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January 3, 2017

Mr. Lennie Collins
Director, Income Tax Division
North Carolina Department of Revenue
Raleigh, NC 27602

Via email: MBSRulesNotification@ncdor.gov

Re: Proposed Market-Based Sourcing Rules for Apportionment of Income

Dear Mr. Collins:

On behalf of the Council On State Taxation (COST), I am submitting comments on the Department's proposed market-based sourcing rules for the apportionment of income. While these comments are not intended to address all the technical aspects of the Department's proposal, COST's comments reiterate several procedural concerns voiced to the Multistate Tax Commission (MTC) regarding its proposed model regulations, which implement model statutory language substantially the same as that contained in House Bill 1030. Several of these concerns were addressed by the MTC in its updated proposal currently pending adoption,¹ but are not addressed in the Department's proposal. We explain these instances and other COST concerns below.

Taxpayer Authority to Change a Method of Assignment on a Prospective Basis (17 NCAC 05G.0504) – The Department's proposal provides that taxpayers may only make a prospective change of method in assigning receipts "for the purpose of improving the accuracy of assigning its receipts consistent with the rules set forth in this Subchapter." Further, the Department's proposal provides that the taxpayer "shall retain and provide to the Secretary upon request documents that explain the nature and extent of the change, and the reason for the change."

The MTC's Hearing Officer, in reporting on the MTC's proposal and COST's comments with respect to that proposal, opined: "...I think it is reasonable to allow taxpayers to adjust their methodology without in effect having to justify the change so long as the new methodology meets the general requirements... What is essential is that the methodology used in any year is lawful, and I see no compelling reason to

¹ The most recent version of the MTC proposed rules is available at: [http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Section-17-Model-Market-Sourcing-Regulations/Sec-1-17-Draft-Regulations-as-of-7-28-16-with-8-10-16-and-10-4-16-modifications-\(1\).pdf.aspx](http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Section-17-Model-Market-Sourcing-Regulations/Sec-1-17-Draft-Regulations-as-of-7-28-16-with-8-10-16-and-10-4-16-modifications-(1).pdf.aspx). Please note that COST is not endorsing the MTC's proposed rules, but rather is consistently advocating for improvements both in the MTC's proposal and in the Department's proposal.

require taxpayers to in effect jump through another hoop because of a decision made in a prior year... COST also proposes that language be stricken from this provision that requires taxpayers to retain and provide to the tax administrator documents that explain the nature and extent of any change, and the reason for the change. This suggestion also seems reasonable to me. If a taxpayer can defend its sourcing methodology in any year under the requirements of the statute and regulations, that ought to be sufficient.”²

The MTC’s Executive Committee agreed with the Hearing Officer and removed the language cited above that apparently formed the basis of the Department’s current proposal. Therefore, the Department’s proposal is based on language no longer found in the MTC model regulation currently pending final adoption, even though North Carolina’s proposed statutory language is consistent with the MTC’s model market-based sourcing statute.

For the reasons cited in the MTC Hearing Officer’s report and reproduced above, COST urges the Department to remove the “improving the accuracy” requirement and requirements to explain the “nature,” “extent,” and “reason” for the change. The Department is amply protected by the provisions in 17 NCAC 05G .0201, including that a taxpayer “shall determine its method of assigning receipts in good faith, and apply it consistently with respect to similar transactions... 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 Secretary upon request... [and] attempt to obtain the most accurate assignment of receipts consistent with the standards set forth in this Subchapter, rather than an attempt to lower the taxpayer's tax liability.” All of these provisions (consistent with the currently pending MTC final regulation) allow the taxpayer to, in the words of the MTC’s hearing officer, “defend its sourcing methodology in any year under the requirements of the statute and regulations...” As stated by the MTC’s hearing officer, “that ought to be sufficient.”

Finally, with respect to a taxpayer’s prospective change, the Department’s proposal requires the taxpayer to “disclose, in the original return filed for the year of the change, the fact that the taxpayer has made the change.” While the MTC’s pending model regulation includes a similar requirement, COST urges the Department to consider some practical limitations on such a requirement. There could be any number of very minor changes in methods under the various rules of assignment contained in the proposal, including changes based on slight variations in taxpayer data. It would be onerous and unworkable to require “notice” each time such a change in the method of assignment is made. If the Department chooses to retain a notice requirement in its rule, COST requests that the Department add language limiting such notice to situations where the new method of assignment leads to a substantive difference in outcome (*e.g.*, a 50 percent or more change in North Carolina-assigned receipts).

Secretary’s Authority to Adjust a Taxpayer’s Return (17 NCAC 05G.0503) – COST is concerned that the Department’s proposal provides six criteria by which a tax agency can retroactively challenge a taxpayer’s assignment of receipts or reasonable approximation methodology, including if “the method of approximation employed by the taxpayer is not reasonable...” This one-sided approach is particularly troubling given the novelty of the “reasonable approximation” rules and the likely learning curve companies will embark on as

² The MTC Hearing Officer’s report is available at: [http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Public-Hearing-3-2016/Hearing-Officer-Report-General-Allocation-and-Appportionment-Regs-\(revised\).pdf.aspx](http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Public-Hearing-3-2016/Hearing-Officer-Report-General-Allocation-and-Appportionment-Regs-(revised).pdf.aspx).

they try to comply with these rules. In order to provide parity, the proposed rules should be changed to allow companies to amend returns, where necessary, to modify their reasonable approximation methodology.

As a result, COST suggests the following be added either to 17 NCAC 05G.0503 (concerning the Secretary's Authority) or to 17 NCAC 05G.0504 (concerning a taxpayer's prospective changes):

However, the taxpayer may adjust its assignment or receipts on a previously filed return (through the form of an audit adjustment, amended return, abatement application, or otherwise) to reflect another reasonable approximation method if the taxpayer does so consistent with the rules or standards provided in this Subchapter).

“Five Percent” Limitation on Safe Harbor (17 NCAC 05G .1004 and .0904) – COST is also concerned by the “five percent” rule that restricts a taxpayer from assigning receipts to the customer's billing address if its sales to one customer exceed five percent of its total receipts. This requirement places an undue constraint on a rule that otherwise encourages flexibility and ease of compliance. COST recommends eliminating the five percent limitation in each place where it occurs.

License of a Production Intangible (17 NCAC 05G .1103) – The Department's proposal provides that “[i]f the actual use of intangible property pursuant to a license of a production intangible takes place in part in North Carolina, the entire use is in the State except to the extent that the taxpayer is able to demonstrate that the actual location of a portion of the use takes place outside North Carolina.”

This places an undue burden on the taxpayer to refute the presumption. The above-cited language should be eliminated, and the assignment of receipts from the source of income should be put on an equal footing with other types of intangibles.

“Look-through” Requirements for Certain Services and Intangibles (17 NCAC 05G.0905 and 17 NCAC 05G.1102) – The Department's proposal includes two “look-through” rules that require taxpayers to look beyond their direct customers to the location of ultimate end-users or consumers. Specifically, taxpayers providing services that are delivered electronically through or on behalf of a customer are required to source receipts from such services based on the location not of the taxpayer's direct customer but on the location of the ultimate end-user of the service. In addition, taxpayers licensing marketing intangibles are required to source receipts from such licenses based on the location not of the licensee but of the ultimate consumers of the licensee's products. In both cases, the taxpayer likely will not know the location of end-users or consumers with whom the taxpayer has no direct relationship. Accordingly, the proposed rules require taxpayers to source such receipts based on proxies such as the ratio of the State's population relative to the population of the entire area covered by the services or intangibles in question. Such proxies could produce distorted results.

Even if taxpayers wishing to avoid such distorted results seek to purchase information about the location of end-users or consumers from their direct customers, such information may not be available because the direct customer either lacks the information or views the information as a proprietary trade secret. COST believes that taxpayers should be able to comply with the

sourcing rules based on information in their own business records, such as the location of the taxpayer's direct customer, rather than be forced to either accept a distorted result or seek information from third parties to potentially produce a more accurate result. In many cases, this information may not even be available from third parties. COST therefore recommends that taxpayers be allowed to look no further than the location of their direct customers in sourcing receipts to North Carolina.

Potential Application of "Professional Services" Sourcing Rules to Banks (17 NCAC 05G.1004) – Finally, COST is concerned that the sourcing rules for "other" professional services described in 17 NCAC 05G.1004 could be interpreted to apply to certain services provided by banks, creating confusion with the operation of proposed market-based sourcing rules for banks under G.S. 105-130.4A. To avoid such confusion, COST suggests amending the proposal to specifically exclude services provided by banks from the operation of 17 NCAC 05G.1004.

Thank you for considering COST's comments on the Department's proposed market-based sourcing rules, and please contact me with any questions.

Sincerely,

A handwritten signature in black ink, appearing to read 'F. Hogroian', with a large, stylized flourish extending to the right.

Ferdinand Hogroian

cc: COST Board of Directors
Douglas L. Lindholm, COST President & Executive Director