

## Regulation 1996-3

### APPORTIONMENT OF BUSINESS INCOME ARISING FROM INTRAGROUP INTANGIBLE LICENSING TRANSACTIONS:

Pursuant to the authority provided in Ark. Code Ann. § 19-1-208 (1987), Ark. Code Ann. § 26-18-301 (1987) and Ark. Code Ann. § 25-15-201, et seq. (1987) (the Arkansas Administrative Procedures Act), the Director of the Arkansas Department of Finance and Administration and the Commissioner of Revenue for the State of Arkansas do hereby promulgate the following Regulation. This Regulation is to be read in conjunction with the previous Regulations of the Department of Finance and Administration (“Department”) and laws of this State, for the administration of Article IV of the Multistate Tax Compact as adopted in Arkansas and found at Ark. Code Ann. § 26-5-101 (“AMTC”) and the Uniform Division of Income for Tax Purposes Act as adopted in Arkansas and found at Ark. Code Ann. § 26-51-701 et seq. (“AUDITPA”).

#### 1. Determination.

a. In accordance with the terms of Ark. Code Ann. § 26-5-101 IV-18 and Ark. Code Ann. § 26-51-718, the Director determines that the allocation and apportionment provisions of the AMTC and the AUDITPA do not fairly represent the extent of business activity in the State of Arkansas for taxpayers described in paragraph 3.

b. A corporation which owns, licenses or manages intangible property has nexus with Arkansas for purposes of filing a corporate income tax return when the corporation seeks the benefit of economic contact with Arkansas by directing its economic activity at this State through the licensing of these intangibles in an intragroup intangible licensing transaction.

#### 2. Definitions. The following words and terms when used in this Regulation shall have the following meanings:

a. “Group” means two or more corporations which are owned or controlled, either directly or indirectly, by the same interests. Corporations which are eligible for inclusion in a consolidated group for the purposes of filing a consolidated return under the Internal Revenue Code are members of a group. However, corporations which are not eligible for inclusion in a federal consolidated return are still part of a group for the purposes of this regulation if there is common ownership, management or control of the corporations or other factors which demonstrate that one corporation has sufficient influence over the affairs of another to cause the corporations to enter into business transactions with each other.

b. “Passive intangible holding company” means a corporation which derives some or all of its income from the management and licensing of intangible assets. As used in this Regulation, the terms “passive intangible holding company” and “licensor” shall be recognized as meaning the same corporation.

c. “Intragroup intangible licensing transaction” means a license of intangible property rights between two or more members of a group, if one of the parties to the transaction is a passive intangible holding company. Intragroup intangible licensing transactions shall include, licensing of trademarks, tradenames, patents, copyrights, and any other transaction authorizing the use of intangible property in this State.

d. “Intangible income” means income generated by an intragroup intangible licensing transaction.

e. “Licensee” means the group member which recognizes an expense for the use of the passive intangible holding company’s intangible property.

f. “Measuring activity” means such action on the part of the licensee which, pursuant to the terms of a licensing agreement, serves as the basis for determining the extent of the licensee’s liability for payment of intangible income.

3. a. Application. This Regulation shall apply only to taxpayers subject to the tax imposed by the Income Tax Act of 1929 (Ark. Code Ann. § 26-51-101 et seq. (1987)) which have the following characteristics:

i. The taxpayer is a passive intangible holding company;

ii. The taxpayer receives business income from intragroup intangible licensing transactions with one or more other members of the same group doing business within the jurisdiction of this State; and

iii. At least one of the other members of the same group from which business income is received by the taxpayer is subject to the tax imposed by the Income Tax Act of 1929 (Ark. Code Ann. § 26-51-101 et seq. (1987)).

b. A passive intangible holding company shall not be subject to the provisions of this regulation for income derived from any intragroup intangible licensing transaction if the licensee does not claim a deduction on its Arkansas income tax return for expenses associated with the intragroup intangible licensing transaction. If the licensee elects to forego this deduction, the passive intangible holding company shall not be required to report the income from the intragroup intangible licensing transaction for Arkansas income tax purposes.

4. Business Income.

a. Where a taxpayer meeting the requirements of paragraph 3 has income from sources both within and without this State, the amount of business income from sources within this state shall be determined pursuant to Ark. Code Ann. §§ 26-51-101 IV-9 and 26-51-709 except as modified by this regulation.

b. If a passive intangible holding company has income both from intragroup intangible licensing transactions and from other sources, the income derived from sources other

than intragroup intangible licensing transactions shall not be subject to Arkansas income tax unless the income would have been taxable in Arkansas regardless of the intragroup intangible licensing transactions. The purpose of this regulation is to require passive intangible holding companies to apportion income derived from intragroup intangible licensing transactions and pay Arkansas income tax on that apportioned income. This regulation is not intended to require the apportionment of other income which would not have otherwise been subject to Arkansas income tax.

5. Sales Factor-Intraroup Intangible Licensing Transactions. The Director of the Arkansas Department of Finance and Administration hereby determines that the sales factor outlined in Ark. Code Ann. § 26-51-217 and Ark. Code Ann. § 26-5-101 IV(17) does not fairly represent the extent of business activity in Arkansas for passive intangible holding companies which derive income from intragroup intangible licensing transactions. Pursuant to the authority provided in Ark. Code Ann. § 26-51-718(d) and Ark. Code Ann. § 26-5-101(18)(d) the Director determines that for purposes of computing the sales factor of a passive intangible holding company, sales or receipts arising from an intragroup intangible licensing transaction are in this State and shall be included in the numerator of the sales factor as follows:
  - a. If the licensing agreement states a method of measuring the activity between the licensor and licensee which accurately reflects the licensor's business activity attributable to this State, then the sales or receipts shall be included in the numerator of the sales factor as provided in the licensing agreement.
  - b. If the licensing agreement does not state a method of measuring the activity between the licensor and licensee, then the measuring activity shall be based on one of the following methods that accurately reflects the licensor's business activity attributable to this State:
    1. If licensee is engaged in an activity which generates sales or receipts, the numerator of the sales factor shall include licensee's percentage of sales in this State compared to the licensee's total sales; or
    2. If licensee is engaged in an activity which does not generate sales or receipts, the numerator of the sales factor shall include licensee's percentage of units produced, or cost of units produced, in this State compared to the licensee's total units produced, or total cost of units produced; or
    3. If neither of the above methods accurately represent the licensor's business activity in this state, the licensor may petition for or the Director of the Department of Finance and Administration may require any other method which will accurately represent the licensor's business activity attributable to this State.

- c. If the licensing agreement states a method of measuring the activity between the licensor and licensee in addition to a specifically stated dollar amount, the sales or receipts attributable to this State shall be based on the stated measuring activity plus the specifically stated dollar amount computed based on one of the methods stated in 5(b) which accurately reflects the licensor's business activity attributable to this State.
6. Examples. The following examples are provided as guidance for purposes of determining whether an intangible income measuring activity is deemed to be readily identifiable to a specific activity occurring within a unique geographic location.
  - a. A licensing agreement provides that royalty income is to be based upon a percentage of licensee's total sales. Such a measuring activity accurately reflects the licensor's business activity occurring within Arkansas due to the fact a licensor may determine the specific geographic location of the sales which generated the licensor's entitlement to income as outlined in paragraph 5(a).
  - b. A licensing agreement provides that royalty income is to be based upon the number of stores displaying a licensed trademark. Such a measuring activity accurately reflects the licensor's business activity occurring within Arkansas due to the fact a licensor may determine the specific geographic location of the stores which generated the licensor's entitlement to income as outlined in paragraph 5(a).
  - c. A licensing agreement provides that royalty income is to be based upon a fixed quarterly amount. Such a measuring activity is not readily identifiable to a specific activity occurring within a unique geographic location due to the fact the royalty income is not based upon an identifiable activity. If the licensee's business activity generates sales or receipts, the numerator of the licensor's sales factor shall be calculated as outlined in paragraph 5(b)(1) of this regulation. If the licensee's business activity does not produce sales or receipts, then the numerator of the licensor's sales factor shall be calculated as outlined in paragraph 5(b)(2) of this regulation.
7. Effective Date. This Regulation shall be effective for tax years beginning on or after January 1, 1996.
8. Withdrawal. This Regulation replaces Revenue Policy Statement 1995-2, which is withdrawn.
9. Penalty. No penalty shall be assessed against any taxpayer for failure to make estimated tax payments for the first year a tax return is due as a result of this regulation.

Issued this 9<sup>th</sup> day of August, 1996 in the City of Little Rock, Arkansas.

Richard A. Weiss, Director  
Department of Finance and Administration

Tim Leathers  
Commissioner of Revenue and  
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