BEFORE THE DEPARTMENT OF REVENUE
OF THE STATE OF MONTANA

In the matter of the adoption of New Rules I though VI, and the amendment of ARM 42.26.201, 42.26.202, 42.26.203, 42.26.204, 42.26.205, 42.26.206, 42.26.207, 42.26.208, 42.26.210, 42.26.229, 42.26.230, 42.26.231, 42.26.232, 42.26.236, 42.26.241, 42.26.251, 42.26.252, 42.26.253, 42.26.254, 42.26.257, 42.26.259, 42.26.263, 42.26.302, 42.26.307, 42.26.308, 42.26.309, 42.26.312, 42.26.401, 42.26.602, 42.26.605, 42.26.606, 42.26.702, 42.26.704, 42.26.705, 42.26.802, 42.26.805, 42.26.807, 42.26.902, 42.26.903, 42.26.904, 42.26.905, 42.26.1002, 42.26.1003, 42.26.1102, 42.26.1103, 42.26.1202, and 42.26.1204 pertaining to the allocation and apportionment of income of multistate corporate taxpayers necessitated by House Bill 511, L. 2017 Also, in the matter of the adoption of New Rule VII (Finnigan Rule) and related amendment of ARM 42.26.255 and repeal of ARM 42.26.511 (Joyce Rule) pertaining to the department's method of administering the corporate income tax regarding unitary multistate taxpayers whose Montana activity is reflected through multiple entities	)	NOTICE OF ADOPTION, AMENDMENT, AND REPEAL

TO: All Concerned Persons

1. On October 13, 2017, the Department of Revenue published MAR Notice No. 42-2-985 pertaining to the public hearing on the proposed adoption, amendment, and repeal of the above-stated rules at page 1790 of the 2017 Montana Administrative Register, Issue Number 19.

2. On November 2, 2017, a public hearing was held to consider the proposed adoption, amendment, and repeal. Bob Story, Montana Taxpayers Association,

appeared and testified at the hearing. Other members of the public attended the hearing but did not testify. Written comments were received from Steve Turkiewicz, Montana Bankers Association, and Walter J. Kero, CPA.

3. The department adopts New Rule II (42.26.246), New Rule III (42.26.247), New Rule IV (42.26.248), New Rule V (42.26.249), New Rule VI (42.26.250), and New Rule VII (42.26.260), amends ARM 42.26.201, 42.26.202, 42.26.203, 42.26.204, 42.26.205, 42.26.206, 42.26.207, 42.26.208, 42.26.210, 42.26.229, 42.26.230, 42.26.231, 42.26.232, 42.26.236, 42.26.241, 42.26.251, 42.26.252, 42.26.253, 42.26.254, 42.26.255, 42.26.257, 42.26.259, 42.26.263, 42.26.302, 42.26.307, 42.26.308, 42.26.309, 42.26.312, 42.26.401, 42.26.602, 42.26.605, 42.26.606, 42.26.702, 42.26.704, 42.26.705, 42.26.802, 42.26.805, 42.26.807, 42.26.902, 42.26.903, 42.26.904, 42.26.905, 42.26.1002, 42.26.1003, 42.26.1102, 42.26.1103, 42.26.1202, and 42.26.1204, and repeals ARM 42.26.511, as proposed, effective January 1, 2018.

4. Based upon the comments received, the department adopts New Rule I (42.26.245) as proposed, effective January 1, 2018, but with the following changes from the original proposal, new matter underlined:

<u>NEW RULE I (42.26.245) NUMERATOR OF RECEIPTS FACTOR - SALES OTHER THAN SALES OF TANGIBLE PERSONAL PROPERTY - MARKET BASED SOURCING</u> (1) and (2) remain as proposed.

(3) Methods with respect to the exclusion of receipts from the receipts factor.

(a) The receipts factor only includes those amounts defined as <u>gross</u> receipts under ARM 42.26.202.

(b) through (4) remain as proposed.

5. The department has thoroughly considered the comments and testimony received. A summary of the comments received and the department's responses are as follows:

COMMENT 1: Mr. Story commented that the Montana Taxpayers Association appreciates the extensive work the department did to develop and amend rules to implement House Bill 511, L. 2017. They realize that the major change in corporate income tax policy adopted with the passage of this legislation necessitates significant modification to the accompanying rules. And, while the proposed rule changes are lengthy, much of it is substitution of words and terms. However, they do have some questions or concerns about a few of the major changes.

RESPONSE 1: The department appreciates the Montana Taxpayers Association's understanding of its efforts to implement the new legislation.

COMMENT 2: Mr. Story commented that the rules are difficult to understand and may create confusion and potential noncompliance by taxpayers during the initial years of implementation and they hope the department will undertake an

extensive education program to help tax practitioners and taxpayers understand the new policy and the effects on them.

New Rule I provides the taxpayer with direction as to how to report and assign their receipts, which is helpful, but it is technical and may be confusing to anyone but a practitioner who works extensively in this area. The rule appears to allow a taxpayer some leeway in making decisions, but has the potential of giving the taxpayer a false sense of security when reporting. The potential for the department to find disagreement, and therefore audit and penalize, is significant.

RESPONSE 2: The 2017 Montana Legislature passed House Bill (HB) 511, requiring corporate income tax taxpayers to use a market sourcing approach for assigning receipts for purposes of the receipts apportionment factor. The new language added by HB 511 is modeled after the Multistate Tax Commission's (MTC) Revised Model Compact, Article IV. Likewise, the language as proposed in New Rule I is modeled after apportionment regulations adopted by the MTC addressing the sourcing of receipts using the market sourcing approach.

The department believes it is necessary to use language consistent with that used in HB 511 when providing guidance to taxpayers on its implementation. The department also recognizes that several western states with similar multistate taxpayers, such as Utah and California, have used market sourcing for some time and have regulations in place that are similar to those proposed by the department in this rulemaking. Many of these multistate taxpayers are familiar with market sourcing and issues that arise. The department does not foresee the technical nature of New Rule I as being a large problem for those taxpayers affected by HB 511.

COMMENT 3: Mr. Story commented that New Rule I(3)(a) talks about receipts, as defined under ARM 42.26.202, but the only definition of receipts in that rule is under "gross receipts." Is that the definition being referenced here?

RESPONSE 3: Yes. "Gross receipts" is the definition intended to be referenced in this section of the rule. The department has amended New Rule I(3)(a) to read "the receipts factor only includes those amounts defined as gross receipts under ARM 42.26.202."

COMMENT 4: Mr. Story commented that New Rule I(4)(a) references 15-31-312, MCA, a statute that was amended in 2017 to refer to the MTC articles under 15-1-601, MCA. This makes for a two-step process to determine the criteria to be complied with. There should be a reference to the compact sections. This is a recurring issue with the rule.

He further commented that ARM 42.26.231 through 42.26.241 addresses the property and payroll factors of the three-factor formula. These rules apparently need to be revised and maintained, due to statutory language requiring their use, but they again reference statutes that were amended to reference the MTC compact and therefore create a two-step process to determine what the law says.

RESPONSE 4: Referencing the compact in Title 15, chapter 31, part 3, MCA, was discussed at length within the department during the legislative session. It was ultimately decided, and recommended to the legislature, that it is best to keep the compact intact in its current location and also retain the statutes in Title 15, chapter 31, part 3, MCA. When drafting these administrative rules, the issue arose again in references within the rules. Although taxpayers will be directed to chapter 31, and then on to the compact, the department believes it is important to keep the references within the administrative rules to chapter 31. The legislature did not repeal the statutes in chapter 31, so changes may be made in future legislative sessions. If references are made directly to the compact, taxpayers may miss changes that affect them that are addressed in chapter 31.

COMMENT 5: Mr. Story commented that New Rule IV is extensive and the department has done a good job in trying to lay out the explanation as to how various services will be accounted for. However, because this is a significant change in policy, he hopes the department will be judicious in its application for a period of time until taxpayers are informed of the new policy and have had time to adapt to it. He stated he would think there would be a significant number of out-of-state people who are now going to have nexus in Montana and need to pay taxes, yet don't know it, and asked how they will find out.

RESPONSE 5: The 2017 Montana Legislature passed House Bill (HB) 511, requiring corporate income tax taxpayers to use a market sourcing approach for assigning receipts for purposes of the receipts apportionment factor. The department proposed New Rule IV not to implement a change in department policy, but rather to provide essential guidance to taxpayers regarding a significant change in Montana law. New Rule IV provides this guidance for various types of receipts under a market sourcing approach. The department has no control over when the new law goes into effect. House Bill 511 is effective for tax periods beginning on or after January 1, 2018. This administrative rule process helps put taxpayers on notice of these changes. In addition, the department will address the law changes in instructions to the corporate income tax forms.

House Bill 511 does not impose new nexus requirements. However, there may be taxpayers that have nexus in Montana but prior to HB 511 did not have any activity reported in the apportionment factors, so they did not have a tax liability in Montana. Under the provisions of HB 511, these taxpayers may now have receipts allocated to Montana in the apportionment factor, creating a tax liability.

The department recognizes that several western states with similar multistate taxpayers, such as Utah and California, have used market sourcing for some time and have regulations in place that are similar to those proposed by the department in this notice. Many of these multistate taxpayers are familiar with market sourcing and issues that arise.

COMMENT 6: Mr. Story commented that he believes the accounting for the sale and use of intangible property, in New Rule V, will create the largest probability for taxpayer misunderstanding resulting in compliance issues. This is the area that was articulated as the major need for the change in policy from cost of performance

to market sourcing. Again, the department appears to have done a lot of work to create rules to clarify the situation, but there will be some confusion for many taxpayers who are unaware of the new policy and its implications on their businesses.

RESPONSE 6: This administrative rulemaking process helps put taxpayers on notice of these changes and provides specific guidance relating to sourcing of sales of intangible property. In addition, the department will address the law changes in instructions to the corporate income tax forms.

COMMENT 7: Mr. Story commented that New Rule VI appears to be where the throw-out portion of the new law appears. A throw-out provision distorts the concept of market based apportionment. This provision is broader than what was explained to the legislature during the presentation of this concept.

RESPONSE 7: The department does not feel that the throw-out provision in New Rule VI distorts the concept of market based apportionment. The throw-out provision is limited to those receipts that do not meet the definition of gross receipts found in ARM 42.26.202, receipts where the place of sale cannot be determined or reasonably approximated, and receipts to states where the taxpayer is not taxable. These receipts would not be reported in the numerator of any state and are properly excluded from the sales denominator to prevent distortion of the sales factor. Section 15-1-601, Article IV, (3)(b), MCA, provides clarification that a taxpayer is considered taxable in another state if that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not do so.

COMMENT 8: Mr. Story commented that New Rule VII is a major change, by rule, in the way the department taxes multistate entities. This policy was never discussed during the adoption of House Bill (HB) 511. While the application of Finnigan may be in line with the basic concept of HB 511, it is another major policy change that was not vetted by the legislature. This rule also references the three-factor formula for apportionment. If the state were truly going to a sales based apportionment policy, a single sales factor should be adopted to provide equal treatment of taxpayers. If the goal is to establish nexus for taxation for sales into Montana by basically using a sales factor formula, the same formula should be used to tax entities in Montana that only sell out of Montana.

RESPONSE 8: The department's change from Joyce to Finnigan is unrelated to House Bill 511, and therefore was not addressed during the adoption of the new legislation. The application of Joyce was previously done through administrative rule and it is proper that the repeal of Joyce and adoption of Finnigan also be done through administrative rule. As provided in the reasonable necessity statement for New Rule VII, the department proposed the adoption of the rule to limit the risk of manipulation of the apportionment factors of a unitary combined group and to more accurately reflect the business activity within the state of the unitary combined

group. The adoption of a single sales factor would require a legislative change to Montana statutes, which is beyond the authority of the department.

COMMENT 9: Mr. Story commented that the new definition of "code," in ARM 42.26.202, leaves the state vulnerable to unexpected changes in the federal tax code. While this may be a convenience for taxpayers, it places the state at risk if major changes are made to the federal code that automatically impact the Montana tax system. He further commented that the proposed definition of "intangible property" is extensive, but also open ended. It is appropriate that the department recognizes the breadth of intangible property, and the potential for that type of property to expand.

RESPONSE 9: There are currently many references within existing statutes and administrative rules citing the Internal Revenue Code (IRC), as currently written and subsequently amended. The department believes it is necessary to be uniform with the IRS and is tied to the code as currently written or amended. The department understands the need to keep current with the federal tax code and the potential need to decouple from changes that may have an adverse effect on state revenues. In most cases, the ultimate decision on whether to decouple from the IRC rests with the legislature. The department acknowledges the need to remain up-to-date on the definition of intangible property and will amend the definition as needed.

COMMENT 10: Mr. Story commented that his recollection of the promotion of House Bill 511 was that it was to deal with the sale of intangible property. Yet the rules applying to tangible property sales are also being modified to treat those sales the same as intangible property sales. ARM 42.26.255(10) appears to allow the taxation of income from sales into a non-tax state. If Montana was truly going to a market based system, then that income should not be taxable in Montana.

RESPONSE 10: The amendments to ARM 42.26.255 are not implementing House Bill (HB) 511 and do not provide provisions of a market based system. ARM 42.26.255 addresses sales of tangible personal property – sales that are not addressed in HB 511. The proposed amendments to this rule implement the change from Joyce to Finnigan.

COMMENT 11: Mr. Story commented that treating certain software transactions as a sale of tangible property, as proposed in ARM 42.26.263(4), may create conflict or confusion with the properties described in the definition of intangible property.

RESPONSE 11: The language in the rule relating to software is modeled after apportionment regulations adopted by the Multistate Tax Commission. The department agrees with this treatment and wants to remain uniform with other states that have adopted the Multistate Tax Commission model regulations.

COMMENT 12: Mr. Turkiewicz commented that as stated in the department's reasonable necessity for the proposed adoption of New Rule VII, the Finnigan Rule,

Montana has had a long standing policy of following the Joyce approach to taxation, which is consistent with statute requiring combined reporting. The department's proposed change to the Finnigan approach effectively adopts consolidated reporting and is a major tax policy change that was not part of the legislature's consideration of House Bill 511, L. 2017. The department should consider delaying the adoption of such a major policy change until it can be addressed by the legislature.

RESPONSE 12: Application of Joyce was previously done through administrative rule and it is proper that the repeal of Joyce and adoption of Finnigan also be done through administrative rule. As provided in the statement of reasonable necessity for New Rule VII, the department proposed adopting the new rule to limit the risk of manipulation of the apportionment factors of a unitary combined group and to more accurately reflect the business activity within the state of the unitary combined group. The change from Joyce to Finnigan is not a change to adopt consolidated reporting. The adoption of Finnigan will not affect Montana's combined reporting. The adoption of Finnigan will have an effect on the computation of the apportionment factor for a combined group.

COMMENT 13: Mr. Kero commented that he testified on House Bill 511, L. 2017, before it was enacted, and still has several concerns regarding this legislation. The legislation and the proposed rules do not address a major weakness in the law. There is no limitation in law or rule to prevent a taxpayer from reporting and paying tax on more than 100 percent of its taxable income to the various states. A taxpayer could end up paying tax on more than 100 percent of its income. No one state taxing a taxpayer or affiliated group of taxpayers would be concerned about levying their pound of flesh. If one state gets what they want, who cares what the other states exact. No taxpayer should have to pay tax on more than 100 percent of its income. This result is not just.

RESPONSE 13: The potential for a taxpayer to report and pay tax on more than 100 percent of its taxable income existed prior to the passage of House Bill 511 and these rules. With more states changing from cost of performance to market sourcing, the department is hopeful that the potential for double taxation will actually be reduced rather than increased.

COMMENT 14: Mr. Kero stated that previous law regarding multi-state taxation relied on the concept of physical nexus and the various courts made rulings on the physical presence concepts. This new law and regulations are adopting the new concept of "economic nexus." These rules are full of weeds and complexity. The use of terms such as "reasonable approximation," "related party customers," "billing address," and "digital goods and services" requires further definition and will likely be the subject of ongoing litigation.

RESPONSE 14: A physical presence is not required for an entity to have nexus in Montana. While establishing nexus is a fact driven process, having an economic presence in Montana can result in taxation. This is not a new concept and House Bill 511 and the rules are not establishing a new policy in this regard.

COMMENT 15: Mr. Kero commented that the header of the rule notice states that the discussion pertains to the allocation and apportionment of multi-state corporate taxpayers, but he believes the intent is to have the rules pertain to any entity form that is involved with multi-state taxpayers. The forms would include, but not be limited to, limited liability companies, partnerships, and trusts.

RESPONSE 15: Mr. Kero is correct that these rules could apply to any entity form that is involved in multi-state activity. The header of the rules was not meant to be misleading. The department's rules relating to multi-state activity are located in ARM Title 42, chapter 26, and apply to entities such as limited liability companies, partnerships, and trusts that have multi-state activity.

COMMENT 16: Mr. Kero stated that proposed New Rule IV is a huge micromanagement on steroids. There is a significant discussion about in-person services, methods of reasonable approximation, services by an electronic transmission, and secondary methods of reasonable approximation. He commented that he sees future litigation as likely because much of this new rule will butt-up against interstate commerce.

RESPONSE 16: The 2017 Montana Legislature passed House Bill (HB) 511, requiring corporate income tax taxpayers to use a market sourcing approach for assigning receipts for purposes of the receipts apportionment factor. The new language added by HB 511 is modeled after the Multistate Tax Commission's (MTC) Revised Model Compact, Article IV. Likewise, the language in proposed New Rule IV is modeled after apportionment regulations adopted by the MTC addressing the sourcing of receipts using the market sourcing approach.

The department believes it is necessary to use language consistent with that used in HB 511 when providing guidance to taxpayers on its implementation. The department also recognizes that several western states with similar multistate taxpayers, such as Utah and California, have used market sourcing for some time and have regulations in place that are similar to those proposed by the department in this rulemaking. Many of these multistate taxpayers are familiar with market sourcing and issues that arise. The department does not foresee the technical nature of New Rule IV as being a large problem for those taxpayers affected by HB 511.

COMMENT 17: Mr. Kero stated that (with the proposed adoption of New Rule VII and repeal of ARM 42.26.511) Joyce gets fired and Finnigan gets hired. This change will allow Montana to lasso in more taxpayers. He commented that he understands that the point is to reduce the ability of a unitary group of businesses to manipulate apportionment factors, however, there is no similar limitation on Montana to reduce its ability to manipulate apportionment factors. The taxpayer can appeal or go to court. He doubts that many small taxpayers who get sucked up in these new rules and legislation will be able to afford the compliance and appeal issues resulting from these 50 plus pages of regulation.

RESPONSE 17: As stated in the reasonable necessity for New Rule VII, the department proposed the adoption of the rule to limit the risk of manipulation of the apportionment factors of a unitary combined group and to more accurately reflect the business activity within the state of the unitary combined group.

COMMENT 18: Mr. Kero commented that in the proposed definition of "billing address," in ARM 42.26.202(8), the use of the term "tax avoidance" is highly objectionable. The term that should be used here is "tax evasion." "Tax avoidance" is legal and compliant with existing law whereas "tax evasion" is illegal and noncompliant.

RESPONSE 18: The definition of "billing address," including the term "tax avoidance," is the same language included in the Multistate Tax Commissions Model Apportionment Regulations and is language agreed upon by the participating states and industry.

COMMENT 19: Mr. Kero commented that he did not see any definitions of what is considered trade or business income and asked if this is a weakness in the proposed rules. Trade or business income typically relates to "apportionable" income, and non-business income typically relates to income subject to "allocation." What do you do with a "personal holding company" under these rules? Is income from a personal holding company subject to apportionment or allocation? A personal holding company is not "in business." The rules do not provide good and clear answers to those questions.

RESPONSE 19: House Bill (HB) 511 changed the term "business income" to "apportionable income" and changed the term "nonbusiness income" to "nonapportionable income." The proposed amendment to these rules updates the terms in the rules to match the changes made in statute by HB 511. The treatment of personal holding income by the department has not changed. Income from a personal holding company is considered apportionable income if it meets the definition in the statute and administrative rules.

<u>/s/ Laurie Logan</u>	<u>/s/ Mike Kadas</u>
Laurie Logan	Mike Kadas
Rule Reviewer	Director of Revenue

Certified to the Secretary of State November 27, 2017.