year (20%) and prior year (18%).

(B) Gains are assigned to the receipts factor numerator in this state as follows:

1. Gains (net of related losses, but not less than zero) from the disposition of stock (or other intangible property rights) representing at least a 20% ownership interest in an entity, are assigned to the receipts factor numerator in this state in a proportion equal to what the entity's separate apportionment factor was in this state for the tax year preceding the disposition as determined pursuant to state law.

2. Gains (net of related losses, but not less than zero) from the disposition of assets of an entity or segment of a business are assigned to the receipts factor numerator in this state in a proportion equal to what the entity's separate apportionment factor was in this state in the tax year preceding the disposition as determined pursuant to [ref. to state law].

3. In applying clauses 1 and 2 of this subparagraph (B), in any case in which the entity did not exist in the prior year, or had an apportionment factor of zero [or had only a *de minimis* apportionment factor], the gross receipts from the gain are attributed to the receipts factor numerator of this state under paragraphs (4), (5), or (6) of this Reg.IV.18.(c) as appropriate.

4. In applying this subparagraph (B), in the case of an entity which was not subject to entity-level taxation, the apportionment percentage shall be computed as if the entity were a C corporation.

EXAMPLES:

(i) Taxpayer, Nuclear Corp. (Nuclear) is a holding company with no "receipts" from transactions and activities in the ordinary course of business. In the prior tax year, Nuclear formed Target Corp. (Target) and transferred its stock ownership interest in three power plants, located in three states, one of which is in this state, to Target in exchange for the stock of Target. In the current tax year, Nuclear sells the stock of Target to Risky Investments for $500 million in cash, recognizing a gain of $100 million. In the tax year preceding the sale, Target's apportionment factor in this state was 30%. Based on Target's prior year apportionment factor, Nuclear would include $100 million in the

denominator of its receipts factor and would assign $30 million to the receipts factor numerator in this state.

(ii) Same facts as (i) except during the current tax year Nuclear formed Target and then sold the Target stock on the same day. Because Target did not exist in the year preceding the disposition, Nuclear would have to use paragraph (4), (5) or (6), as appropriate, to assign a portion of the $100 million gain to its receipts factor numerator in this state.

(iii) Same facts as (i) except Nuclear makes an IRC 338(h)(10) election, which this state conforms to, so the sale is treated as the sale by Target of its assets. The sale of Target's assets in this state (the power plant) generated a gain of $150 million, and the sale of Target's remaining two power plants generated a loss of $50 million. Target would include $100 million of gain (the net amount) in the denominator of its receipts factor and would include 30% of that gain in the receipts factor in this state based on Target's apportionment factors in this state in the year preceding the sale.

DRAFTER'S NOTE: IF THE STATE HAS ADOPTED OTHER RULES FOR APPORTIONING AND ALLOCATING THE NET INCOME OF FINANCIAL INSTITUTIONS, THE FOLLOWING SUBSECTION AND THE EXAMPLES SHOULD REFERENCE THOSE RULES IN LIEU OF REFERENCING THE MTC'S FINANCIAL INSTITUTIONS APPORTIONMENT MODEL.

(C) Gross receipts from lending activities are included in the receipts factor denominator and assigned to the receipts factor numerator in this state to the extent those gross receipts would have been assigned to this state under the MTC Financial Institutions Apportionment Model (including the rule of assignment to commercial domicile under 3(p) of that model statute) [or your state's Financial Institutions Apportionment Rules] as if the taxpayer were a financial institution subject to the MTC Financial Institutions Apportionment Model [or your state's Financial Institutions Apportionment Rules], except that:

1. in the case of gross receipts derived from loans to a related party as defined by [reference to state law], which are not secured by real property, including interest, fees, and penalties, the gross receipts are included in this state's numerator in a proportion equal to the related party's apportionment factor in this state as determined by [reference to state law] in the year the gross receipts were included in apportionable income; and,

2. Gross receipts derived from accounts receivable previously sold to or otherwise transferred to the taxpayer are assigned under subparagraph (D).

EXAMPLES:

DRAFTER'S NOTE: TREATMENT OF DIVIDEND INCOME VARIES WIDELY AMONG THE STATES. STATES SHOULD CHECK THEIR TAX BASE WHEN ADOPTING THIS EXAMPLE TO AVOID CONFUSION.

(i) Taxpayer Bigbox Holding, Inc. (Holding) is a domestic corporation, domiciled in Delaware, with numerous foreign and domestic subsidiaries. Holding has no "receipts," as defined under this state's apportionment statutes. Holding is the corporate

parent of Bigbox Retailing, Inc. (Retailing), a domestic corporation with its commercial domicile in state X. During the current tax year, Holding receives $100 million in dividends from Retailing and $100 million in dividends from Holding's foreign subsidiaries. Because the foreign-source dividends are excluded from this state's tax base pursuant to this state's laws, they are not "gross receipts" subject to apportionment and are not included in the receipts factor. In both the current tax year and the prior tax year, Retailing conducted operations in ten states, including this state. Retailing's apportionment factor in this state in the current year is 20%, and this factor was 18% in the prior year. In a prior year, Holding lent its excess capital to Retailing as an unsecured loan. In repayment of that loan, Holding received $40 million of interest income from Retailing in the current tax year, in addition to the $100 million of dividend income that Holding received from Retailing. Pursuant to subparagraph (3)(C), Holding's interest income would be included in its receipts factor denominator, and 20% of Holding's interest income ($8 million) would be included in its receipts factor numerator in this state because 20% of Retailing's apportionment factors were in this state in the year the interest income was included in taxable income. Assuming Holding had no other gross receipts, Holding's receipt factor numerator in this state is 19.28% ($27 million /$140 million).

(ii) Taxpayer Loan Participation Inc. (LPI) was formed to acquire and hold a participation in loans secured by real property originated by an unrelated financial institution. LPI has no employees or property and no other gross receipts except for payments of interest on the participation loan held. Even though LPI would not be considered a financial institution under the MTC's Financial Institutions Apportionment Model for purposes of this state's rules, LPI's gross receipts are included in the denominator and assigned to the receipts factor numerator in this state under subsection 3(d) of the MTC's Financial Institutions Apportionment Model, in proportion to the value of loans secured by real property in this state compared to the value of loans secured by real property everywhere.

(D) Gross receipts derived from accounts receivable previously sold to or otherwise transferred to the taxpayer are included in the denominator and assigned to the receipts factor numerator in this state to the extent those accounts receivable are attributed to borrowers located in this state; provided however, that if the taxpayer is not taxable [as defined in Compact Article IV, section 3 or similar state law] in a state in which the borrowers are located, those gross receipts are excluded from the denominator of the taxpayer's receipts factor.

EXAMPLES:

(i) Taxpayer IH Factoring, Inc. (Factoring) is a Delaware corporation that has twenty employees all of whom are located in Delaware. Factoring purchases installment agreements (accounts receivable) from its parent corporation, Iron Horse Motorcycles, Inc. (Iron Horse). Factoring has access to information showing the addresses of the installment agreement customers. Factoring purchases installment agreements originating from Iron Horse's borrowers in States A and B, and this state. Factoring is taxable in State A and this state, but

not State B. Factoring re-sells the agreements as securitized instruments to institutional investors. Factoring's gross receipts from selling the securitized instruments originating from Iron Horse's borrowers in State A and this state would be included in the receipts factor denominator, and Factoring's gross receipts from selling securitized instruments originating from Iron Horse's borrowers in this state would be assigned to the receipts factor numerator in this state.

(ii) Same facts as above, but IH Factoring retains its ownership in the installment agreements and receives principal, interest and related fees from Iron Horse's customers (borrowers). The principal, interest and related fees received by Factoring from borrowers in State A and this state would be included in Factoring's receipts factor denominator, and Factoring's receipts received from Iron Horse's customers (borrowers) in this state would be assigned to the receipts factor numerator in this state.

(E) The net amount, but not less than zero, of gross receipts not otherwise assigned under this paragraph (3) arising from investment activities, including the holding, maturity, redemption, sale, exchange, or other disposition of marketable securities or cash are assigned to the sales factor numerator in this state if the gross receipts would be assigned to this state under Subsections (3)(n) or (3)(p) of the MTC's Financial Institutions Apportionment Model [or similar state financial institutions receipts factor rules]; all other gross receipts from investment activities not otherwise assigned under this paragraph (3) are assigned to the receipts factor numerator in this state if the investments are managed in this state.

DRAFTER'S NOTE: THIS PROVISION IS FOR STATES THAT USE A MULTI-FACTOR FORMULA. STATES WITHOUT A MULTI-FACTOR FORMULA SHOULD EXCLUDE THIS PROVISION.

(4) Gross receipts, other than those included and assigned under paragraph (3), are included in the receipts factor denominator, and are assigned to the receipts factor numerator in this state in a proportion equal to the average of the taxpayer's other non-*de minimis* apportionment factors [or other non-*de minimis* apportionment factor] in this state as determined pursuant to [reference to state law].

EXAMPLES:

(i) Taxpayer Windfall, Inc. (Windfall) is a wholly-owned subsidiary of ABC Manufacturing Corp. (ABC). During the tax year, Windfall has 10% of its property and 20% of its payroll in this state, and neither its property nor its payroll factor is *de minimis*. Windfall's only gross receipt during the year is $1 billion received in settlement of ABC's patent infringement suit against a business competitor that has been ongoing for several years. Because this settlement amount is not assigned to the receipts factor in this state under paragraph (3), Windfall is to assign the gross receipts to its receipts factor numerator in a proportion equal to the average of its property and payroll factors. Therefore, Windfall would include $1 billion in its receipts factor denominator and would include 15% of that amount ($150 million) in the receipts factor numerator in this state, under this state's apportionment formula.

(ii) Same facts as above, except that Windfall's property and payroll factors are *de minimis.* Windfall would accordingly include the $1 billion settlement amount in the receipts factor

denominator and would include a portion of that amount to the receipts factor numerator in this state in accordance with paragraphs (5) or (6) of this regulation, as appropriate.

DRAFTER'S NOTE – FROM THIS POINT – THE DRAFT'S NUMBERING ASSUMES THAT THE STATE INCLUDES PARAGRAPH (4). IF NOT – THE FOLLOWING PROVISIONS AND CROSS-REFERENCES TO THE PROVISIONS REFERENCED BELOW WILL HAVE TO BE RENUMBERED.

DRAFTER'S NOTE: THIS PROVISION IS FOR STATES THAT ALLOW OR REQUIRE STATE-LEVEL COMBINED FILINGS. IN PARAGRAPH (5), THE TERM "COMBINED REPORT" IS USED IN THE SAME SENSE AS THAT TERM IS USED IN THE MTC MODEL COMBINED FILING STATUTE.

(5) Except for gross receipts included and assigned under paragraphs (3) or (4), gross receipts of a taxpayer whose income and factors are included in a combined report in this state are included in the receipts factor denominator and are assigned to the receipts factor numerator in this state in the same proportion as the ratio of: (A) the total of the receipts factor numerators of all members of the combined group in this state, whether taxable or nontaxable, as determined pursuant to [reference to state law], to (B) the denominator of the combined group.

EXAMPLE:

Taxpayer Windfall, Inc. (Windfall) is a wholly-owned subsidiary of ABC Manufacturing Company (ABC). Windfall's only gross receipt during the year is $1 billion received in settlement of ABC's patent infringement suit against a business competitor that has been ongoing for several years. Windfall is included on a combined report filed by ABC on behalf of ABC, Windfall and other direct and indirect control subsidiaries of ABC (collectively, the Combined Subsidiaries). The ratio of the total numerators of ABC and Combined Subsidiaries in this state, as reported on the combined report, to the denominator of the combined group is 25 percent. Windfall would include $1 billion in its receipts factor denominator and would include $250 million in the receipts factor numerator in this state.

DRAFTER'S NOTE – FROM THIS POINT – THE DRAFT'S NUMBERING ASSUMES THAT THE STATE INCLUDES PARAGRAPHS (4) AND (5). IF NOT – THE FOLLOWING PROVISIONS AND CROSS-REFERENCES TO PROVISIONS REFERENCED BELOW WILL HAVE TO BE RENUMBERED.

(6) Except for those gross receipts included and assigned under paragraphs (3), (4) or (5), gross receipts of a taxpayer that files as part of a federal consolidated return are included in the receipts factor denominator and are assigned to the receipts factor numerator in this state in a proportion equal to a percentage (but not greater than 100%), the numerator of which is the total of the consolidated group members' income allocated to or apportioned to this state pursuant to [ref. to state law], and the denominator of which is the total federal consolidated taxable income.

EXAMPLE:

DRAFTER'S NOTE: STATES SHOULD CHOOSE ONE OF THE FOLLOWING ALTERNATIVES AS NOTED.

[Alternative 1– States that adopt paragraph (5)]

Taxpayer Windfall, Inc. (Windfall) is a wholly-owned subsidiary of ABC Manufacturing Corp. (ABC). Windfall's only gross receipt is $1 billion received in settlement of ABC's patent infringement suit against a business competitor that has been ongoing for several years. Windfall is not included on a combined report filed in this state, but is included on a consolidated federal return filed by ABC on behalf of Windfall and

other affiliated corporations that are included in such consolidated return. The total federal taxable income of that consolidated group is $5 billion, and the total amount of that income that is apportioned to this state by members of the consolidated group other than Windfall is $500 million. Because the percentage the consolidated group's income that would be apportioned to this state is 10%, Windfall would include $1 billion in its receipts factor denominator and would assign 10% of that amount ($100 million) to the receipts factor numerator in this state.

[Alternative 2 – States that do not adopt paragraph (5)] –

Taxpayer Windfall, Inc. (Windfall) is a wholly-owned subsidiary of ABC Manufacturing Corp. (ABC). Windfall's only gross receipt is $1 billion received in settlement of ABC's patent infringement suit against a business competitor that has been ongoing for several years. Windfall is included on a consolidated federal return filed by ABC on behalf of Windfall and other affiliated corporations that are included in such consolidated return. The total federal taxable income of that consolidated group is $5 billion, and the total amount of income of that income apportioned to this state by members of the consolidated group other than Windfall is $500 million. Because the percentage the consolidated group's income that would be apportioned to this state is 10%, Windfall would include $1 billion in its receipts factor denominator and would assign 10% of that amount ($100 million) to the receipts factor numerator in this state.

(7) Nothing in this Reg.IV.18.(c) shall prohibit the taxpayer from petitioning for, or the [state tax agency or administrator] from applying an alternative method to calculate the taxpayer's receipts factor in order to fairly represent the extent of the taxpayer's business activity in this state as provided for in [reference to Compact Article IV, Section 18 or similar state law], including the application of this rule in situations that do not meet the threshold of paragraph (2) of this Reg.IV.18.(c). Such alternative method may be appropriate, for example, in situations otherwise addressed under subparagraph (3)(A) where dividends were paid from earnings that were generated by the activities of a related party of the dividend payor, in which case the dividends may be more appropriately assigned to the receipts factor numerator in this state using the related party's average apportionment factors in this state.