

Demystifying the Sales Factor: Conduit Receipts

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In this article, which is part of a series on the sales factor, the authors examine issues that might develop in a transaction, whereby a taxpayer collects funds as a conduit for payment to another party.

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I. Introduction

This is the sixth article in a series on the composition of the sales factor and the potential tax saving opportunities hidden within state statutes and regulations. As more states shift to a single or more heavily weighted sales factor, it is important for taxpayers to understand the intricacies of the sales factor and the opportunities that exist in computing it. This article will focus on issues that could arise and opportunities that may be available for conduit receipts.

This issue has arisen frequently in our practices, and arguments can be made to exclude conduit receipts from both the numerator and the denominator of the sales factor based on the federal claim of right doctrine. That may present a significant opportunity for taxpayers in many states.¹

¹While beyond the scope of this article, the exclusion of conduit receipts from the sales factor may also prove useful to taxpayers in states with factor presence nexus standards. To the extent conduit receipts do not constitute receipts of the taxpayer, those receipts may be excluded for purposes of determining whether that taxpayer has established nexus with the taxing jurisdiction based on its receipts in the state. *See, e.g.*, N.Y. Tax Law section 209.1(b) (effective Jan. 1, 2015).

II. Conduit Receipts

A. Defining Receipts

The sales factor is a fraction, the numerator of which is the total sales (or receipts) of the taxpayer in the state during the tax period and the denominator of which is the total sales (or receipts) of the taxpayer everywhere during the tax period.² Therefore, the first step in determining whether conduit receipts can be excluded from the sales factor is examining the definition of sales or receipts for that purpose.

Some states define sales or receipts with reference to federal gross income, meaning that a receipt must be in gross income for federal income tax purposes to be in that state's sales factor.³ In those states, it is appropriate to examine whether conduit receipts would constitute gross income for federal income tax purposes when determining whether conduit receipts should be in a taxpayer's sales factor.

Some states define sales or receipts with reference to that state's apportionable tax base, meaning that an item must be included in a taxpayer's state apportionable tax base to be included in that taxpayer's sales factor.⁴ If a state computes its apportionable tax base based on federal gross (or taxable) income, an item must constitute gross income for federal income tax purposes to be in that state's receipts factor.

²*See, e.g.*, Uniform Division of Income for Tax Purposes Act section 14.

³For example, the Multistate Tax Commission's regulations define gross receipts for sales factor purposes as "the gross amounts realized . . . on the sale or exchange of property, the performance of services, or the use of property or capital (including rents, royalties, interest and dividends) in a transaction which produces business income, in which the income or loss is recognized (or would be recognized if the transaction were in the United States) under the Internal Revenue Code." MTC Reg. IV.(2)(a)(5). *See also* W.Va. Code section 11-24-7(c)(10).

⁴*See, e.g.*, UDITPA section 1(g) (defining sales as "all gross receipts of the taxpayer not allocated under . . . this Article"); Ark. Code section 26-51-1403(a)(2) ("The receipts factor shall include only those receipts . . . which constitute business income and are included in the computation of the apportionable income base for the taxable year"); Md. Code Regs. 03.04.08.04 ("The receipts factor shall include only those receipts described in this regulation and which are included in the computation of the apportionable income base for the taxable year"); Vt. Code R. 1.5833-1(d) ("The receipts factor shall include only those receipts which constitute business income and are includable in the apportionable base for the tax year").

Therefore, it is also appropriate to consider whether conduit receipts would constitute income for federal income tax purposes when determining whether conduit receipts should be in a taxpayer's sales factor in those states.

Even if sales or receipts are defined broadly and are not explicitly tied to federal or state taxable income, a constitutionally fair apportionment formula must reflect the economic activities that contribute to the production of a taxpayer's income.⁵ To maintain parity between a taxpayer's income base and apportionment formula, a taxpayer's sales factor should include only receipts that are in the taxpayer's apportionable tax base. Receipts that are not in a taxpayer's apportionable tax base — either because the receipts are not in the taxpayer's taxable income base at all or because the receipts are from sales that generate allocable (or non-apportionable) income — should be excluded from both the numerator and denominator of the taxpayer's sales factor. Inasmuch as a state computes its apportionable tax base based on federal gross (or taxable) income, it is again appropriate to look to federal definitions of income in determining whether conduit receipts should be in a taxpayer's sales factor in those states.

B. Federal Claim of Right Doctrine

Section 61(a) of the Internal Revenue Code defines gross income as “all income from whatever source derived.” Gross income includes “all accessions to wealth that are clearly realized and over which the taxpayer has complete dominion.”⁶

Implicit in the requirement that the taxpayer has “complete dominion” is an exclusion from gross income when the taxpayer receives money under an obligation to pay the money to another on the payer's behalf:

It is well established that a taxpayer need not treat as income payments that he did not receive under a claim of right, that were not his to keep, and that he was required to transmit to someone else as a mere conduit.⁷

That principle applies regardless of whether the taxpayer receives the money first and then pays it to another person, or first pays the money to another person and is later reimbursed. In the latter situation, the taxpayer's initial payment on the payer's behalf is in the nature of a loan or an advance to the payer.⁸ Thereafter, when the payer reim-

burses the taxpayer, the taxpayer is receiving the money in repayment of the loan, which is not income to the taxpayer.⁹

That principle is also found in revenue rulings issued by the IRS. For example, in Rev. Rul. 57-60,¹⁰ as modified by Rev. Rul. 60-280,¹¹ a taxpayer needed to drive his child to school because bus service was unavailable. The taxpayer was reimbursed by the state for the expenses the taxpayer incurred in doing so. The ruling concluded that the reimbursements were not includable in the taxpayer's income because the taxpayer incurred the expenses for the local school board, which was obligated to furnish transportation to the taxpayer's child.

The well-established claim of right doctrine thus provides that for a taxpayer to recognize income for federal income tax purposes, the taxpayer must receive that income under a valid claim of right that is free of restrictions.¹² Amounts received by a trustee or agent or as a mere conduit for the passage of funds to another are not received under a claim of right and are not taxed to the trustee, agent, or conduit.

For example, in *Seven-Up Co. v. Commissioner*,¹³ the taxpayer manufactured 7-Up extract, received funds from bottling companies that purchased the extract to finance a national advertising campaign, and passed those funds on to the advertising agency. The U.S. Tax Court held that the amounts received by the taxpayer from the bottling companies for the advertising campaign were not taxable income to the taxpayer because “all the facts and circumstances surrounding the transaction clearly indicate that it was the intention of all of the parties concerned that these contributions were to be used to acquire national advertising for the 7-Up bottled beverage and for that purpose only.”¹⁴ The petitioner was to be a “conduit for passing on the funds contributed to the advertising agency which was to arrange for and supply the national advertising.”¹⁵ The Tax Court likened the taxpayer's role to that of a trustee handling the bottlers' money and noted that the commingling of the unexpended portions of the bottlers' money with the taxpayer's own funds did not destroy their identity as trust funds because the bottlers could prohibit the taxpayer from using the funds for any purpose other than advertising.

Similarly, in *Central Life Assurance Society, Mutual v. Commissioner*,¹⁶ the Eighth Circuit Court of Appeals concluded that some earnings of a taxpayer were not income to

⁵ See, e.g., *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

⁶ *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

⁷ *Martinez v. Commissioner*, T.C. Memo. 2005-213. See also *North Am. Oil Consol. v. Burnet*, 286 U.S. 417 (1932) (“If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income”).

⁸ Of course, in either situation, the taxpayer cannot deduct its expenditure, which would be inconsistent with being a conduit or making a loan.

⁹ *Canelo v. Commissioner*, 53 T.C. 217 (1969), *aff'd*, 447 F.2d 484 (9th Cir. 1971) (payments a lawyer made on behalf of his clients were treated as in the nature of loans that were not income to the lawyer when he recovered them).

¹⁰ 1957-1 C.B. 25.

¹¹ 1960-2 C.B. 12.

¹² See, e.g., *North Am. Oil Consol. v. Burnet*, 286 U.S. 417 (1932).

¹³ 14 T.C. 965 (1950).

¹⁴ *Id.* at 977.

¹⁵ *Id.* at 977.

¹⁶ 51 F.2d 939 (8th Cir. 1931).

the taxpayer for federal income tax purposes because the taxpayer secured no beneficial interest in the funds. The taxpayer in *Central Life Assurance* was a mutual life insurance company organized to take over the assets and business of another life insurance company, which issued both participating and nonparticipating plans. The contract governing the acquisition provided that the taxpayer was obligated to pay the earnings from the nonparticipating business to the former stockholders of the acquired company for a specified time frame. The court held that those amounts were not taxable income of the taxpayer and wrote that:

While, for purposes of convenience and certainty in collection of [federal income] taxes, it is sometimes provided that those who collect income for others shall pay there from the taxes thereon, yet a cardinal purpose of the income tax laws is to tax the income to the person who has the right or beneficial interest therein, and not to throw the burden upon a mere collector or conduit through whom or which the income passes.¹⁷

The court stated that it was not necessary to determine whether the relationship between the taxpayer and the former stockholders was a “full clothed trust or . . . something else” because “these earnings never became the absolute property of petitioner and it could lawfully do with them but one thing, which was to pay them in accordance with the contract. It secured no beneficial interest whatsoever from them.”¹⁸

In another example, in *Electric Energy Inc. v. United States*,¹⁹ the Court of Federal Claims held that the taxpayer, a public utility, was not liable for tax on some payments it received from the Department of Energy because those payments were amounts that the DOE was required to pay to the taxpayer’s owners (the sponsoring companies) and the taxpayer acted as only a conduit between the DOE and the sponsoring companies. Even though the payments were billed by the taxpayer to the DOE as a surcharge for electricity the taxpayer provided to the DOE, the taxpayer credited the full amount of the surcharge against amounts owed by the sponsoring companies to the taxpayer for electricity. The IRS argued that the surcharges were part of the purchase price of the electricity paid by the DOE to the taxpayer and were, therefore, income to the taxpayer and that the credits to the sponsoring companies were dividends.

The claims court stated that two well-established common law doctrines — the claim of right doctrine and the trust fund doctrine — establish that gross income does not include amounts received by a taxpayer acting as a conduit for payment to another. The court then found that the surcharge was not at the unrestricted disposal of the taxpayer

because it was to be used exclusively to reimburse the sponsoring companies. Citing the reasoning of the court in *Central Life Assurance*, quoted above, the court held that the taxpayer’s use of the surcharge was subject to restriction and therefore was not taxable to the taxpayer. The court further stated that a taxpayer’s receipt of funds in a role of agent or trustee is subject to similar restrictions because the taxpayer is a mere conduit or collector through which the income passes. Citing *Seven-Up*, described above, the claims court noted that the trust fund doctrine applies if the taxpayer is obligated to spend the amount for a specific purpose and derives no profit, gain, or any benefit from the money and found that because those elements were present, the trust fund doctrine provided further support that the surcharge the taxpayer received from the DOE was not income to the taxpayer.

C. State Treatment of Conduit Receipts

Because many states explicitly tie the definition of sales or receipts for sales factor purposes to federal gross (or taxable) income or to the taxpayer’s state apportionable tax base (which in most states is computed based on federal taxable income) and because the items in a taxpayer’s sales factor should reflect the items in the taxpayer’s apportionable tax base (which in most states is computed based on federal taxable income), conduit receipts that are excluded from a taxpayer’s federal gross income based on the claim of right doctrine should also be excluded from the numerator and denominator of the taxpayer’s sales factor.

A few states have examined conduit receipts and have reached conclusions generally consistent with the federal claim of right doctrine described above.

For example, the Massachusetts Appellate Tax Board (ATB) determined in *New England Power Service Co. v. Commissioner*²⁰ that payments received by a taxpayer as a mere conduit were properly excluded from the taxpayer’s sales factor. The taxpayer in the case had received two payments from an affiliate in connection with fuel purchased by the affiliate for use at its electric power plant: a payment for the cost of fuel and a markup. The cost of fuel reflected the price that third-party vendors charged the affiliate for fuel oil supplied to the affiliate. After the affiliate forwarded the cost of fuel amounts to the taxpayer, the taxpayer immediately remitted the money to the third-party vendors as payment for the fuel oil the vendor had previously supplied to the affiliate. The markup payments reimbursed the taxpayer for losses incurred in oil and gas exploration and production activities conducted outside of Massachusetts for the affiliate’s benefit. The arrangement between the taxpayer and the affiliate was instituted primarily to facilitate external funding and to comply with SEC concerns regarding the affiliate’s rate payers.

¹⁷*Id.* at 941 (citations omitted).

¹⁸*Id.* at 941.

¹⁹13 Cl. Ct. 644 (1987).

²⁰Dkt. nos. F233000, F240556, F250895, and F250896 (Mass. App. Tax Bd. Feb. 14, 2000).

The ATB said that the taxpayer did not actually supply fuel (or sell tangible personal property) to the affiliate. Instead, the affiliate purchased the fuel from third-party vendors, and the taxpayer, for legitimate business reasons and purposes, “served as a mere conduit for the payment of a portion of the fuel oil purchased and delivered to [affiliate] by the unrelated third-party vendors.” Therefore, the ATB ruled that the cost-of-fuel payments were not includable in the numerator or denominator of the taxpayer’s sales factor. Also, the ATB found that the markup payments were not includable in the numerator of the taxpayer’s sales factor because they were not for sales of tangible personal property or for income-producing activities conducted within Massachusetts. Curiously, the ATB determined that the issue of whether the markup payments should be in the denominator was moot given the findings regarding the numerator.

The California State Board of Equalization has also applied the federal claim of right doctrine in the corporate income tax context, finding that “the recipient of income who is a mere conduit, who lacks unfettered control over the income or is bound to pay it over to others and who receives no benefit or possibility of gain there from, may not be taxed on that income.”²¹ As previously explained, based on principles of fair apportionment (and in some states, based on the definition of sales or receipts), items excluded from a taxpayer’s apportionable tax base should also be excluded from a taxpayer’s sales factor.

Similarly, the Indiana Court of Appeals has held that when a taxpayer is “merely acting as an agent . . . in collecting payments . . . the payments do not constitute gross income” to the taxpayer.²² The Indiana Department of Revenue has also recognized that receipts can be excluded from a taxpayer’s apportionable tax base and sales factor if the taxpayer is a “mere conduit collecting . . . the same amount that it pays.”²³ However, the DOR has also concluded that if a taxpayer makes a profit on a transaction, the taxpayer has an interest in the receipts (and is not a mere conduit) such that the receipts should be in the taxpayer’s Indiana receipts factor.²⁴

The Indiana DOR’s conclusion is interesting. It suggests that even though a taxpayer may receive a portion of funds as a mere conduit, all of the funds received as part of that transaction are receipts of the taxpayer includable in the taxpayer’s apportionment factor if the taxpayer makes a profit on the transaction involving those funds.

For example, assume that representative A sells goods produced by corporation B and receives a 10 percent commission on its sales of corporation B’s products. If represen-

tative A sells \$100 of corporation B’s goods to customer C, customer C pays the full sales price of \$100 to representative A. Representative A then retains \$10 as its commission and remits the remaining \$90 of the funds to corporation B. Because representative A made a \$10 profit on the transaction, according to Indiana, all \$100 should be included in representative A’s receipts. That conclusion might be inconsistent with the federal tax treatment of representative A’s receipts, which would depend on whether representative A is merely a sales agent of corporation B (that is, a conduit to which the \$90 of receipts would be excluded from federal income under the claim of right doctrine) or a reseller that buys and then resells the goods while taking on all of the benefits and burdens of ownership (akin to a wholesaler/distributor).

The inclusion of conduit receipts in the sales factor on the basis that a taxpayer has a profit interest in those receipts may present opportunities for taxpayers that would benefit from including such receipts in the denominator but not in the numerator of their sales factors. For example, if representative A is regarded as a service provider and performs all of its sales services in state C but is computing its sales factor in state D, which sources service receipts under a greater costs-of-performance sourcing method,²⁵ representative A’s sales factor in state D would include \$100 of receipts in the denominator but nothing in the numerator.²⁶

Also, numerous questions can arise under the Indiana DOR’s profit interest rationale. What if a corporation that acts as an intermediary earns interest on funds for a brief holding period? Is that earned interest enough to constitute a profit interest in the funds such that the funds should be in the computation of the corporation’s receipts factor?

III. Conclusion

The ability to exclude conduit receipts from the sales factor altogether may create opportunities in states where those receipts would otherwise be in both the numerator and denominator of the sales factor. Also, opportunities may also be created in some states for taxpayers that act as intermediaries in transactions in which a portion of the money received is paid to another party but a portion of the money is retained by the taxpayer. Those taxpayers may have the opportunity to include the total amount received (including the portion that arguably could be classified as a conduit receipt) in the sales factor denominator but not the numerator, depending on the state’s specific sourcing provisions. ☆

²¹ *Matter of Coalinga Oil Corp.*, No. 66-SBE-034 (Cal. State Bd. of Equal. June 28, 1966).

²² *Ind. Dept. of Rev. v. Waterfield Mortgage Co. Inc.*, 400 N.E.2d 212 (Ind. App. 1980); *reh’g denied* Mar. 20, 1980.

²³ Ind. Letter of Finding No. 02-20090673 (May 1, 2011).

²⁴ *Id.*

²⁵ See Battin et al., “Demystifying the Sales Factor: Costs of Performance,” *State Tax Notes*, Jan. 20, 2014, p. 153.

²⁶ Ind. Letter of Finding No. 02-20090673 suggests that that kind of approach would not be permissible but provides no rational explanation other than to state that a taxpayer “cannot have the best of both worlds.”