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The MTC Amends Its Regulation For Sourcing Of Sales Other Than Sales Of Tangible Personal Property

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The Multistate Tax Commission ("MTC") recently amended the income producing activity and cost of performance provisions of its sales factor regulation, MTC Regulation IV.17 (the "Regulation"), to include transactions performed by independent contractors "on behalf of" the taxpayers. The MTC approved the amendments during its Annual Meeting on August 2, 2007. States are now in the process of considering whether to adopt the changes proposed by the MTC. For example, the California Franchise Tax Board held an Interested Parties Meeting on January 9, 2008 to discuss whether and to what extent the Regulation should be adopted in California.

The new Regulation has additional complexity. It incorporates a controversial "throw-out" rule. Some question whether the amendments will further the MTC's stated goal to "facilitate taxpayer convenience and compliance" or if the amendments will lead to taxpayer frustration and litigation.

The MTC is "an intergovernmental state tax agency working on behalf of states and taxpayers to administer, equitably and efficiently, tax laws that apply to multistate and multinational enterprises."[1] One of the MTC's functions is to issue regulations providing tax guidance to the states. States may voluntarily adopt the regulations as part of their tax regimes.

The Regulation provides guidance on apportioning income based on the percentage of a taxpayer's sales in the state. According to the Regulation, gross receipts from transactions other than sales of tangible personal property are included in a state's numerator of the sales factor if:

> (a) "income producing activity which gave rise to the receipts is performed wholly within this state," or
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> (b) "with respect to a particular item of income, the income producing activity is performed within and without this state but the greater proportion of the income producing activity is performed in this state, based on costs of performance."

[1] http://www.mtc.gov/About.aspx?id=40.

To determine whether gross receipts from transactions other than sales of tangible personal property should be included in the sales factor numerator, a taxpayer must identify the income producing activity associated with those transactions. Furthermore, if the income producing activity is performed both inside the taxing state and outside the taxing state, the taxpayer must take the additional step of determining the cost of performance related to each income producing activity. The steps may seem fairly straightforward, but in practice they are often difficult to apply.

Unfortunately for taxpayers, states that have adopted either the pre-amendment Regulation or adopted substantially similar regulations have varied widely in their interpretation of its provisions. For example, under the Massachusetts approach, a taxpayer's entire activity related to a particular type of service would constitute a single income producing activity. All the aggregate activity from all sales of that particular service would be tested together to determine if the greater proportion of an activity is performed in the state. *See Boston Professional Hockey Ass'n, Inc. v. Comm'r of Revenue*, 820 N.E.2d 792 (Mass. 2003)(holding that the taxpayer's income producing activity was "the operation of an NHL franchise rather than the playing of individual games" such that the taxpayer's gate receipts from all hockey games were a single income producing activity). Under the Michigan approach, however, the "costs of performance analysis is not applied to the total business activity of the taxpayer, but to each sale separately." Mich. Dep't of Treas. Int'l Policy Dir. 2006-8 (Sept. 29, 2006).

The MTC amended the definitions of "income producing activity" and "cost of performance" to include the transactions performed by independent contractors "on behalf of" the taxpayers. The amended Regulation provides as follows (the added language is underlined):

> **(2) Income producing activity: defined.** The term "income producing activity" applies to each separate item of income and means the transactions and activity ~~directly~~ engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of producing that item of income ~~obtaining gains or profit~~. Such activity ~~does not~~ includes transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor. Accordingly, income producing activity includes but is not limited to the following:
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> (A) The rendering of personal services by employees or by an agent or independent contractor acting on behalf of the taxpayer or the utilization of tangible and intangible property by the taxpayer or by an agent or independent contractor acting on behalf of the taxpayer in performing a service.
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> **(3) Cost of performance: defined.** The term "cost of performance" means direct costs determined in a manner

> consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer to perform the income producing activity which gives rise to the particular item of income. Included in the taxpayer's cost of performance are taxpayer's payments to an agent or independent contractor for the performance of personal services and utilization of tangible and intangible property which give rise to the particular item of income.

The amended Regulation provides a "hierarchy of rules" to determine when an income producing activity performed on behalf of a taxpayer by an independent contractor is attributable to a state. An independent contractor's activities are attributed to a state:

> (i) when the taxpayer can reasonably determine at the time of filing that the income producing activity is actually performed in this state by the agent or independent contractor, but if the activity occurs in more than one state, the location where the income producing activity is actually performed shall be deemed to be not reasonably determinable at the time of filing under (4)(C)(a)(i);
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> (ii) if the taxpayer cannot reasonably determine at the time of filing where the income producing activity is actually performed, when the contract between the taxpayer and the agent or independent contractor indicates it is to be performed in this state and the portion of the taxpayer's payment to the agent or contractor associated with such performance is determinable under the contract;
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> (iii) if it cannot be determined where the income producing activity is actually performed and the agent or independent contractor's contract with the taxpayer does not indicate where it is to be performed, when the contract between the taxpayer and the taxpayer's customer indicates it is to be performed in this state and the portion of the taxpayer's payment to the agent or contractor associated with such performance is determinable under the contract; or
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> (iv) if it cannot be determined where the income producing activity is actually performed and neither contract indicates where it is to be performed or the portion of the payment associated with such performance, when the domicile of the taxpayer's customer is in this state. If the taxpayer's customer is not an individual, "domicile" means commercial domicile.

The amended Regulation also provides a “throw-out” rule, stating that if the location of the income producing activity by an independent contractor, or the portion of the payment associated with such performance, cannot be determined under (i) through (iii) above, or the taxpayer’s customer’s domicile cannot be determined under (iv) above, the income producing activity is disregarded. Further, the income producing activity of an agent or independent contractor is disregarded if the income producing activity is performed in a state where the taxpayer “is not taxable.”

The MTC’s amendments to the Regulation seek to achieve a more equitable apportionment of receipts from transactions other than sales of tangible personal property by broadening the scope of the income producing activity and cost of performance analysis. At the same time, the amendments seek to aid the taxpayer compliance process. However, the MTC’s amendments introduce an additional level of complexity to the income producing activity and cost of performance analysis.

Taxpayers are likely to find the last element of the “throw-out” rule particularly troubling, because it “throws out” the income producing activity of the independent contractor solely on the basis that the taxpayer is not subject to tax in a state. The “throw-out” provision could operate to exclude the income producing activity of an agent or independent contractor in several different scenarios such as where: 1) the taxpayer has nexus with a state but is not subject to tax because the state does not impose an income tax; 2) the taxpayer has nexus with a state but is not subject to tax because it is exempt from that state’s income tax under Public Law 86-272; or 3) the taxpayer has no nexus with the state and is, therefore, not subject to the state’s income tax. Although the MTC found that “tax administrators and taxpayers alike would benefit from greater … fairness by the adoption of the proposed amendment,”[2] taxpayers and practitioners may find that this particular aspect of the “throw-out” provision stretches their notions of fair apportionment because it may attribute extraterritorial values to the taxing state.

It is well settled that “[u]nder both the Due Process and the Commerce Clauses of the [United States] Constitution, a State may not, when imposing an income-based tax, tax value earned outside its borders.” [3] For internal consistency, independent contractors should be deemed to generate taxpayer’s income in the states where the independent contractors perform the income producing activity on behalf of the taxpayer. The Regulation “throws out” the income producing activity performed in the states where the taxpayer “is not subject to tax.” As a result, the taxing state effectively reallocates, at least, a portion of the income generated in those states to itself. This result occurs because the taxing state’s denominator of the apportionment formula is reduced by the “thrown out” amount, whereas the numerator is unchanged. Thus, the “throw-out” rule arguably violates the Constitution because it attributes income that was generated in another state to the taxing state. Additionally, the “throw-out” rule may violate other

[2] MTC Resolution Adopting an Amendment to Multistate Tax Commission Regulation IV.17.

[3] *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983) (citing *ASARCO Inc. v. Idaho State Tax Comm’n*, 458 U.S. 307, 315) (internal quotations omitted).

constitutional principles, such as "fair apportionment"[4] and "freedom to trade with any State across all state boundaries."[5]

Thus, while some may argue that the amendments to the Regulation achieve a more equitable apportionment, it remains to be seen whether states that adopt the amendments will interpret them in a consistent manner and whether taxpayers will find themselves confronted with the need to challenge the Regulation's "throw-out" provision to prevent a potentially unconstitutional result.■

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

[5] *Boston Stock Exchange v. State Tax Comm'n*, 429 US 318 (1977); *see also New Energy Co. of Indiana v. Limbach,* 486 US 269 (1988) (a state cannot penalize commerce with another state simply because the other state has a disfavored taxing scheme).