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LEGAL ALERT

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No Sale! MTC Proposes to Limit Receipts Included in the Sales Factor

On April 26, the Multistate Tax Commission (MTC) Income & Franchise Tax Uniformity Subcommittee (Subcommittee) held the first of three scheduled meetings to revise corporate income tax apportionment. Specifically, the MTC is seeking to limit the definition of "sales" under Article IV.1(g) of the Uniform Division of Income for Tax Purposes Act (UDITPA) for purposes of calculating the sales apportionment factor.[1] The effect of the proposed limitation will lead to reducing the sales factor denominator in certain situations – and increasing state apportionable income.

Background

The Subcommittee reached a consensus that the revised definition of "sales" should reflect a substantially narrower meaning than under the current version of UDITPA, which broadly defines "sales" as "all gross receipts of the taxpayer" not specifically allocated.[2] In the April 26 meeting, Subcommittee members repeatedly described the proposed definition as including only those receipts that would meet UDITPA's transactional test (and not UDITPA's functional test) for purposes of determining what constitutes business income.

The proposal to limit the definition of "sales" reads as follows:

> 1(g) "Sales" means amounts that give rise to apportionable income and that are received by the taxpayer from:
>
> (1) transactions and activity in the regular course of its trade or business for:
>
> (A) the sale, rental, lease, or licensing to a customer of goods, products or other property which would properly be included in the inventory of the taxpayer if on hand at the close of the tax period; or
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> (B) the sale of services to a customer, or from
>
> (2) tangible or intangible property that is:
>
> (A) a contract right, government license, or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area;
>
> (B) [Other?][3]

Thus, the limitation contained in the proposal would result in excluding from the sales factor many types of receipts associated with apportionable business income – a concerning disconnect between apportionable income and the apportionment formula.

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[1] The Subcommittee's effort to revise the definition of "sales" is being done in conjunction with proposals to change the rules for sales factor numerator sourcing for receipts from transactions other than sales of tangible personal property.

[2] The Uniform Division of Income for Tax Purposes Act § 1(g).

[3] The current version of the proposed definition of "sales" can be found on the MTC's Web site.

The current MTC proposal narrows the definition further by limiting “sales” to receipts received from the taxpayer’s customers. Therefore, receipts from a transaction otherwise meeting the UDITPA transactional test of defining business income are excluded from the definition of “sales” if the transaction was not entered into with a taxpayer’s customer. “Regular transactions,” such as those producing treasury receipts or regular turnover of a rental car fleet, would likely not produce “sales” for purposes of the sales factor.

Sutherland Observation: The implications of requiring a transaction to be with a “customer” for the receipt to be included in the sales factor is somewhat uncertain because the Subcommittee intends on specifically defining the term “customer.” However, based on the discussion at the meeting and other documents issued by the MTC regarding the revision, the Subcommittee’s perception of what constitutes a customer is a rather narrow one. For example, a list of transactions that would not produce “sales” was attached to an MTC memorandum discussing its preliminary policy position regarding the revised “sales” definition, and an example of a non-sale was the regular turnover of a rental car fleet. Therefore, despite the transaction being “regular,” limiting the meaning of the term customer, for example, to only those renting vehicles results in the sale of the cars not being a “sale” for sales factor purposes.

Further, the meaning of “inventory” in the proposal is also unclear. The proposal seems to be intended to include within “sales” receipts from the licensing of intangibles so long as the licensing is in the regular course of a taxpayer’s trade or business because the “license to a customer of . . . other property” is included in the proposed definition. This intent is also reflected in the MTC memorandum pertaining to its preliminary policy position regarding the revised meaning of “sales.”[4] However, the proposed language provides that a license would only be a sale if the property licensed is properly “included in the inventory of the taxpayer.” Intangible personal property is typically not considered inventory for tax purposes. Thus, defining the term inventory or rewording Section 1(g)(1)(A) may be needed to clarify the treatment of the licensing of intangibles such as software.

The Subcommittee asked its drafting team in March to prepare a list of transactions that would produce receipts excluded from the proposed definition of “sales.” The purpose of this list” was for the Subcommittee to consider whether specific transactions should be characterized as *not* producing “sales” regardless of the application of the proposed “sales” test. In the Subcommittee meeting on April 26, it was concluded that no additions were necessary. Thus, under the proposed “sales” definition, amounts received from transactions, such as the sale or lease/license of tangible or intangible assets used in the production of a good or service, the sales of a non-unitary or unitary subsidiary, and those involving liquid assets held in connection with one or more treasury functions (i.e., treasury receipts) would be excluded from the sales factor despite the fact that these transactions often produce business income. A complete list of the transaction receipts which would be excluded from the definition of “sales,” and thus excluded from the sales factor, is available on the MTC’s Web site.

What’s Next?

At the MTC Annual Meeting in July, the Subcommittee intends to vote on the proposed changes to sales factor receipts as well as the proposed changes to sales factor sourcing for receipts from transactions other than sales of tangible personal property under Art.IV.17. If the revisions pass at the Subcommittee’s

[4] The memorandum can be found on the MTC’s Web site.

July meeting, MTC's full Uniformity Committee may consider the proposal at the same meeting. The Subcommittee will meet again on May 24 and has asked the business community to provide comments on the proposed definition of "sales" as well as on whether the proposal has sufficient clarity for taxpayers to apply the proposed definition from a compliance perspective.

Sutherland Observation: Sutherland would like your feedback on the MTC's proposal. Please take part in our poll regarding the definition of sales at: http://www.stateandlocaltax.com/polls/salt-poll-mtc-considering-broad-throwout-rule-under-cloak-of-redefining-sales/.

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If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

Michele Borens	202.383.0936	michele.borens@sutherland.com
Jeffrey A. Friedman	202.383.0718	jeff.friedman@sutherland.com
Stephen P. Kranz	202.383.0267	steve.kranz@sutherland.com
Marc A. Simonetti	212.389.5015	marc.simonetti@sutherland.com
Eric S. Tresh	404.853.8579	eric.tresh@sutherland.com
W. Scott Wright	404.853.8374	scott.wright@sutherland.com
Douglas Mo	202.383.0847	douglas.mo@sutherland.com
Jonathan A. Feldman	404.853.8189	jonathan.feldman@sutherland.com
Pilar Mata	202.383.0116	pilar.mata@sutherland.com
Michele L. Pielsticker	916.498.3311	michele.pielsticker@sutherland.com
Diann L. Smith	202.383.0884	diann.smith@sutherland.com
Marlys A. Bergstrom	404.853.8177	marlys.bergstrom@sutherland.com
Andrew D. Appleby	212.389.5042	andrew.appleby@sutherland.com
Zachary T. Atkins	404.853.8312	zachary.atkins@sutherland.com
Madison J. Barnett	404.853.8191	madison.barnett@sutherland.com
Michael L. Colavito Jr.	202.383.0870	mike.colavito@sutherland.com
Miranda K. Davis	404.853.8242	miranda.davis@sutherland.com
Maria P. Eberle	212.389.5054	maria.eberle@sutherland.com
Seth A. Fersko	212.389.5049	seth.fersko@sutherland.com
Lisbeth A. Freeman	202.383.0251	beth.freeman@sutherland.com
Charles C. Kearns	202.383.0864	charlie.kearns@sutherland.com
Jessica L. Kerner	212.389.5009	jessica.kerner@sutherland.com
David A. Pope	212.389.5048	david.pope@sutherland.com
Melissa J. Smith	202.383.0840	melissa.smith@sutherland.com
Maria M. Todorova	404.853.8214	maria.todorova@sutherland.com
Mark W. Yopp	212.389.5028	mark.yopp@sutherland.com

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