Proposed Revisions to the MTC Special Industry Regulation on Airlines
Submitted by the Model Receipts Sourcing Regulation Work Group
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[Editor's note: All changes from the current text of IV.18.(e), other than changes/additions to the mathematical equations in the Examples, are underscored or shown with a strikethrough. All changes/additions to the mathematical equations in the Examples from the current model are highlighted in blue, rather than underscored.]

Introductory Note: This Regulation IV.18.(e) includes multiple references to the MTC's model General Allocation and Apportionment Regulations, which can be found at FINAL-APPROVED-2018-Proposed-Amendments-042020.docx. The Commission revised these regulations in 2017 to apply market-based sourcing principles to source the receipts from sales of services and intangibles. Whether or not a state has adopted the MTC's model General Allocation and Apportionment Regulations or any alternative framework using market-based sourcing principles, this Regulation IV.18.(e), can serve as a model to source the receipts of airlines.

••• **Reg. IV.18.(e). Special Rules: Airlines.** [Adopted July 14, 1983; revised ________________]

The following special rules apply ~~are established with respect~~ to airlines and, with respect to the sourcing of "points" or "miles," also apply to certain other taxpayers that are related to an airline:

> *Drafter's Note: The provision of this Reg. IV.18.(e) relating to the sourcing of receipts from the sale of certain "points" or "miles" applies not only to airlines but also to any taxpayer that is related to an airline under Reg. IV.17.(a).(3)(H). See Reg.IV.18.(e)(2)(iv)(C).*

(1) In General. ~~Where an airline has income from sources both within and without this state, the amount of business income from sources within this state shall be determined pursuant to Article IV. of the Multistate Tax Compact except as modified by this regulation.~~ Except as otherwise provided in this Reg. IV.18.(e), the apportionment provisions of [insert reference to general allocation and apportionment statutes and regulations – see model Compact Art. IV and the model General Allocation and Apportionment Regulations] apply to airlines and related parties, including the definition of "receipts" under Reg. IV.2.(a)(6) and the determination of apportionment factors. "Revenue" or "receipts" are considered received under this regulation when they are recognized by the Internal Revenue Code.

(2) Apportionment of Business Income.

(i) General Definitions.

The following definitions are applicable to the terms used in the apportionment factor descriptions.

A. "Airline" means a taxpayer that transports passengers, freight, or packages by air for a charge and that holds an air carrier certificate issued by the Federal Aviation Authority or a foreign air carrier permit issued by the U.S. Department of Transportation.

B. "Value" of owned real and tangible personal property ~~shall~~ means its original cost. (See Article IV.11. and Reg.~~ulation~~ IV.11(a).)

C. "~~Cost~~ Value of aircraft by type" means the average ~~original cost~~ ~~or~~ value of aircraft by type which are ready for flight.

D. "Original cost" means the initial federal tax basis of the property plus the value of capital improvements to such property~~, except that, for this purpose, it shall be assumed that Safe Harbor Leases are not true leases and do not affect the original initial federal tax basis of the property~~. (See Reg.~~ulation~~ IV.11(a).)

E. "Average value" of the property means the amount determined by averaging the values at the beginning and ending of the income year, but the [insert here the appropriate title of the administrative agency] may require the averaging of monthly values during the income year if such averaging is necessary to reflect properly the average value of the airline's property. (See Article IV.12. and Reg.~~ulation~~ IV.12.)

F. The "value" of rented real and tangible personal property means the product of eight (8) times the net annual rental rate. (See Article IV.11. and Reg. IV.11(b).)

F. "Net annual rental rate" ~~means the annual rental rate paid by the taxpayer~~ has the meaning stated in Reg. IV.11.(b).

G. "Property used during the income year" includes property which is available for use or is capable of being used in the taxpayer's trade or business during the income year. (See Reg. IV.10.(b).)

H. "Aircraft ready for flight" means aircraft owned or acquired through rental or lease (but not interchange) which are in the possession of or used by the taxpayer and are available for service on the taxpayer routes.

I. "Related party" has the meaning stated in Reg. IV.17.(a).(3)(H).[*]

J. "Revenue service" means the use of aircraft ready for flight for the production of revenue.

K. "Transportation ~~revenue~~ receipts" means ~~revenue earned by transporting passengers, freight and mail as well as revenue earned from liquor sales, pet crate rentals, etc.~~ passenger transportation receipts and freight transportation receipts.

Drafter's Note: The Internal Revenue Code and IRS guidance govern when the income of an airline must be recognized. For example, in the case of the sale of loyalty "points" or "miles," the IRS generally allows airlines to defer the related income until the tax year following the tax year in which the sale occurred (unless the "points" or "miles" are redeemed sooner). See IRS Rev. Proc. 2004-34, Rev. Proc. 2011-18.

This Reg.IV.18.(e) does not address when income of airlines is recognized. Rather, it addresses where receipts are sourced in order to apportion income once recognized under applicable law.

L. "Passenger transportation receipts" means revenue earned by an airline from:

I. selling air transportation services to transport passengers and their baggage, including but not limited to the sale of capacity on its aircraft to other airlines or

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[*] Reg. IV.17.(a).(3)(H) reads as follows:

"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]

entities in order to transport passengers, the sale of tickets to passengers under agreements (*e.g.*, codesharing agreements) with other airlines, baggage fees, and the sale of "points" or "miles" which may be redeemed by the purchaser or by a third party for air travel; and

II. selling or renting property or services to be used or consumed by passengers during the course of air transportation, including but not limited to the sale of food or liquor, the sale of on-flight services such as entertainment and Wi-Fi, and the rental of pet crates.

M. "Freight transportation receipts" means revenue earned by an airline from:

I. selling air transportation services to transport freight, packages, or mail, including but not limited to the sale of capacity on its aircraft to other airlines or entities in order to transport freight and the sale of freight transportation services under agreements (*e.g.*, codesharing agreements) with other airlines; and

II. selling or renting property or services to be consumed or used during the course of an aircraft flight.

N. "Departures" means, for purposes of ~~these~~ this regulation~~s~~, all takeoffs, whether they be regularly scheduled or charter flights, that occur during revenue service.

(ii) Property Factor

A. Property valuation. Owned aircraft shall be valued at its original cost and rented aircraft shall be valued at eight (8) times the net annual rental rate in accordance with Article IV.11. and Reg.~~ulation~~ IV.11. The use of the taxpayer's owned or rented aircraft in an interchange program with another air carrier will not constitute a rental of such aircraft by the airlines to the other participating airline. Such aircraft shall be accounted for in the property factor of the owner. Parts and other expendables, including parts for use in contract overhaul work, will be valued at cost.

B. The denominator and numerator of the property factor. The denominator of the property factor shall be the average value of all of the taxpayer's real and tangible personal property owned or rented and used during the income year. The numerator of the property factor shall be the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the income year.

In determining the numerator of the property factor, all property except aircraft ready for flight shall be included in the numerator of the property factor in accordance with [insert reference to Article IV.10.-.12, inclusive]. Aircraft ready for flight shall be included in the numerator of the property factor in the ratio calculated as follows:

Departures of aircraft from locations in this state weighted as to the ~~cost and~~ value of aircraft by type compared to total departures similarly weighted.

(iii) ~~The~~ Payroll Factor

The denominator of the payroll factor is the total compensation paid everywhere by the taxpayer during the income year. (See Article IV.13.-.14.) The numerator of the payroll factor is the total amount paid in this state during the income year by the taxpayer for compensation. With respect to non-flight personnel, compensation paid to such employees shall be included in the numerator as provided in Article IV.13-.14. With respect to flight personnel (the air crew aboard an aircraft assisting in the operations of the aircraft or the welfare of passengers while in the air), compensation paid to such employees shall be included in the ratio of departures of aircraft from locations in this state, weighted as to the ~~cost and~~ value of aircraft by type compared to total departures similarly weighted, multiplied by the total flight personnel compensation.

(iv) ~~Sales (Transportation Revenue)~~ <u>Receipts</u> Factor.

~~The transportation revenue derived from transactions and activities in the regular course of the trade or business of the taxpayer and miscellaneous sales of merchandise, etc., are included in the denominator of the revenue factor. (See Article IV.1. and Regulation IV.1.) Passive income items such as interest, rental income, dividends, etc., will not be included in the denominator nor will the proceeds or net gains or losses from the sale of aircraft be included. The numerator of the revenue factor is the total revenue of the taxpayer in this state during the income year. The total revenue of the taxpayer in this state during the income year is the result of the following calculation:~~

~~The ratio of departures of aircraft in this state weighted as to the cost and value of aircraft by type, as compared to total departures similarly weighted multiplied by the total transportation revenue. The product of this calculation is to be added to any non-flight revenues directly attributable to this state.~~

A. <u>**Denominator.** The denominator of the receipts factor is the total amount of receipts of the taxpayer under [insert reference to general allocation and apportionment statutes and regulations – see model Compact Art. IV and the model General Allocation and Apportionment Regulations] during the income year except for receipts from the sale of aircraft including aircraft parts.</u>

<u>*Drafter's Note: Note that the definition of "receipts" in the model MTC's General Allocation and Apportionment Regulations (Reg. IV.17) excludes interest and dividends.*</u>

<u>*Drafter's Note: In the case of airlines, the receipts factor excludes receipts from the sale of aircraft including aircraft parts because these sales are typically not a regular part of an airline's trade or business and inclusion of the related receipts in the factor may cause the apportionment of the airline's income to not fairly represent the extent of its business activity in the state. Note that under section 18.(a), receipts received from transactions or activities other than the sale of*</u>

aircraft including aircraft parts may, under certain circumstances, also be excluded from the factor. See Reg.IV.18.(a).

B. **Numerator**. The numerator of the receipts factor is the total amount of receipts of the taxpayer in this state during the income year. The total receipts of the taxpayer in this state is:

(I) the taxpayer's transportation receipts in this state during the income year; and

(II) any other receipts attributable to this state during the income year under [insert reference to general allocation and apportionment statutes and regulations – see model Compact Art. IV and the model General Allocation and Apportionment Regulations] except for receipts from the sale of aircraft including aircraft parts.

The taxpayer's transportation receipts in this state during the income year is determined by multiplying the taxpayer's transportation receipts by the departure ratio. The departure ratio is the ratio of the number of departures of its aircraft in this state weighted by the value of aircraft by type to the number of departures of its aircraft everywhere weighted by the value of aircraft by type.

Drafter's Note. Under the MTC's model General Allocation and Apportionment Regulations, "receipts" are the amounts realized upon the performance of services in a transaction which produces apportionable income in which the income or loss is recognized under the Internal Revenue Code. See Reg. IV.2.(a)(5),(6). Therefore, in the case where a passenger purchases a ticket from one airline to fly on an aircraft operated by another airline (where the two airlines have entered into a codesharing or similar arrangement), if the selling airline receives a commission for selling the ticket and the Internal revenue Code treats only the commission and not the entire ticket price as income to that airline, then the airline's "receipts" with respect to the sale are limited to the amount of the commission. See, e.g., The Seven-Up Company v. Commissioner of Internal Revenue, 14 T.C. 965 (1950); IRS Chief Counsel Advice No.202138001 (9/24/2021).

C. If a taxpayer and an airline are related parties under Reg. IV.17.(a).(3)(H), but the taxpayer is not an airline, the taxpayer will source any receipts from its sale of "points" or "miles" that may be redeemed by the purchaser or by a third party for air travel by applying the departures ratio applicable to the related airline.

Drafter's Note: A transportation company may transport a passenger or property in part by an aircraft and in part by another means of transportation. For example, customers may hire a delivery company to deliver a package across the country. That company may typically transport packages in part by aircraft and in part by truck. Under the terms of this Reg.IV.18.(e), the company is an airline and under the Trucking Rule, Reg. IV.18 (g), the company may be a trucking company. These *two special industry regulations impose different sourcing methodologies (departures and mileage, respectively).*

To address this situation, states may consider adopting guidance to indicate which of these special industry regulations to apply or to indicate how to allocate the receipts between the various modes of transportation.

(3) Records. The taxpayer must maintain the records necessary to ~~arrive at~~ identify departures by type of aircraft as used in ~~these~~ this regulation~~s~~. ~~Such~~ These records are to be subject to review by the respective state taxing authorities or their agents.

EXAMPLES OF THE MANNER IN WHICH THE MULTISTATE TAX COMMISSION AIRLINE REGULATION WOULD APPLY TO SPECIFIC FACT SITUATIONS

Example 1: Assume the following facts for ~~an airline~~ Airline A for a tax year:

1. It has ten 747s ready for flight and in revenue service at an average cost per unit of $40,000,000 for nine of the aircraft. It rents the tenth 747 from another airline for $9,000,000 per year. At eight times rents, the latter is valued at $72,000,000 for apportionment purposes. The total 747 valuation is, therefore, $432,000,000 for property factor denominator purposes.

2. It has twenty 727s ready for flight in revenue service at an average cost per unit of $20,000,000. The total 727 valuation is, therefore, $400,000,000 for property factor denominator purposes.

3. It has nonflight tangible property (n.t.p.) valued at an original cost of $200,000,000.

4. It has the following annual payroll:

Flight personnel	$60,000,000
Nonflight personnel (n.p.)	40,000,000
Total	$100,000,000

5. From its operations, it has total transportation receipts of $50,000,000, business net income of $1,000,000, and no nonbusiness income.

6. It has the following within state X:

a. 10% of its 747 flight departures (.10 x $432,000,000)	$43,200,000
b. 20% of its 727 flight departures (.20 x $400,000,000)	$80,000,000
c. 5% of its n.t.p. (.05 x $200,000,000)	$10,000,000
d. 15% of its n.p. payroll (.15 x $40,000,000)	$6,000,000

7. State X has a corporate tax rate of 10%.

The airline's tax liability to state X would be determined as follows:

Property Factor:

$$\frac{43{,}200{,}000\ (747s) + 80{,}000{,}000\ (727s) + 10{,}000{,}000\ (n.t.p.)}{432{,}000{,}000 + 400{,}000{,}000 + 200{,}000{,}000} = \frac{133{,}200{,}000}{1{,}032{,}000{,}000} = .1291$$

~~Sales~~ Receipts Factor:

$$\frac{\dfrac{43{,}200{,}000\ (747s) + 80{,}000{,}000\ (727s)}{432{,}000{,}000 + 400{,}000{,}000} \times \$50{,}000{,}000}{\$50{,}000{,}000} = .1481$$

Payroll Factor:

$$\frac{6{,}000{,}000\ (n.p.) \quad + \quad 8{,}880{,}000\ [=.148 \times 60{,}000{,}000](flight)}{100{,}000{,}000} = \frac{14{,}880\cancel{0}{,}000}{100{,}000{,}000} = .1488$$

Average ratio:	(.1291 + .1481 + .1488)/3 = .4260/3 = .1420
Taxable Income in State X:	.1420 x $1,000,000 = $142,000
Tax Liability to State X:	.10 x $142,000 = $14,200

Example 2: Same facts except that paragraphs 6 and 7 are changed to read:

6. It has the following within state Y:

a.	6% of its 747 flight departures (.6 x $432,000,000)	$25,920,000
b.	31% of its 727 flight departures (.31 x $400,000,000)	$124,000,000
c.	3% of its n.t.p. (.03 x$200,000,000)	$6,000,000
d.	7% of its n.p. payroll (.07x$40,000,000)	$2,800,000

7. State Y has a corporate tax rate of 6.5%.

The airline's tax liability to state Y would be determined as follows:

Property Factor:

$$\frac{25{,}920{,}000\ (747s) + 124{,}000{,}000\ (727s) + 6{,}000{,}000\ (n.t.p.)}{432{,}000{,}000 + 400{,}000{,}000 + 200{,}000{,}000} = \frac{155{,}920{,}000}{1{,}032{,}000{,}000} = .1511$$

~~Sales~~ Receipts Factor:

$$\frac{\dfrac{25{,}920{,}000\ (747s) + 124{,}000{,}000\ (727s)}{432{,}000{,}000 + 400{,}000{,}000} \times \$50{,}000{,}000}{\$50{,}000{,}000} = .1802$$

Payroll Factor:

$$\frac{2{,}800{,}000 \text{ (n.p.)} + 10{,}812{,}000\ [= .1802 \times 60{,}000{,}000]\text{(flight)}}{40{,}000{,}000 + 60{,}000{,}000} = \frac{13{,}612{,}000}{100{,}000{,}000} = .1361$$

Average ratio:	(.1511 + .1802 + .1361)/3 = .4674/3 = .1558
Taxable Income in State Y:	.1558 x $1,000,000 = $155,800
Tax Liability to State Y:	.065 x $155,800 = $10,127

Example 3: Same facts as example 1, except that the airline sells $10 million of swag at U.S. airports, with 10% of swag sales occurring at airports in State X (thus increasing receipts from operations to $60 million), and earns $1 million of interest income from various bank accounts:

Receipts Factor

$$\frac{\left(\dfrac{43{,}200{,}000 \text{ (747s)} + 80{,}000{,}000 \text{ (727s)}}{432{,}000{,}000 + 400{,}000{,}000} \times \$50{,}000{,}000\right) + \$1{,}000{,}000}{\$60{,}000{,}000} = .1401$$

Example 4: Same facts as example 1, except that Airline A's receipts include the following:

(1) $3 million from its sale of plane tickets are to passengers who will fly on airplanes operated by Airline B pursuant to a codesharing agreement between Airline A and Airline B; and

(2) $2 million received from Airline C pursuant to a codesharing agreement between Airline A and Airline C. Under this agreement, Airline C sold plane tickets to passengers who will fly on airplanes operated by Airline A and remitted a portion (i.e., $2 million) of its receipts from the sale of those tickets to Airline A.

Receipts Factor

$$\frac{\dfrac{43{,}200{,}000 \text{ (747s)} + 80{,}000{,}000 \text{ (727s)}}{432{,}000{,}000 + 400{,}000{,}000} \times \$50{,}000{,}000}{\$50{,}000{,}000} = .1481$$

Example 5:

Airline A and Major Bank are parties to an agreement which authorizes Major Bank to issue an Airline A branded credit card to consumers. Each card prominently displays the airline's name and logo (as well as the bank's name and logo). The agreement gives Major Bank the right to purchase "miles" from Airline A in bulk. Under the terms of the agreement and consistent with the value of the intangibles and miles, 20% of any amount paid by the bank to the airline will be treated as consideration for the licensing of intangible property, such as the right to use Airline A's logo, and 80% will be treated as consideration for the purchase of "miles."

Major Bank awards the miles it purchases from the airline to cardholders, based in part on each cardholder's card usage. Cardholders may redeem their miles for either air travel or for various other goods and services over time. Assume that under federal tax rules to which the state conforms, recognition of the income for sale of miles may be deferred until the miles are actually redeemed, but no longer than the end of the year following the year in which the miles were sold.

During Tax Year 1, Major Bank pays the airline $10 million. which, under the agreement, is treated as follows:

Total Amount Paid by Major Bank	$10,000,000
Amount Treated as Paid for Miles	$8,000,000
Amount Treated as Paid for Intangibles	$2,000,000

Tax Year 1: Prior to the end of Tax Year 1, cardholders have redeemed 25% of miles, 90% for travel and 10% for other goods and services. In this year, Airline A includes in its receipts factor the receipts from Major Bank and sources them as follows:

Transportation Receipts - sourced using the weighted departure ratio for that year	$2,000,000
Intangible Receipts - sourced using the applicable rules for sourcing receipts from sales or licensing of intangible property	$2,000,000
Total Included in Receipts in Year 1.	**$4,000,000**

Tax Year 2: Because in Tax Year 2 Airline A recognizes all the deferred income and receipts from selling miles, even if they have not been redeemed, Airline A includes in its receipts factor the receipts from Major Bank and sources them in Year 2 as follows:

Transportation receipts - sourced using the weighted departure ratio for that year	**$6,000,000**