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LEGAL ALERT

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# MTC Meeting Summary: Uniformity Proposals Progress; UDITPA/Compact Amendments and Model Sales and Use Tax Notice and Reporting on Hold

On May 10, the Multistate Tax Commission's (MTC) Executive Committee approved for further consideration model uniformity laws dealing with: (1) communications transaction tax centralized administration; and (2) tax collections responsibilities of accommodations intermediaries. However, in light of the recent permanent injunction on Colorado's sales and use tax notice and reporting law, the Executive Committee took no action on its uniformity proposal modeled after the Colorado law. The Executive Committee also decided not to take action on the five proposed amendments to the Uniform Division of Income for Tax Purposes Act (UDITPA), which is incorporated into Article IV of the Multistate Tax Compact. The UDITPA amendments likely will be considered further at the MTC's annual meeting, which is scheduled for July 29 – August 2.

## Communications Transaction Tax Centralized Administration

In 2007, communications industry representatives requested that the MTC begin a uniformity project to address the burdensome requirements of complying with a myriad of state and local communications transaction taxes. At the forefront of the industry's concern was developing a model statute that states could use to centralize the collection and administration of communications transaction taxes. The MTC's Uniformity Committee developed a proposal that includes three options that address the varying approaches that states have employed for administering communications transaction taxes.

If ultimately adopted by the MTC, states will have the option of utilizing a model law intended to simplify the administration and collection of communications taxes based on either:

1. State administration and state imposition of tax (based on Virginia law);
2. State administration and local imposition of tax (based on Florida law); and
3. Local administration and local imposition of tax (based on South Carolina law).

Citing strong industry support for uniformity in this area, the Executive Committee approved the proposal with minor technical changes. The proposal now will go through a MTC Bylaw 7 survey, which requires a majority of affected MTC member states to respond as to whether they will consider adoption of the proposal. The survey of affected members is required before the proposals may be considered by the full Commission.

## Tax Collection Responsibilities of Accommodations Intermediaries

The MTC's uniformity project regarding the lodging tax collection responsibilities of Internet accommodations intermediaries (sometimes referred to as Online Travel Companies or OTCs) began in 2004. The MTC's May 10 meeting was the second time the Executive Committee considered the model statute; an earlier proposal failed a Bylaw 7 survey (i.e., states did not signal their desire to adopt it). The current version of the proposal, which was approved by the Executive Committee for a Bylaw 7 survey, provides states two options with respect to the collection obligations of OTCs. Industry representatives were divided in their support/opposition to the two options.

**Sutherland Observation:** Litigation continues across the country regarding whether OTCs are required to collect and remit tax on sales of hotel rooms. The MTC's uniformity project does not address the taxability issue, but provides proposals that a state can use if it determines it has the right to impose tax. The Hearing Officer's report regarding the project called the proposals "adjuncts to existing law in states where accommodations fees are taxed."

The first option, the single track remittance model, requires OTCs to collect taxes due upon the customer's purchase of accommodations, and then remit the entire tax collected to the accommodations provider (i.e., hotel), which, in turn, remits the entire tax due to the state or local taxing agency.

The second option, the dual track remittance model, requires the OTC to collect taxes when a customer purchases an accommodation and to remit the portion of the tax due on the discount room charge (only) to the accommodations provider (i.e., hotel) and remit the tax due on the accommodations fee to the state or local tax agency.

Both options include a safe harbor provision for OTCs in that an assessment for unpaid tax associated with a discount room charge paid to an accommodations provider may only be pursued against the accommodations provider, not the OTC.

## Sales and Use Tax Notice and Reporting

The Model Sales and Use Tax Notice and Reporting Statute that was considered by the Executive Committee largely is based on Colorado's notice and reporting law. The proposal requires remote sellers to (1) give notice to a customer at the time of a sale that the customer may be required to remit use tax to the taxing authority on the sale; (2) provide each customer an annual report generally indicating the products purchased from the remote seller and the price for each product purchased; and (3) provide to the taxing authority an annual report listing all of the remote seller's customers that purchased items from the remote seller including the total dollar amount of such purchases.

However, in light of the recent permanent injunction placed on the enforcement of Colorado's notice and reporting law by the U.S. District Court of Colorado in *The Direct Marketing Association v. Huber*, Civil Case No. 10-cv-01546-REB-CBS (March 30, 2012), the Executive Committee sensibly put on hold any further action on the model statute pending the outcome of the litigation.

## Amendments to UDITPA and the Multistate Tax Compact

The project to amend UDITPA began in 2006 through efforts of the Uniform Law Commission (ULC), as a number of UDITPA's provisions were viewed as significantly outdated. However, the ULC, amid public opposition, ended the project in 2009. Determined to continue the project, the MTC picked up where the ULC left off and has focused on the following five UDITPA provisions, which were considered by the Executive Committee on May 10 after being approved by the MTC's Uniformity Committee earlier this year:

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

The Executive Committee decided to suspend action on all five of the proposals. In supporting the decision to delay further action, Cory Fong, Tax Commissioner of North Dakota and Chair of the MTC Executive Committee, described the proposals as having "significant consequences" for states and the Compact. A summary of the proposed amendments are provided below.

**Sales Factor Sourcing of Services and Intangibles**

The sourcing of services and intangibles is viewed by the MTC as the provision in most need of change because of concerns with identifying taxpayers' "income producing activity" and the "all or nothing" approach to assigning receipts under the current costs-of-performance sourcing methodology. The MTC views a market-based method as being consistent with the intended purpose of the sales factor, which it described in its report to the Executive Committee as being to "reflect the taxpayer's market."

The MTC is considering abandoning UDITPA's rules for sourcing receipts from services and intangibles (Compact Art.IV.17) from the costs-of-performance rule to a market-based rule. The proposed amendment would source service receipts to a state to the extent the "service is delivered to a location in th[e] state." Receipts from intangible personal property would be sourced based on where the intangibles are used. The most contentious portion of the new intangible income sourcing rule is the proposal to source receipts from so-called "marketing intangibles" to the location of the ultimate purchaser.

**Sutherland Observation:** During the drafting process, the MTC was made aware of the public opposition to the marketing intangible sourcing rules. Many taxpayers will likely not have the available data to determine where an ultimate purchaser is located. A taxpayer that has licensed an intangible may have to "look through" multiple transactions related to a product containing its intangible that is ultimately purchased by an end user. Such a taxpayer will likely have to resort to the default "reasonable approximation" method of assigning income. The "reasonable approximation" provision could end up "swallowing the rule" and will likely require the promulgation of regulations to give taxpayers guidance on what constitutes a reasonable approximation.

**Definition of Sales**

In addition to the proposal to move to a market-sourcing method for receipts from services and intangibles, the MTC is considering amending the definition of "sales" for purposes of determining the receipts that are included in the sales factor. The current definition of "sales" (Compact Art.IV.1(g)) is broadly defined to mean all gross receipts of the taxpayer not allocated.

The proposal significantly narrows the types of receipts which are included in the sales factor. The amendment would require taxpayers to apply the "business income" transactional test (but not the functional test) in determining the scope of receipts that will be included in the sales factor. This change, according to the MTC, is consistent with the generally agreed purpose of the sales factor of reflecting a taxpayer's market activity. The amendment also provides for the exclusion of so-called treasury receipts from the sales factor.

**Sutherland Observation:** The change to the definition of "sales" will result in occasional asset sales (e.g., sale of a plant) being excluded from the sales factor. However, the income from such sales will be included in the apportionable tax base if that income meets the functional test. This is an inconsistency in the MTC's approach that interested taxpayers may want to comment on before the Executive Committee makes a decision on the proposal.

**Definition of Business Income**

The definition of "business income," which encompasses the apportionable income tax base for state corporate income taxpayers, has caused substantial litigation in recent years. A good portion of the controversy has stemmed from the varying interpretations of whether the current definition includes both the transactional and functional test or only the transactional test. In an attempt to make the definition clearer, the MTC's proposal, which includes a broad constitutional standard for defining business income, clarifies that income meeting the transactional and functional test is included in the definition. The proposal would also change the term "business income" to "apportionable income"

**Sutherland Observation:** The functional test in the proposed amendment is broader than the functional test applied by several states. The proposal requires that property from which income is earned only be "related to the operation of" as opposed to "integral" to a taxpayer's trade or business, as is required in the current definition. If states were to ultimately adopt this proposal into law, taxpayers would see a broader application of apportionable income. Indeed, the report presented to the Executive Committee provides that the definition is "intended to include gains from liquidation of a unitary business, including a liquidation that is a deemed sale of assets under I.R.C. 338(h)(10) . . . regardless of how the gains are used."

**Factor Weighting (Compact Art. IV.9)**

Many states in recent years have placed more weight on the sales factor to apportion income. The MTC's project to amend UDITPA considered a number of possible changes to the weighting of the factors in the apportionment formula. The MTC considered adopting a single sales factor and also mulled over possibly giving up on uniformity all together by allowing states to use whatever factors they choose.

Ultimately, the proposal by the Uniformity Committee is to amend UDITPA from the current three-factor, equally weighted formula to a three-factor formula with a double-weighted sales factor. The MTC viewed the proposed amendment as giving equal recognition to a taxpayer's production activities and marketing activities.

**Sutherland Observation:** It is difficult to imagine a significant number of states adopting the new factor weighting provision. Six of the 20 MTC member states have adopted a single sales factor. It is unlikely that these states will reverse course and reduce the weight given to the sales factor in response to the state.

**Alternative Apportionment**

Finally, the proposal attempts to clarify Compact Art. IV.18, which allows a taxpayer to petition for, or a tax administrator to require, an alternative apportionment methodology when the general formula does not fairly reflect a taxpayer's in-state business activities. Additionally, the MTC and many states have adopted special industry formulas pursuant to section 18. This rulemaking has been questioned by taxpayers as beyond the scope of section 18. The proposed amendment specifically grants tax administrators the authority to adopt special industry rules or regulations for determining allocation and apportionment. This authority is in addition to the ad-hoc authority that allows a taxing authority to require (or a taxpayer to seek) alternative apportionment.

**Sutherland Observation:** The proposal falls short in at least two areas. First, the amendment does not include guidance on the requisite burden that must be met as a prerequisite to invoking an alternative apportionment method. This is an area that has spawned litigation and is in much need of uniformity. Second, even though the proposal allows a taxing authority to promulgate special apportionment regulations for a specific industry, the proposal allows a taxing authority to require an alternative apportionment method for one or more taxpayers within that special industry.

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