2020

Letter from Jeffery M. Kadet and David L. Koontz to Internal Revenue Service (Jan. 16, 2020) on Proposed Regulations REG-100956-19

Jeffery M. Kadet
University of Washington School of Law

David L. Koontz

JEFFERY M. KADET
511 W Prospect St
SEATTLE WA 98119
(206) 285-1324
JEFFKADET@gmail.com

DAVID L. KOONTZ
401 Enchanted Hilltop Way
Austin TX 87838
(512) 838-6964
DLKOONTZ@aol.com

January 16, 2020

Internal Revenue Service
Attn: CC:PA:LPD:PR (REG-100956-19) Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: REG-100956-19

Dear Sir or Madam:

We applaud the thought and care that have gone into these proposed regulations. We hope the comments set forth below will be useful. We are happy to respond to written questions or to discuss the comments herein by phone.

Please note that the content of this submission is consistent with and expands on discussion and suggestions included in our Priority Guidance Plan submissions of June 2 and October 6, 2019, regarding Part I of Subchapter N.

1. Need to Expand Reg §1.863-3(c)(1)(i)(A) Coverage

Reg §1.863-3(c)(1)(i)(A) continues to expressly limit production activities to "those conducted directly by the taxpayer".

This express limitation must be eliminated and coverage expanded.

The current limitation, of course, is fine for an independent company that directly conducts its own business and only outsources limited production activities to unrelated persons. However, today multinational groups (MNCs) conduct much of their manufacturing through unrelated contract manufacturers, a development that was reflected a decade ago by the addition of Reg

§1.954-3(a)(4)(iv) to the "foreign base company sales income" rules.[1] This is complicated even further due to the fact that multiple group members of MNCs may each perform limited manufacturing functions in various locations around the world.

If these regulations do not address the myriad of issues covering MNC manufacturing, they will effectively exclude from the scope of the regulations a significant portion, if not the bulk, of manufacturing today. This is a major issue.

As background, MNCs typically transfer intangibles to a foreign group member (virtually always in a zero- or low-taxed jurisdiction) that in turn acts contractually as an entrepreneur that manufacturers and sells the group's products. Often, the entrepreneur group member performs few functions, other than being the contracting party, and may have few or no employees. To overcome the lack of operating personnel at the entrepreneur level, other group members around the world perform the necessary production activities directed by a central worldwide management in an integrated whole, yet these other group members act only as putative independent contractors. The physical manufacturing is often conducted by unrelated contract manufacturers and sometimes by limited-risk group members conducting the physical manufacturing as a service for the entrepreneur group member.

In the case of an MNC, very often, one or more U.S. group members perform activities that are both critical and core production functions for the foreign group member entrepreneur, a company that normally has no management or other personnel of its own involved in production. However, in the case of an independent manufacturing company, it conducts its own production and outsources only limited functions to independent contractors. Where it does outsource functions, the independent manufacturing company's own management will be fully capable of directing the independent contractors and assessing and controlling all commercial and other risks. In contrast and as noted above, the MNC entrepreneur typically lacks personnel who could

[1] There was discussion regarding the use of contract manufacturers in the context of Reg §1.863-3 when the December 11, 1995, proposed regulations (INTL-0003-95_RIN 1545-AT92) were finalized on November 29, 1996 (61 FR 60540-01, 1996-2 C.B. 47). Since that discussion, found in II.7.a.i. of the Explanation of Provisions section, may be helpful to readers of this submission, II.7.a.i. is reproduced in full in this footnote. It should be noted that this 1996 discussion about contract manufacturers was before many MNCs began using modern profit-shifting business models (described in this submission letter) that utilize centralized management, transferred intangibles, a tax-haven entrepreneur, and multiple group members, each of which perform limited manufacturing functions in various locations around the world.

> i. Contract manufacturing. Under the proposed regulations, production assets are limited to those owned directly by the taxpayer that are directly used by the taxpayer to produce the relevant inventory. These rules are intended to insure that taxpayers do not attribute the assets or activities of related or unrelated parties manufacturing under contract with the taxpayer. One commentator asked that the definition of production assets be expanded to include production assets owned by related or unrelated contract manufacturers. The commentator contends that by limiting production assets to those owned by the taxpayer, the regulations source income differently depending upon the form in which the taxpayer conducts business. Treasury and the IRS, however, believe it is appropriate to limit production assets in the apportionment formula to assets owned by the taxpayer and used by the taxpayer to produce the inventory. In addition, taxpayers generally do not know the contract manufacturer's basis in its production assets. Further, it would be very difficult to draw a clear line between contract manufacturers and other suppliers. Thus, Treasury and the IRS do not believe the source of a taxpayer's income should take into account activities of others or assets owned by others with whom the taxpayer has manufacturing arrangements. The final regulations clarify, however, that this rule does not override the single entity rules set forth under §1.1502-13 (dealing with members of an affiliated group filing on a consolidated basis), or the rules under §1.863-3(g) dealing with partnerships.

direct the independent contractors or even more generally manage the various manufacturing and commercial risks of the entrepreneur's own business. Rather, the management of these manufacturing and commercial risks resides within the U.S. group members who are putative independent contractors.

As this approach to manufacturing by MNCs is so pervasive, Reg §1.863-3(c)(1)(i)(A) must be expanded to explicitly include activities by other group members. The amendment suggested below to Reg §1.863-3(c)(1)(i)(A) will accomplish this. Note that this amendment defines production in a manner that is consistent with the regulation for foreign base company sales income in subpart F.

Suggested Amendment to Reg §1.863-3(c)(1)(i)(A)

Amend the first three sentences of this subclause to read:

> For purposes of this section, production activity means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory including activities that constitute a substantial contribution (within the meaning of section 1.954-3(a)(4)(iv)) to the manufacture, production, or construction of personal property. See section 1.864-1. Subject to the provisions in section 1.1502-13 or paragraph (f)(2)(ii) of this section, the production activities that are taken into account for purposes of sections 1.863-1, 1.863-2, and this section are those conducted directly by the taxpayer and those conducted by the taxpayer's agents and by related persons within the meaning of section 1.954-1(f) under service or similar intercompany arrangements.

If Treasury and the IRS desire to do so, they could make this change regarding related persons a rebuttable presumption. If this were done, then language could be added to say that in the event that a taxpayer establishes to the satisfaction of the Commissioner that the foreign group member exercises through its own officers and operating personnel working from its offices in its country of incorporation management and direction of an independent contractor that is a related person, then the production activities of that related person would not be taken into account.

2. Need to Expand Reg §1.863-1(b)(3)(i) Coverage

The discussion above regarding expansion of Reg §1.863-3 applies equally to Reg §1.863-1(b)(3)(i). Reg §1.863-1(b)(3)(i) should be similarly expanded to include, in addition to those production activities conducted by the taxpayer directly, "those conducted by the taxpayer's agents and related persons within the meaning of section 1.954-1(f)".

3. Need to Expand Prop Reg §1.863-3(c)(1)(ii)

Consistent with the above, amend the first sentence to read:

> Subject to the provisions of section 1.1502-13 and paragraph (f)(2)(ii) of this section, production assets include tangible and intangible assets owned directly by the taxpayer, the taxpayer's agents, and related persons (within the meaning of section 1.954-1(f)) that are directly used to produce inventory described in paragraph (a) of this section.

4. Need to Re-Think Approach to Allocation in Prop Reg §1.863-3(c)

This portion of the regulation was written decades ago and worked appropriately with an independent manufacturer that used its own plant and equipment for the production of its products. For such an independent manufacturer, it made sense to use the adjusted basis of its production assets to apportion gross income between U.S. and foreign sources. This approach can still work well for independent manufacturers.

Today, however, as explained in the section above "Need to Expand Reg §1.863-3(c)(1)(i)(A) Coverage", MNCs use contract manufacturers and foreign group member entrepreneurs that hold intangibles and contractually bear the commercial and manufacturing risks, while U.S. group members typically conduct high-value-adding portions of the production process and manage the risks the entrepreneur contractually bears.

In saying that U.S. group members typically conduct high-value-adding portions of the production process, we are not speaking of the R&D to develop the products (which of course is often substantially conducted within, or is directed and managed from, the U.S.). Rather, we are speaking of the ongoing day-to-day work that is required for physical production to occur and for risks to be managed. These ongoing day-to-day work activities and functions can include: evaluating sources of raw materials and components, negotiating with vendors, making business decisions concerning contractual terms as well as the decisions on which vendors or contract manufacturers to use, overseeing and controlling the production process as well as the levels of raw materials, work-in-process, and finished goods inventories, etc. While not all-inclusive, these are just a few of the high-value-adding functions typically conducted by U.S. group members. Reg §1.954-3(a)(4)(iv)(*b*) includes a more complete listing.

The use by MNCs of multi-group member structures with foreign group member entrepreneurs and contract manufacturers is pervasive. For such MNCs, the production-asset basis for allocating income between U.S. and foreign sources is simply not appropriate. This is because many of the high-value-adding core production and risk management functions require only office premises, desks, and computers. Where unrelated contract manufacturers are used, which is often, there would be little or no plant and equipment included in the production-asset allocation. Where there are limited-risk group member contract manufacturers owning plant and equipment, whether within or without the U.S., and U.S. group members conducting high-value-adding core production functions, managing risks and owning and/or renting only office premises, desks, and computers, the production-asset basis is terribly skewed and can only provide nonsensical results.

Reg §1.863-3 must be modernized to reflect new business models such as those using foreign group member entrepreneurs, limited-risk contract manufacturers (whether related or unrelated), and activities constituting a "substantial contribution to the manufacture of personal property" as described in Reg §1.954- 3(a)(4)(iv)(*b*). As such, consideration must be given to alternative methods of apportionment rather than basing apportionment on the location of production assets. For example, perhaps allocations based on the location of personnel (including those employed by the taxpayer, its agents, and its related parties) involved either directly in production or in the Reg §1.954-3(a)(4)(iv)(*b*) production activities could be more appropriate in such situations. Or, the personnel costs of such production-involved personnel could be used since cost may be a closer indication of relative value.

Such an approach in the regulation (e.g. based on personnel or personnel costs) could be drafted as a rebuttable presumption. Thus, allocation on this "personnel" basis would be required unless a taxpayer established to the satisfaction of the Commissioner that the adjusted basis of production assets or some other approach provided a more appropriate result.

5. Need to Retain Certain Guidance in Deleted Reg §1.863-3(c)(2)

Paragraph (c)(2) of Reg §1.863-3 has been deleted because sales activities no longer are important to the sourcing of "Section 863(b)(2) Sales". However, this paragraph also includes two items of guidance that are still relevant to post-TCJA rules focusing solely on the country of production. The first such item is:

> … However, notwithstanding any other provision, for purposes of section 863, the place of sale will be presumed to be the United States if personal property is wholly produced in the United States and the property is sold for use, consumption, or disposition in the United States. See section 1.864-6(b)(3)(ii) to determine the country of use, consumption, or disposition. …

MNCs with their many group members are free to arrange for U.S. products manufactured by one group member to be sold to a foreign group member that then resells the products to buyers that ultimately use, consume, or dispose of those products in the U.S. Such structuring transforms some of what would otherwise be U.S. source income (due to production occurring in the U.S.) into foreign source income. If §865(e)(2) does not apply to cause U.S. source treatment of the sales income, then such income could escape treatment as effectively connected income.

In such a case, where the foreign group member is not a controlled foreign corporation (CFC), profits are shifted out of the U.S. and avoid U.S. tax completely. Even if the foreign group member is a CFC so that subpart F or GILTI applies, MNCs would often pay little if any U.S. tax if they apply foreign tax credits through cross crediting. Further, as subpart F or GILTI, the §884 branch profits tax would not apply.

Whether this is added to the anti-abuse rule in Prop Reg §1.863-3(c)(3) or included elsewhere in the proposed regulation, we suggest the following language:

> Notwithstanding any other provision, for purposes of section 863, in the case of gross income from the sale of personal property sold for use, consumption, or disposition in the United States that was purchased or otherwise acquired from a related person (within the meaning of section 1.954-1(f)) who produced that property partly or wholly within the United States, the character of the gross income from the sale will be treated as income from production activity. The source of this gross income will be treated as being within the United States to the extent that the property was produced within the United States by the related person. See section 1.864-6(b)(3)(ii) to determine the country of use, consumption, or disposition.

It will be noted that the above suggested language expands the coverage of this provision so that it does not only apply to property "wholly produced" in the U.S. Given the manner in which MNCs conduct production activities within many group members and locations around the world, this appears to be a fairer and more accurate approach for both the government and taxpayers.

The second item deleted due to the elimination of paragraph (c)(2) of Reg §1.863-3 is:

> Also, in applying this paragraph, property will be treated as wholly produced in the United States if it is subject to no more than packaging, repackaging, labeling, or other minor assembly operations outside the United States, within the meaning of section 1.954-3(a)(4)(iii)(property manufactured or produced by a controlled foreign corporation).

This is guidance that is still relevant following the TCJA amendment to §863(b) and should be added to Prop Reg §1.863-3(c)(1)(i).

If this guidance is added as we suggest, then any packaging, repackaging, labeling or other minor assembly operations outside the U.S. would be disregarded and the relevant property would be treated as wholly produced within the U.S.

6. Alignment of Definition of Production Activities

Reg §1.863-1(b)(3)(ii) includes:

> … Whether a taxpayer's activities constitute additional production activities will be determined under the principles of section 1.954-3(a)(4). …

By referring to "the principles of section 1.954-3(a)(4)", a broad definition of production activities is being provided. This broad definition includes activities that constitute a substantial contribution (within the meaning of section 1.954-3(a)(4)(iv)) to the manufacture, production, or construction of personal property. In light of today's MNC manufacturing structures, this is important.

Prop Reg §1.863-3(c)(1)(i) must be similarly expanded both because it is a better approach and because there should be consistency between Reg §§1.863-1 and 1.863-3. This could be done simply by expanding Reg §1.864-1 to read as follows:

> For purposes of sections 1.861-1 through 1.864-7, the word "sale" includes "exchange"; the word "sold" includes "exchanged"; the word "produced" includes "created", "fabricated", "manufactured", "extracted", "processed", "cured", "aged", and the conduct of activities that constitute production under the principles of section 1.954-3(a)(4) through the activities of a taxpayer's employees, agents, and related persons (within the meaning of section 1.954-1(f)).

This same expansion should be included by adding to the penultimate sentence in Prop Reg §1.865-3(d)(2)(i).

7. Determination of Source of Taxable Income

Prop Reg §1.965-3(e) makes reference to Reg §§1.882-4 and 1.882-5. This of course is appropriate for foreign corporation taxpayers. However, why not also include Reg §1.873-1 for nonresident alien taxpayers who are also covered by Prop Reg §1.865-3? While nonresident alien taxpayers who have a tax home in the U.S. are not covered by §865(e)(2) and Prop Reg §1.865-3, those nonresident alien taxpayers who have no tax home in the U.S. would still be covered.

8. Dealing with MNC Integrated Business Models – Purchased and Sold or Produced and Sold

Prop Reg §1.865-3 understandably assumes a single independent taxpayer and not a group of related taxpayers that are conducting a worldwide manufacturing business in an integrated manner. In the case of a single independent taxpayer, it will normally be easy to determine whether that single taxpayer is purchasing or producing the products that it sells. Factually the issue of whether a product is produced or purchased becomes more complicated with taxpayers that are a part of MNC groups. Because of this, Prop Reg §1.865-3 needs to provide guidance for such situations.

Background

Considering all of Part I of Subchapter N, there should be acknowledgement and integration within the sourcing rules of today's reality that a high proportion of international business is conducted not by independent taxpayers, but rather by MNCs that operate with a central management that directs individual group members, each of which performs a portion of the integrated business and does not in any practical sense operate as an independent entity conducting its own business.

Prop Reg §1.865-3 itself deals with certain sales of personal property and not the full range of international business. As such, the below comments reflect Prop Reg §1.865-3's more limited scope.

Over the past several decades, increasing numbers of MNCs[2] have used profit-shifting structures that involve transfers of intangibles from U.S. group members into one or more foreign group members via licenses or cost sharing agreements (CSAs). These MNCs use integrated centrally-managed structures wherein, as noted above, each group member performs only a portion of the integrated business as merely one cog in an integrated whole.

Through the license or transfer of intangibles, the foreign group member licensee/transferee holds the rights to manufacture (or have manufactured by a contract manufacturer) certain products and to sell those products and otherwise exploit the intangible property within its defined territory.[3] This foreign group member is often labeled an "entrepreneur".

Typically, the foreign group member entrepreneur[4] (including any of its disregarded entity subsidiaries) will have personnel in many countries outside the U.S. involved in marketing, sales, and/or customer support. However, that foreign group member will normally have neither management nor other personnel who have the production knowledge, skills, or capabilities to either conduct manufacturing itself or to oversee and direct contract manufacturers. Rather, it is primarily U.S.-based group personnel within U.S. group members who have the requisite knowledge, skills, and capabilities. And it is these U.S.-based personnel who conduct the

[2] Including U.S.-based MNCs, MNCs that have conducted inversion transactions, private equity acquisitions of U.S.-based MNCs made through foreign structures, etc.

[3] In some less aggressive structures, the defined territory does not include the U.S. In other more aggressive structures, the territory includes the U.S.

[4] In the case of a U.S.-based MNC and sometimes in the case of other MNCs, the foreign group member will be a controlled foreign corporation under the subpart F rules.

production activities, make both policy and day-to-day business decisions on behalf of the foreign group member entrepreneur, and manage commercial and production risks.[5]

Yes, often there will be production-related personnel[6] at the site of a contract manufacturer, but often their principal functions will be liaison and quality control. There may also be some foreign-based personnel involved in sourcing raw materials and components from foreign suppliers and undoubtedly in some cases performing other important production functions such as controlling raw material and component inventory levels. However, even if the production functions of these foreign-based personnel are broader than liaison, quality control, and sourcing raw materials and components, they will often be few in number compared with the U.S.-based production-related personnel who conduct the full gamut of production activities.

Contractually, the foreign group member entrepreneur pays the contract manufacturer directly. The entrepreneur will presumably also pay service fees to U.S. group members for conducting the production activities. They take the position that the U.S. group members are acting as independent contractors and not as agents, partners, or joint venture participants.

Under these contractual and legal structures, a foreign group member entrepreneur is a manufacturer and reports profits commensurate with that manufacturer status. In recognition of the production role played by the U.S.-based personnel in the manufacturing process, there will be intercompany service or similar agreements as well as a license or CSA under which the foreign group member pays internally set amounts to one or more U.S. group members. Based on the U.S. group members being mere independent contractors performing some production and other support functions (in the case of a service agreement) or licensors or participants under a CSA, the payments normally reflect contractual terms that leave all commercial risk and related

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[5] What are these production activities? They can include production planning and management involving, for example, quantities of production, control of inventory levels (including raw materials, work-in-progress, and finished goods), quality control, logistics, and other functions listed in Reg §1.954-3(a)(4)(iv)(b). These of course include as well identification of and negotiation with vendors of raw materials and product components as well as with contract manufacturers for production services.

[6] The legal employment status of an MNC's foreign-based production-related personnel is important under sourcing rules.

Reg §1.863-3(c)(1)(i)(A) currently reads, in part:

> For purposes of this section, production activity means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory. See section 1.864-1. Subject to the provisions in section 1.1502-13 or paragraph (g)(2)(ii) of this section, *the only production activities that are taken into account for purposes of sections 1.863-1, 1.863-2, and this section are those conducted directly by the taxpayer*. … [Emphasis added.]

The proposed amendments to Reg §1.863-3 included in REG-100956-19 do not change these sentences.

This point about which activities are to be taken into account in the Prop Reg §1.863-3 computation of source leads to an important factual point concerning any foreign-based production personnel. Under both the existing and proposed regulation, these foreign-based production personnel must be employees of the taxpayer (including any disregarded entity subsidiaries of the taxpayer). The language "conducted directly by the taxpayer" implies that even the activities of an agent might not be taken into account. In any case, *it is clear that production activities conducted by other group members acting as independent contractors would not be included*.

Given this need for foreign-based production personnel to be employees of the taxpayer, it will be very important to the sourcing of income from production activities to determine the actual group-member employer of each of these personnel. We expect that there will be many cases where such personnel are not only directly managed and supervised by U.S. group members, but are also employed by group members other than the taxpayer (i.e. the entrepreneur and its disregarded entity subsidiaries).

profit within the entrepreneur and only limited-risk returns within the U.S. group members. With this structure, the bulk of the profits attributable to the manufacturing functions and the intangible rights remain within the foreign group member entrepreneur.

Need for Additional Guidance

Assume a foreign group member entrepreneur is making "Section 865(e)(2) Sales". As described above, assume this foreign group member is legally and contractually a manufacturer, but it conducts through its own personnel (including the personnel within any disregarded entity subsidiaries) an insubstantial amount of production activities.

A first issue in the context of Prop Reg §1.865-3 is whether this foreign group member is *producing the products sold* (in which case, Prop Reg §1.865-3(d)(2) applies) or whether it is merely *purchasing and reselling* (in which case, Prop Reg §1.865-3(d)(3) applies).

Given the pervasiveness of MNC profit-shifting structures involving manufacturing and the preponderance of production activities and functions typically conducted by U.S. group members, we believe that requiring Prop Reg §1.865-3(d)(3) to apply in situations such as that of the above-assumed foreign group member entrepreneur would obtain a tax result that best reflects the actual production activities of the group as a whole. This is a "practical" and simple approach to achieve an economically realistic result.

To put this into effect, we suggest that the following be added to Prop Reg §1.865-3(d)(2) as paragraph (d)(2)(iii):

> (iii) Inventory property produced by the taxpayer. For purposes of this section 1.865-3, a taxpayer (whether or not a controlled foreign corporation within the meaning of section 957(a)) will only be considered to have produced inventory property if that taxpayer manufactured, produced, or constructed that property within the meaning of section 1.954-3(a)(4), including making a substantial contribution through the activities of its employees at its offices and other fixed places of business outside the U.S. to the manufacture, production, or construction of the personal property within the meaning of section 1.954-3(a)(4)(iv).

This suggested language referring to "its employees" would include the employees of any disregarded entity subsidiaries of that taxpayer.

There will, of course, be some cases where an MNC has its own contract manufacturing operations outside the U.S. If these operations are within the foreign group member entrepreneur or within one of its disregarded entity subsidiaries, then the entrepreneur should normally meet the above standard for having produced the inventory property.

There will undoubtedly be instances where the contract manufacturing operations are within one or more other foreign group members that are not disregarded entity subsidiaries of the entrepreneur. Under Prop Reg 1.865-3 as currently written, the regulation only applies to the taxpayer (i.e. the entrepreneur) including its disregarded entity subsidiaries. It does not apply to other group members that are separate taxpayers under U.S. rules. As a result, these MNC production activities in other group members would be disregarded when determining the status of the entrepreneur as a producer or purchaser of its inventory property under above suggested paragraph (d)(2)(iii).

Treasury and the IRS could consider changing the "taxpayer only" approach in current Prop Reg §1.865-3 described in the immediately preceding paragraph. A unitary approach is suggested both further below and in above section "Need to Expand Reg §1.863-3(c)(1)(ii) Coverage". Under this unitary approach, activities conducted by other group members that are separate taxpayers under U.S. rules would be included in this determination of whether the taxpayer has produced the inventory property or has only purchased it.

Assume that Treasury and the IRS do not adopt the above suggestion to add paragraph (d)(2)(iii) to Prop Reg §1.865-3. Further, assume that foreign group member entrepreneurs (including their disregarded entity subsidiaries) that conduct minimal or no production activities take the position that their manufacturer status, based solely on internal contractual arrangements, allows them to be treated under Prop Reg §1.865-3(d)(2) as having produced the inventory property they sell. Such entrepreneurs would take the position that their U.S. group members that conduct production activities on their behalf are merely independent contractors. As such, they would ignore these U.S. production activities and maintain that all of their own production activities (even if minimal or nil) are outside the U.S. Under this position, they would maintain that their income from production activities (as determined under the 50/50 method or the books and records method described in Prop Reg §1.865-3(d)(2)) is foreign source and excluded from effectively connected income treatment.

As will be appreciated, the structure and mechanisms within Prop Reg §1.865-3 must be changed to disallow such an inappropriate result. If Treasury and the IRS choose not to add paragraph (d)(2)(iii) as suggested above, then the Prop Reg 1.863-3(c) rules must be expanded so that they are applied on a unitary basis that includes relevant production activities conducted by all group members. Section 954(d)(3) could be used to identify other group members. See above section "Need to Expand Reg §1.863-3(c)(1)(ii) Coverage" for one very simple approach for accomplishing this.[7] Undoubtedly, if a unitary approach is adopted, additional guidance would be needed on identifying unitary arrangements and determining which entities and which of their activities are to be included. Given that some states have used unitary taxation for many years, this should not be unduly difficult.

9. Minor Matters

Item 13 on page 46 of REG-100956-19 removes the ninth sentence in newly redesignated paragraph (c)(4)(i)(A). It appears that this item 13 should refer to the tenth sentence, which reads: "A uses the 50/50 method to divide its gross income between production activity and sales activity."

Prop Reg §1.863-3(e) makes various changes to require sourcing based on a taxpayer's business activity. As we understand the proposed changes overall, for example, the IFP method will no longer be relevant. Despite this, existing Reg §1.863-3(f)(4) (Reg §1.863-3(e)(4) after the proposed changes) still refers to the IFP method. Accordingly, it appears that appropriate changes should be made to this section to be fully consistent with the proposed changes.

[7] See Priority Guidance Plan submission by Jeffery Kadet dated October 6, 2019, for recommendation concerning sourcing rules on a unitary basis as applied to cloud services. If requested, the undersigned would be glad to provide further comments on such a unitary structure for sourcing income from production activities.

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We would be pleased to respond to written questions or to discuss the comments herein by phone.

Very truly yours,

Jeffery M. Kadet
(206) 395-9849
jeffkadet@gmail.com

David L. Koontz
(773) 315-7660
dlkoontz@aol.com