Montana Department of Revenue

Economic Impact Statement

For Adoption of New Rules I through IV relating to Telecommunications Services for Corporate License Taxes (MAR Notice 42-2-845)

The Montana Department of Revenue is proposing to adopt new rules for the apportionment of income to Montana by multistate corporations that provide telecommunications services. The primary purpose of these rules is to fulfill the objective in 15-31-312, MCA of ensuring that the income reported to Montana fairly represents the extent of the taxpayer's business activity in the state. The rules also seek to achieve greater equity among corporate taxpayers by treating income earned by telecommunication corporations in a similar and consistent manner as income earned by multistate corporations generally. The rules also aim to provide clear and specific guidance to telecommunications companies on how to apportion income to Montana for tax purposes.

The proposed rules provide for standard definitions for various telecommunications services that are drawn from the definitions enacted in Montana law for the Retail Telecommunications Excise Tax (RTET). The proposed rules address the issue of outer jurisdictional property—such as satellites and undersea cables—in calculating the property factor used in allocating taxable income to Montana by corporations providing telecommunications and ancillary services. The proposed property factor rule is intended to prevent the assignment of income earned in the United States (including Montana) to locations beyond the U.S. The proposed rules would require telecommunications companies to calculate their Montana sales factor to reflect sales made to Montana citizens and businesses—which is the same "market sourcing" method required of approximately 92% of 6,500 multistate corporate taxpayers and used by virtually all 8,100 Montana based corporate taxpayers. The market sourcing method recognizes the contribution of Montana sales to the earning income in this state and is the predominant method of calculating the sales factor because it fairly represent business activity in this state. This market sourcing rule would replace a "greater cost of performance method" currently allowed for a small number of multistate telecommunications companies. The department has determined that the "greater cost of performance" method typically under-represents the extent of the Montana business activity of multistate telecommunications companies and, due to its lack of clarity and consistent accountability, provides opportunities for such companies to manipulate the assignment of income among various states in ways not permitted for corporations generally.

Introduction

The four proposed rules do the following – Rule I provides definitions for the new section; Rule II provides that these rules apply to corporations providing telecommunications and ancillary services (ancillary services include call waiting, call forwarding, etc.); Rule III provides direction on reporting outer jurisdictional property for Montana tax purposes; Rule IV provides direction on calculating the sales factor based upon gross receipts from sales of telecommunications services.

The proposed rules are based upon a model rule developed by the Multistate Tax Commission (MTC), of which Montana is a member by virtue of its adoption of the Multistate Tax Compact (15-1-601, MCA). The MTC consists of member states which focus its efforts on resolving taxation issues that impact the member states. The model rule was developed during the period from 2003 through 2007 with the involvement and leadership of a number of states including Montana. The MTC conducted a public participation process which included a public hearing and opportunities for comment. According to the hearing officer's report, industry representatives provided comment, some of which was incorporated in the model language. Several states, including Illinois, Massachusetts, Michigan, Ohio, and California have already adopted the model rule or key elements of the rule. But at least 15 other states have adopted some version of the principle that allocation of sales of services should be based on market data,

not the greater cost of performance. According to the Hearing Officer's Report, the model rule is designed to be consistent with the Streamlined Sales Agreement data. The MTC also consulted with Federal Communications Commission (FCC) staff regarding FCC required reporting data.

Rule III updates the property apportionment factor for corporations providing telecommunications and ancillary services. Rule I defines outer jurisdictional property as property, such as underseas cable and orbiting satellites, that is not physically located in any particular state. Under the proposed rule, this kind of property would not be included in either Montana property or in the total amount of property used in calculating the property factor. This kind of property cannot be in the numerator of the property factor, since it is in outer space or in the ocean, not in any state, and therefore should not be in the total property denominator.

The MTC model rule updates the sales apportionment factor for corporations providing telecommunications and ancillary services. The hearing officer's report indicates that the reason for the development of the new model rule is the far greater degree of deregulation in the industry. As noted in the hearing officer's report (p.4):

> "As regulated utilities, telecommunications carriers were excluded from UDITPA's coverage. This is, therefore, the first time the Commission has considered the adoption of an appropriate apportionment formula for income arising from the sale of telecommunications and ancillary services."

Montana apportionment factor calculations for corporate license tax are based upon Uniform Division of Income for Tax Purposes Act (UDITPA). UDITPA was a model act developed in the 1950s and finalized in 1957. UDITPA was intended to reduce the issues and costs corporations may have in complying with different tax laws and definitions in the many different states.

Corporations with business activities in Montana and other states calculate the amount of taxable revenue to apportion to Montana using three factors – payroll, property, and sales – which are weighted equally. For example, a multi-state corporation with $1 million in payroll in Montana and $10 million in total payroll would have a payroll apportionment factor of 0.1 ($1 million / $10 million = 0.1). Similarly the corporation would calculate the other two factors based upon the Montana property versus total property and Montana sales versus total sales. The average of the three factors produces the total apportionment factor. The total apportionment factor is multiplied by the total taxable income to get Montana taxable income. This method was adopted to make it easier for multi-state corporations to calculate their taxable income in the states they operate, instead of requiring them to keep track of the revenues and costs associated with multiple individual transactions. The three factors - payroll, property and sales – are thought to provide a reasonable representation of a corporation's business activity in the state.

Assigning sales to a state based upon sales actually made to customers in that state—market sourcing—is the predominant method of calculating the sales factor to apportion business income. As noted above, approximately 97% of multistate corporations filing in Montana are required to calculate their sales factor on this basis because of the general provisions of corporate tax law or various rules the department has adopted over several decades.

However the original UDITPA rules provided a different method for assigning sales, other than sales of tangible personal property, to a state. Sales, such as sales of services, are treated as in-state sales if the income-producing activity is performed in the state. If the income-producing activity is performed both inside and outside the state and the greater proportion of the income-producing activity is performed in the state versus any other state, based on costs of performance, then the total amount is assigned to the state. Conversely, if the greater cost of performing a service lies in another state, then the sales of the service is not assigned to this state.

This original language is reflected in 15-31-311, MCA. However, the following section, 15-31-312, provides language allowing the tax administrator to employ another method if the allocation and apportionment provisions do not produce a fair representation of the taxpayer's business activity in the

state because it fails to recognize the contribution to corporate income from the Montana market--sales made to Montana citizens and businesses. Thus, the department has determined that the greater cost of performance for the sales factor calculation is inappropriate in the case of providers of telecommunications services—as it has several times in past decades for other service industries, including railroads, trucking, airlines, construction contracts, publishing companies, and television and radio broadcasting.

While 15-31-312, MCA provides the tax administrator the ability to modify the sales factor calculation if determined to be necessary to satisfy the "fair representation of business activity standard" state law, it does not inform these taxpayers in advance as to how to do their tax calculations to meet this standard. Besides exposing the taxpayer to challenges, reviews and audits of their business workpapers and tax returns, not providing clear guidance upfront is inconsistent with the Montana Taxpayer Bill of Rights. The Montana Taxpayer Bill of Rights, 15-1-222 (14) states "the taxpayer has the right to assistance from the department in complying with state and local tax laws that the department administers;".

The telecommunications sector is complex and has changed over time, especially since the break-up of the Bell system in the early 1980s and the passage of the 1996 Telecommunications Act. Besides the legal and business framework, the technology has changed dramatically, creating new products and services, and allowing companies to computerize and centralize operations. So the MTC model rules fill a void by providing definitions and property and sales factor calculation information, including clarifying that the greater cost of performance method is not appropriate for telecommunications services by multistate corporations.

Montana has retained the original equally-weighted three-factor formula developed more than 50 years ago, but over time has found it necessary to adopt rules specific to an industry or activity to achieve the goal of using formulas which fairly represent the extent of the taxpayer's business activity in the state. To date these rules have addressed railroads, trucking, airlines, construction contracts, publishing companies, and television and radio broadcasting. The rules specific to an industry or activity were developed through the MTC as well, and are intended to provide better clarity and equity for taxpayers and greater efficiency for both the taxpayers and the tax administration agency.

A base assumption in the following answers to the questions required by an EIS is that state law, 15-31-312, MCA, will be followed by the tax administrator. That section states:

> **15-31-312. Apportionment formula -- unitary business provisions.** If the allocation and apportionment provisions of this part do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or *the tax administrator may require*, in respect to all or any part of the taxpayer's business activity, if reasonable:
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> (1) separate accounting, provided the taxpayer's activities in this state are separate and distinct from its operations conducted outside this state and are not a part of a unitary business operation conducted within and without this state. For purposes of this part, a "unitary business" is one in which the business conducted within the state is dependent upon or contributory to the business conducted outside this state or if the units of the business within and without this state are closely allied and not capable of separate maintenance as independent businesses.
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> (2) the exclusions of any one or more of the factors;
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> (3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
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> (4*) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.* (Italics added)

Economic Impact Statement

►The class of persons affected by the proposed rule, including classes that will bear the costs of the proposed rule and classes that will benefit from the proposed rule. (2-4-405(2)(a), MCA)

This rule applies to corporations who provide telecommunications services and who are doing business in the state of Montana and also in other states. It addresses apportionment of net business income and exclusion of outer jurisdictional property for Montana corporate tax purposes by those telecommunications firms that do business in more than one state. If the telecommunications corporation does business in multiple states, including Montana, this rule may affect calculation of the overall apportionment factor used to apportion income to Montana for corporate tax purposes because the rule removes the option of calculating the sales ratio using the greater cost of performance method for these corporations in many instances and it eliminates outer jurisdictional property in calculation of the property factor.

The department has determined that an estimated 15 multistate telecommunications corporations may be materially affected by the proposed rules. Another 32 multistate telecommunications corporations may be minimally affected. This estimate is based on returns from 245 companies that filed Retail Telecommunications Excise Tax returns for the last quarter of FY 2010. Of these 245 companies, more than 190 are judged not to be affected at all because they operated wholly within Montana and are not subject to income apportionment; they are cooperatives or pass-through entities instead of corporations; or they have little or no sales in Montana. The 32 multistate telecommunications corporations that may be minimally affected had Montana sales between $25,000 and $250,000 per quarter. The 15 multistate telecommunications corporations that may be materially affected had Montana sales of $250,000 or more per quarter.

In terms of the classes that benefit, for telecommunications firms doing business only in Montana, the proposed rule has no direct impact since 100% of their net income is earned in the state and is taxable only in the state, both currently and under this rule. However this class benefits indirectly because the rule change improves equity in taxation, vis-á-vis multi-state corporations providing telecommunications services. Equity in taxation means that taxpayers with comparable sales or income and similar circumstances (for example, not eligible for different tax credits) are taxed similarly.

Currently equity in taxation between single state and multistate companies offering telecommunications services is not guaranteed. For example a multistate firm who is providing services in multiple states, including Montana, and who has less than half of its costs for performing the service inside Montana may argue that none of its sales of services in Montana should be in the sales factor calculation. If fact, the Hearing Officer's report (p. 8-9) includes the following from the State of California:

> "…Recently, some members of the telecommunications industry have asserted claims that the numerator of the sales factor in California should be zero, even to the exclusion of intrastate calls, because the greatest cost of performance is located in another state."

The Montana only company does not have the choice to lower its taxable income by claiming that in-state sales should be excluded. All of its net income is taxable.

A second equity issue involves access to the capital markets and capital. If a multistate corporation can reduce its taxes relative to its in-state competition and the rest of its expenses remain the same, the multistate corporation creates a relative advantage in obtaining capital in the markets both in terms of cost and availability. This advantage does not just play out in the telecommunications sector, but improves the multistate corporation's ability to compete against all businesses in the capital markets. This is inconsistent with the state interest in maintaining competitive neutrality. Approximately 14,000 corporations filing tax returns in Montana—either multistate corporations or Montana only corporations that already report using Montana market sales for tax apportionment purposes—will benefit from better competitive equity when multistate telecommunications corporations are required to report sales on the same market basis.

►A description of the probable economic impact of the proposed rule upon affected classes of person, including but not limited to providers of services under contracts with the state and affected small businesses, and quantifying, to the extent practicable, that impact. (2-4-405(2)(b), MCA)

The department does not anticipate the market-based sales factor calculation will have a direct effect on small businesses since the fifteen multistate corporations that may be affected cannot be characterized as small businesses. Small Montana-based telecommunications businesses will benefit when competing with larger multistate businesses for contracts or when procuring resources such as capital and equipment from a more equitable tax treatment. The rule excluding use of outer jurisdictional property – satellites and underseas cable - in the property factor is not expected to affect small businesses.

Depending upon how the multistate telecommunications taxpayer calculated the sales factor, this may have some impact on its taxes owed or tax refunds. In order to determine the economic impact upon this class, a fairly extensive review of the corporate filings, and possibly additional information, may have to be requested from the companies in order to determine the economic impact on the class. In the absence of clear rules corporations can and do develop their own methods which may or may not be consistent with state law. The one case where an effect is known, was a change in the low six figures (individual taxpayer information is confidential). Without substantial additional audit resources devoted to the question, which the department cannot spare, it is not certain how many other corporations would be affected or if they are affected in the same way.

As discussed above, the current policy allows a small set of taxpayers to choose the greater cost of performance method for calculating the sales factor is not consistent with competitive neutrality. It puts Montana providers at a competitive disadvantage, both in the private marketplace and in terms of securing contracts to provide services to the state. It distorts the cost of capital and access to capital for all corporations except for the select few, relative to the competitive norm. Revising this fifty-three year old concept for today's reality forwards the state goal of competitive neutrality.

The change in data is not expected to impose substantial costs on the taxpayers in terms of being able to comply with state tax rules. In Montana companies providing telecommunications services to retail customers are required to collect retail telecommunications excise taxes (RTET) based upon sales, as well as PSC, Consumer Counsel Tax and other taxes, either based upon sales or customer information. The department modified the MTC model rule definitions in order to utilize definitions already established in Montana law for the RTET. In fact, this modification represents the only substantial revision of the MTC model, and the intent was to reduce the cost to taxpayers. A number of other states have adopted the model rules for telecommunications services, including Massachusetts, Michigan, Illinois and Ohio, and at least 16 other states have replaced the greater cost of performance with market based sales calculations for services. Furthermore, the MTC Hearing Officer's report notes that the model rules were drafted to track as closely as possible the sourcing rules for sales and use tax purposes in the Streamlined Sales and Use Tax Agreement. The MTC Hearing Officer's report also notes that FCC staff familiar with FCC reporting requirements for providers of telecommunications services were consulted in the process of developing the model rules.

Increased clarity in how these apportionment factors are to be calculated may reduce the costs of properly complying with state tax law for these taxpayers.

►The probable costs to the agency and to any other agency of the implementation and enforcement of the proposed rule and any anticipated effect on state revenue. (2-4-405(2)(c), MCA)

The department expects that the rules will provide clarification and guidance to the affected taxpayers and will make the process of ensuring that state tax law is complied with as efficient and effective as possible.

The department does not anticipate increased costs due to implementation to this agency or to other agencies, and has not projected additional revenue due to this rule. However if companies affected are profitable in the future, there may be some additional revenue which goes directly to the state general fund. If this sector is not profitable and sustains losses, the net operating losses allocated to the state will be greater under this rule. Under current law Montana allows corporations to claim current year losses against the three prior years' net income, and file amended tax return(s). Adoption of the rule may therefore, lower state revenue, when there are higher net operating losses during an economic recession.

►An analysis comparing the costs and benefits of the proposed rule to the costs and benefits of inaction. (2-4-405(2)(d), MCA)

The costs of the rule change fall into two categories – compliance costs and changes in taxes owed due to the rule change. The costs accrue to two general parties – taxpayers and the tax administrator.

Over the last 5 years, the department's corporate license tax audit, penalty and interest have averaged over $20 million per year - $13.4 million from audits and $6.7 million from penalties and interest. Shifting resources to focus more on a particular industry group, when the issue can be addressed by rules, is not an effective use of limited state resources and risks loss of revenue from the state's existing audit program. Another potential consequence of this alternative may be an increase in complaints or litigation, raising costs for the DOR and taxpayers, and potentially also putting state revenues at risk.

Taxpayer costs will be reduced because staff time taken up with questions from the tax administrator, audit work, protests, appeals and litigation will be reduced.

The costs of compliance will be reduced for the tax administrator since the need to review and audit taxpayer workpapers and tax returns should be reduced. The clarity brought to the process should reduce the tax administrator's litigation and appeal costs. It will also reduce the risk that the state's tax policy (and tax revenue) will be eroded over time by inadvertent or conscious failure to use formulas that fairly represent the extent of the taxpayer's business activity in the state.

►An analysis that determines whether there are less costly or less intrusive methods for achieving the purpose of the proposed rule. (2-4-405,(2)(e), MCA)

The department does not believe that there is a less costly or intrusive method for achieving the purpose of the proposed rule. The likely alternative is to increase the frequency and depth of review of this group of corporations' tax returns to determine if the apportionment of income adequately and equitably reflects the level of business activity within the state. Conduct increased audits of multistate corporations in this industry would be significantly more intrusive of corporate business operations than adopting this rule.

The other alternative is to do nothing and the DOR believes that doing nothing does not support state law or state tax policy.

►An analysis of any alternative methods for achieving the purposes of the proposed rule that were seriously considered by the agency and the reasons why they were rejected in favor of the proposed rule. (2-4-405(2)(f), MCA)

Please see the response above.

►A determination as to whether the proposed rule represents an efficient allocation of public and private resources. (2-4-405(2)(g), MCA)

The department anticipates that the proposed rule will improve efficiency in terms of public resources and has the potential to improve allocation of resources in the private arena. The proposed rule improves efficiency for the DOR because it clarifies and standardizes the filing method for all members of the industry. Right now taxpayers can and do file using different methodologies. This proposed rules uses information that is available to this group of taxpayers already. As noted already, some twenty or more other states have adopted this rule or a similar, broader rule applying to all corporations. The state administers other telecommunications taxes which require companies to maintain market sales data.

In terms of the allocation of private resources, the rule, as described above, is judged to improve competitive equity within the telecommunications industry and potentially in corporate capital markets generally. Any improvement in competitive equity improves the efficiency of the capital markets in allocating private capital to its best uses.

►Quantification or description of the data upon which subsections (2)(a) through (2)(g) are based and an explanation of how the data was gathered. (2-4-405(2)(h), MCA)

The information on which the responses above were based includes discussion with department audit staff and legal staff. Also the following MTC documents: Report of the Hearing Officer (April 2008) and the Supplemental Report of the Hearing Officer (May 2008) Regarding the Proposed Model Regulation for Apportionment of Income from the Sale of Telecommunications and Ancillary Services were reviewed. Information was also gathered from the MTC and a number of other state tax administration agencies regarding use of market versus cost of performance for services. The most recent corporate license tax return masterfile (2008), updated in May 2010, was used for the total number of corporations filing in Montana and the number with Montana addresses. The information on corporate gross revenue and retail revenue is from the Retail Telecommunications Excise Tax return data for quarter 4, FY 2010 and the audit, penalty and interest revenue is from SABHRS – the statewide accounting, budgeting and human resource system.