Statement of Benjamin F. Miller
for the
Hearing On Proposed Amendments to Article IV
of the Multistate Tax Compact
Washington D.C.
March 28 and 29, 2013

My name is Benjamin F. Miller, I appear at this hearing today as an individual who has worked for over 40 years as a tax attorney for a state that adopted the Uniform Division of Income for Tax Purposes Act (UDITPA) in 1967. My appearance today is not on behalf of any state or any client. It is motivated by the fact that my professional life has been devoted to the subject matter of UDITPA. The comments and opinions expressed herein are solely my own. I have not consulted with any individual with respect to these comments and opinions. Specifically I would like it to be noted that I am not speaking on behalf of, or as a representative of, the California Franchise Tax Board or any member of the staff of that agency.

I am a Certified Tax Specialist in California and a member of the California Bar's Tax Law Advisory Commission. I have lectured and taught about state income tax principles in a variety of forums. I have served as a consultant to a variety of states and appeared as an expert witness. I am one of three named authors on CCH's Expert Treatise Library: State Taxation of Income and Other Business Taxes. My contributions in the area of state taxation of multistate businesses have been recognized by the Multistate Tax Commission, the Federation of Tax Administrators and various committees and subdivisions of the bar of the State of California.

For most of my professional life I have been involved in the presentations to the United States Supreme Court of issues regarding the division of income between the states either as a party or as an amicus. I have been a principal draftsperson of legislation and regulations involving the determination of and assignment of the income of multistate businesses to an individual state, including the implementation of UDITPA. I have been involved in the activities of the Multistate Tax Commission for many years as a member of the Litigation Committee, the Uniformity Committee and as a representative of a state to both the Commission and the Executive Committee of the Commission. I was a participant in the drafting of the proposed amendments that are the subject matter of this hearing.

UDITPA

The Uniform Division of Income for Tax Purposes Act (UDITPA) was promulgated in 1957. UDITPA was an effort by the Commissioners on Uniform State Laws to promote uniformity in state laws regarding the division of income of businesses conducted in more than one state. It served as a model for such laws in over 35 states and achieved a significant degree of uniformity.

Comments on the MTC's Proposed Amendments to Article IV Of the Multistate Tax Compact

Presented to the MTC Public Hearing
Washington, DC
March 28, 2013

INTRODUCTION

Sutherland Asbill & Brennan LLP respectfully submits the following comments in response to the Multistate Tax Commission's ("MTC") Proposed Amendments to Article IV of the Multistate Tax Compact ("Proposed Amendments"). These comments address substantive concerns with the Proposed Amendments, and are best understood in the context of the broader policy pressures on state apportionment formulas.

The apportionment provisions of the Multistate Tax Compact ("Compact") are based on the Uniform Division of Income for Tax Purposes Act ("UDITPA"). Drafted in 1957, States initially adopted UDITPA in varying degrees as a basis to apportion corporate income—either as standalone legislation or through the adoption of the Compact. Uniformity grew steadily and reached its zenith in 1978 before the United States Supreme Court decided *Moorman* and held that the states were free to craft unique apportionment regimes that departed from the uniform standard embodied in UDITPA.[1] Since 1978, nearly every state has departed from UDITPA and the Compact—largely driven by the desire of state policy makers to tailor their state's taxing regimes to different circumstances (e.g., economic climate, presence of specific industries, workforce utilization, etc.). The exodus from uniformity in the way states tax business is a reminder that traditions and attitudes do differ from state to state. Indeed, the principles of federalism[2] encourage diverse attitudes to manifest themselves, which is exactly what has happened with state tax apportionment.

The MTC's stated goal in drafting the Proposed Amendments is to create a more uniform system of state income tax apportionment.[3] The Proposed Amendments fall short of offering an attractive and workable uniformity option in a number of respects. We ask that the Uniformity Committee and interested stakeholders be given the opportunity to address the issues discussed below prior to adopting the Proposed Amendments. We also ask that the MTC actively and aggressively seek additional input from taxpayers—either collectively or through industry groups—prior to adopting any revisions to the Proposed Amendments.

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[1] *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978).

[2] Principles of Federalism are often cited by the MTC and state policy makers in the context of limiting Federal involvement in state tax matters.

[3] In fact, one of the purposes of the MTC was described by the U.S. Supreme Court as "promoting uniformity and compatibility in state tax systems." *U.S. Steel Corp. v. Multistate Tax Comm'n*, 434 U.S. 452 (1978).

I. Sourcing of Sales of Other Than Tangible Personal Property

The most significant policy shift in the Proposed Amendments is a dramatic sourcing change to sales of "other than tangible personal property." The Compact sources receipts from sales of other than tangible personal property based on the location of the taxpayer's costs-of-performance. This methodology contemplates sourcing sales based on the location of the income producing activities. The Proposed Amendments ignore all business activities except for the market.

In considering whether to adopt the Proposed Amendments, the MTC should undertake a comprehensive evaluation of whether the proposed market-based sourcing rule is an improvement over costs-of-performance. Among the issues that should be considered are: Will state legislators support and adopt the change in policy? Can taxpayer's easily apply the methodology based on existing business practices and record keeping? Does the proposed methodology fairly apportion income among the states? Does the methodology create the risk of multiple and discriminatory taxation?

Undoubtedly, most sourcing methods have flaws and some difficulties in application. The core question for the MTC should be whether market-based sourcing presents an improvement over the current regime as to warrant a complete change of policy. We believe that the market-based approach raises as many questions as it answers and we encourage the MTC to explore the possibility of preserving some form of costs-of-performance sourcing, before eliminating it in favor of a market-based approach.

A. MTC's Market-Sourcing Approach

To replace costs-of-performance sourcing for services and intangible property, the Proposed Amendments take a market-based sourcing approach that attempts to sidestep many of the sourcing difficulties that have plagued market sourcing in the past. The proposed sourcing rule is contained within a single sentence: "if and to the extent the service is delivered to a location in a state." If delivery of the service cannot be determined, the sourcing location can be "reasonably approximated." If both of these rules fail—or if the taxpayer is not taxable in the state to which a service is sourced—the receipts for the services are "thrown out" of the denominator. The Proposed Amendments also change the sourcing of receipts from intangibles. Receipts from licensing intangibles are sourced based on whether an intangible is "used in" a state. In addition, the Proposed Amendments also adopt a controversial "look through" approach that sources sales of "marketing intangibles" to the location of the taxpayer's customer's customer. Sold intangibles will be sourced according to where the property is used.

B. Difficulties with Market-Based Sourcing Approach

The MTC's stated goal in this process is to develop a basic rule that will "work best for more taxpayers than any alternative rule." However, the proposed market-source rule is new, vague, and not based on any state's law.[4] The Proposed Amendments falls short of being an adequate multistate model in several respects.

An overarching concern with the MTC's approach is the flawed premise that the sales factor should reflect market activity because the property and payroll factors reflect other business activity. This premise ignores the reality that a large number of states have adopted single sales factor apportionment. The MTC's approach, when coupled with single sales factor, would disregard the contribution of the state where production takes place. In the case of a company that delivers its services remotely to a single state, the proposed approach would result in the "market state" computing tax on 100% of the taxpayer's income and the state where all of the work is done receiving no tax at all. An all-or-nothing result that ignores significant business activities only furthers the inequities that states have cited as a basis for reviewing costs-of-performance sourcing.

1. Sourcing of Services

A memorandum dated July 15, 2010, from MTC staff (and presumably the drafting group for the Proposed Amendments) to the MTC Income and Franchise Tax Subcommittee, classified the market-sourcing approaches taken by states at that time for services into three different categories:

- States that source where the taxpayer's customer receives a benefit from the service: California, Georgia, Michigan, Ohio, Wisconsin, Utah;[5]
- States where the taxpayer's customer receives the services: Maine, Minnesota; and
- States where the taxpayer performs the service: Connecticut, New Jersey, New York, Rhode Island, South Carolina, Texas.[6]

The memorandum concludes that "because the objective of each of these alternatives is to source to the market, the results should not diverge in most circumstances, but certainly could in some." After discussing alternatives, the approach taken in the Proposed Amendments uses the phrase "delivery," which in the view of the Committee, also had the same "market objective" as the other varieties and would have the same consequence. This is simply not the case.

"Delivery" is the key concept embedded in the approach and should be clearly and unambiguously defined. The Working Group discussed scores of examples of how there could be confusion in the application of a delivery rule, yet the language was left simplistic. The drafters admit that regulations may be needed, but that the basic rule could be universally applied in most

[4] Alabama prematurely adopted a version of the Proposed Amendments'' market sourcing rules in 2011. Ala. Code § 40-27-1, Article IV.17.

[5] Utah sources receipts from the performance of a service to the state if the purchaser of the service receives a greater benefit from the service in Utah than in any other state. Utah Code Ann. § 59-7-319(3).

[6] There is some question as to whether some of these states are in fact market states because they use some costs-of-performance concepts. For example, South Carolina sources receipts from services to the state to the extent the income-producing activity is performed in South Carolina. S.C. Code Ann. § 12-6-2295(A)(6).

circumstances. Reexamining a few examples that were considered demonstrate how uncertain it will be to leave tough questions to regulations.

Example A — Software Support: A software company has a call center located in Minnesota, and it provides support services to individual customers using its software in California, Illinois, and Michigan for a set monthly fee specified in its contracts. Fifty percent of the calls originate from California, 10 percent from Illinois, and 40 percent from Michigan. Thirty percent of the customers' billing addresses are in California, 20 percent in Illinois, and 50 percent in Michigan. All three states purport to source using a "market" approach applying a "benefits received" rule. However, because of unique regulations—or the lack thereof—it is not easy to determine how to source these receipts with certainty.

Because the sales are to individuals, California sources the sale to the billing address of the taxpayer's customer.[7] The customer's billing address serves as a safe harbor—taxpayers may choose it as a proxy for the location where the benefit of the service actually is received. As a result, 30 percent of the receipts will be sourced to California as a general rule.

Illinois offers no billing safe harbor in the case of sales to individuals and the only guidance is the statutory language of where the "services are received."[8] Consequently, it would seem that only 10% of the receipts would be sourced to Illinois based on the services received by those making calls, and that 20 percent of Illinois' billing addresses would be irrelevant.

For Michigan tax purposes, sales of services performed within and outside the state are sourced in proportion to the benefit in each state.[9] Michigan Revenue Administrative Bulletin (RAB) 2010-5 provides more guidance to ascertain where the benefit of the service is received. For example, it provides that if a service relates to tangible personal property owned or leased by the purchaser, the service is sourced to Michigan if the tangible personal property was located in Michigan or delivered to a purchaser in Michigan. Thus, Michigan sourcing depends on whether the software is prewritten (tangible property) or custom (intangible property), which is often not defined in any state. If the service relates to prewritten software located in Michigan, the entire benefit of the service received in Michigan is sourced to Michigan. Naturally, it may be difficult for the taxpayer to determine whether that software is located in Michigan, so questions will arise as to whether the billing address or source of call is the best proxy for determining whether the software is located in Michigan. If the service relates to custom software (intangible property), the benefit of the service is sourced to Michigan to the extent that the intangible property is "used" in Michigan. The state likely will look to the origination of the call to determine proportion of use.

Example B — Accounting Services: Acme Accounting Firm provides accounting services to Multistate Manufacturing Corp. (MMC). MMC has facilities in California, Illinois, and Michigan, but its principal place of business and state of commercial domicile is Illinois. MMC ordered accounting services for its entire company from Illinois where most of its in-

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[7] Cal. Code Regs. tit. 18, § 25136-2.
[8] 35 Ill. Comp. Stat. Ann. § 5/304(a)(3)(C-5)(iv).
[9] Mich. Comp. Laws Ann. § 208.1305(2)(a).

house accountants are located. MMC's individual state facilities differ greatly. MMC's largest facility is in California, but it is a highly automated factory with the fewest employees. MMC's Michigan facility is its smallest, but it is the location of its R&D engineers who have invented patents that represent 90% of the value of the company. The Illinois facility houses the largest number of MMC employees, many of which manage third-party licenses for the manufacturing of MMC's products overseas. The contract with MMC specifies the nature of the work to be done by Acme—including filing reports with the SEC in Washington, DC—but it does not specify where the benefit of the accounting service is received.

Unlike the rule for transactions with individuals, California has no safe harbor for transactions between businesses. Instead, the regulations provide that the location where a business customer receives the benefit of the service is presumed to be in California to the extent indicated in the contract between the taxpayer and its customer or the taxpayer's books and records, regardless of the customer's billing address.[10] If the taxpayer's contract or books and records do not indicate where the benefit of the service was received, the regulation allows the location to be reasonably approximated. If reasonable approximation is impossible, only then can the source be determined based on the location where the customer ordered the service. The customer's billing address is the last resort; it can be used only after the other rules have been exhausted. Because the contract does not (and perhaps cannot) specify the location of where the services are performed, the taxpayers and the state likely will have to reasonably approximate the location. The reasonable approximation could be based on: value; square footage; number of employees; income; or some other method, but regardless of the method the taxpayer can never be certain of the appropriate method.

The answer is equally unclear in Illinois. Generally, receipts for services provided to a corporation, partnership, or trust may be sourced only to a state where the business customer has a fixed place of business (the customer's address).[11] If the state where the customer receives the service is not readily determinable, or the corporation, partnership, or trust has no fixed place of doing business, the office where the customer ordered the service in the regular course of business is deemed to be the location where the service is received. If that location is not determinable, the services are deemed received at the customer's billing address. The concept of "readily determinable" is distinctly different from the "reasonable approximation" approach used in California and the Proposed model. As a result, the ability to use billing address would occur more quickly in the analysis than in those instances where "reasonable approximation" is allowed. One could easily see how Illinois might source a sale based on billing address, which would provide for a 100 percent Illinois factor.

Example C — Architectural Design Services: Design Corp. is an architectural firm located in Minnesota that is designing a new hamburger restaurant chain for Beef on a Bun. Beef on a Bun is located in California, and plans to franchise its stores in 5 states. Design Corp.'s employees travel frequently to California to meet with Beef on a Bun and discuss the blueprints for the restaurants, and the Beef on a Bun only employees travel to Minnesota to do the same.

[10] Cal. Code Regs. tit. 18, § 25136-2(c)(2)(A).
[11] 35 Ill. Comp. Stat. Ann. § 5/304(a)(3)(C-5)(iv).

Design Corp. drafts the blueprints in Minnesota. The contract specifies that the location where the service is received is Minnesota.

This example shows how easy it is for states and taxpayers alike to get whipsawed under unclear market rules that are applied differently by states. Under California's cascading approach, the taxpayer may argue that the location specified in the contract controls, which would be Minnesota. However, the FTB may rebut this presumption by arguing that the benefit actually was received in California because the taxpayer met with clients in California. California may also "reasonably approximate" and assign sales to the 5 states in which the design services are ultimately used when the stores are built. However, that method of "reasonable approximation" may be inconsistent with Minnesota, which allows sourcing only to a state where the purchaser has a fixed place of business. Beef on a Bun arguably does not have a fixed place of business because its franchisees are the only entities operating in the 5 states.

2. Sourcing of Intangibles

The application of this proposed test to the licensing of intangibles presents many of the same practical difficulties that are discussed above with respect to the delivery of a service. It is simply too difficult to determine where intangible property is "used."

Additionally, the model provides a special rule for the licensing of "marketing intangibles," receipts from which will be sourced to the location of the underlying tangible property to which it relates. It is virtually impossible for many licensors to track the ultimate sale of property associated with the intangible. For example, a university licensing its logo for the use on drink cozies has no way track the sales of those cozies around the world.

One last concern with the sourcing of sales of intangibles is with the Proposed Amendments' disparate treatment of different types of intangibles. The Proposed Amendments only allow for the inclusion of sold intangibles in the sales factor if the intangibles are associated with a contractual (or governmental) right in a specific geographic area or if they are contingent on the subsequent use of the intangible. Receipts from all other intangible sales are excluded. As a result, many sales of intangibles (e.g., customer lists) will be excluded from the factor. Another commonly sold intangible is a contract. For example, a company that sells extended warranties to repair vehicles may at some point bundle the contracts and transfer them to another for administration. That transfer could result in a gain or loss, but be excluded from the apportionment formula. We fail to see the justification for such exclusion, particularly since the gain from those sales will be reflected in the apportionable tax base. The rule would also be subject to manipulation by taxpayers who could include or exclude geographic contractual restrictions based on a desired outcome.

C. Modernizing Costs-of-Performance

In light of the problems in defining the market and the potential for distortion, the MTC should reconsider its dramatic shift to market-based sourcing for services and intangible receipts. The Uniformity Committee and its working groups too quickly embraced a policy to abandon costs-of-performance sourcing. The simple fact is that costs-of-performance has sourced income for a number of industries for the past 50 years and should not be laid to rest so quickly. This is particularly true as the nation's economy evolves and it becomes increasingly difficult to determine the "market" for many services and intangibles.

In lieu of complete abandonment of costs-of-performance sourcing, the MTC could consider modernizing the existing costs-of-performance rules to resolve any perceived deficiencies. For example, many of the issues associated with ascertaining where the taxpayers costs of performance are located stems from factual issues like whether income producing activity is measured on a transactional or an operational basis.[12] Similarly, there has been controversy over whether to include the activities of third parties in the calculation of a taxpayer's costs of performance, which the MTC addressed in regulations.[13] A proportional costs-of-performance approach may also be more equitable and administrable in certain circumstances because it avoids an all-or-nothing result. The MTC should examine whether these issues can adequately address perceived problems with the application of costs-of-performance.

An additional alternative to complete abandonment of costs-of-performance is to carve out specific industries. For example, utilities and financial organizations are now generally carved out from all of UDITPA. If the MTC feels that costs-of-performance does not work well work for particular industries, they could similarly carve them out.[14]

D. Throwout Should be Thrown-Out

Another troubling aspect of the Proposed Amendments is the inclusion of a throwout rule. Under the throwout rule, if a taxpayer is not taxable in the destination state or if it is too difficult to tell where the receipts should be sourced, the related receipts are excluded from the numerator and denominator of the sales factor (i.e., sales that are sourced to a state that does not tax the service provider are "thrown out" of the factor altogether). The throwout rule often increases the apportionment percentage by excluding certain receipts from the factor. Income earned in states where the taxpayer is not taxable is redistributed among the states where the taxpayer is taxable, in accordance with those states' apportionment factors.

The MTC apparently believes that if all states adopted throwout, full apportionment would be realized without creating a windfall for the origin state, by spreading the impact of "nowhere sales" among each of the states in which the taxpayer is taxable. As an initial matter, any notion of full apportionment is a myth given the substantial deviation among states in factor weighting. A throwout rule cannot remedy the significant differences between states apportionment rules. The throwout rule is also constitutionally suspect, because the state that applies throwout may have no connection with the sales that are eliminated from the sales factor. For example, state C can benefit if a taxpayer provides a service from State A into State B that is

[12] *Mass. Comm'r of Rev. v. AT&T Corp.*, Dkt. No. 11-P-1462 (Mass. App. Ct. July 13, 2012) (holding that AT&T properly sourced its receipts from its interstate and international telecommunication services using the "operational" approach); *AT&T Corp. v. Dept. of Rev.*, TC 4814 (Or. Tax Ct. January 1, 2012) (requiring AT&T to source its receipts using the "transactional" approach).
[13] MTC Reg. 17(4)(C) and *General Motors v. Virginia*, 602 S.E.2d 123 (2004).
[14] The MTC regulations include special rules for airlines, broadcasters and other industries.

thrown out because the sale is difficult to source. State C gets a windfall from an activity that has no connection State C. Increasing the tax base by ignoring out-of-state activity (i.e., sales) violates the dormant Commerce Clause's fair apportionment requirement, generally, and the external consistency prong of fair apportionment specifically. The MTC should consider the irony that the throwout rule contradicts the very market approach the MTC propounds is the proper way to determine the gross receipts factor

II. Factor Weighting

As currently drafted, Compact Article IV.9 sets forth an equally-weighted three-factor apportionment formula, consisting of the taxpayer's property, payroll, and sales. The Proposed Amendments modify the language to the following:

> All business income shall be apportioned to this State by multiplying the income by a fraction, [State should define its factor weighting fraction here. Recommended definition: "the numerator of which is the property factor plus the payroll factor plus two times the sales factor, and the denominator of which is four."]
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> Proposed Compact Art. IV § 9.

In place of a standard, the Proposed Amendment leaves the option to the state to define its factor weighting fraction. With states already varying widely in the components of the apportionment formula, this option surely will lead to numerous deviations from the suggested Compact language of a three-factor formula with a double-weighted sales factor. States could weigh the factors as they see fit and presumably will consider the introduction of non-traditional factors – perhaps an intangible property factor – and still fall within the supposed uniformity promoted by the Compact. Nowhere else in the Compact are states given the ability to freely craft a rule. At the very least, there should be a menu of options for states to choose from.

It should be noted that the full state option language was the least discussed of any of those included in the Proposed Amendments. The Uniformity Committee, after much discussion, voted to recommend a double-weighted sales factor formula. After a brief discussion at an Executive Committee meeting, the Executive Committee decided to change the language and allow states unfettered discretion in determining the use of factors. This area deserves more attention by the drafting group.

III. Equitable Apportionment

The current version of equitable apportionment provided in Section 18 allows taxpayers and tax administrators to adjust the apportionment formula when the standard formula does not fairly reflect in-state business activities. The use of the equitable apportionment powers was intended to apply to unusual factual situations on a taxpayer-by-taxpayer basis. Section 18 reflects an understandable concern that unfettered use of equitable apportionment would lead to a "free-for-all" of ad-hoc apportionment methods, undermining the goals of predictability and uniformity.

Although Section 18 allows for deviation from the standard formula, such deviation is permitted only in narrow circumstances involving unusual facts. UDITPA's drafters realized the importance of providing for "some alternative method [that] must be available to handle the constitutional problem as well as the unusual cases."[15] The drafters believed that a narrow interpretation of Section 18 is essential to achieve the fundamental purpose of UDITPA.[16] The drafters also made it clear that Section 18 was "designed to permit the use of methods different from those prescribed in the Act *only in unusual cases* and in cases where the application of specifically prescribed methods might be held unconstitutional."[17] In fact, Prof. William J. Pierce was of the opinion that the fundamental purpose of UDITPA would be seriously undermined if Section 18 "were interpreted to give administrators in the different states broad discretion in the selection of alternative methods."[18] A similar message is embedded in the Multistate Tax Commission's model apportionment regulations, which, in construing UDITPA, provide that Section 18 should apply "only in limited and specific cases . . . where unusual facts situations (which ordinarily will be unique and non-recurring) produce incongruous results under the apportionment and allocation provisions contained [in UDITPA]."[19]

The long-term and severe consequences of a broad interpretation of Section 18 were readily predictable in 1967:

> There are completely compelling reasons for giving the relief provisions a narrow construction. Under a broad construction the purposes of obtaining uniformity through the adoption of the Uniform Act would be defeated. If a choice of methods is permitted, different administrators in different states inevitably will choose different methods. As a result, even if all the states imposing taxes on or measured by income should adopt the Uniform Act, the chaotic condition heretofore existing would continue to exist.[20]

Historically, state courts shared Pierce's and the MTC's narrow view of the scope of Section 18 and have argued that the equitable apportionment provision is "the exception,"[21] and

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[15] William J. Pierce, "The Uniform Division of Income for State Tax Purpose," 35 *Taxes* 747, 781(1957).

[16] *Id.*
[17] *Id.* (Emphasis added.)
[18] *Id.*
[19] Multistate Tax Commission Reg. IV. 18(a).
[20] Frank M. Keesling and John S. Warren, "California's Uniform Division of Income for Tax Purposes Act," 15 *UCLA L. Rev.* 156, 171 (1967).
[21] *St. Johnsbury Trucking Co., Inc. v. State*, 118 N.H. 209 (1978) ("The alternative formula is the exception . . . Merely because the use of an alternative form of computation produces a higher business activity attributable to [the taxing state], is not in and of itself a sufficient reason for deviating from the legislatively mandated formula."); *see also Deseret Pharm. Co., Inc. v. State Tax Comm'n*, 579 P.2d, 1326 (Utah 1978) ("Apportionment under U.D.I.T.P.A. is the prescribed method. The use of any method other than apportionment should be

that it should be applied only in "unusual and limited circumstances."[22] However, in recent years, state tax authorities appear to have expanded the application of Section 18, claiming that it entitles them to a broad grant of authority.[23] Although states certainly have a "wide latitude to devise formulae" for apportioning and taxing income of a multistate enterprise,[24] state taxing authorities cannot rely on Section 18 to adjust a taxpayer's apportionment without a showing of inequity.

Section 18 is limited to unusual circumstances,[25] but how unusual must the circumstances be to warrant Section 18 relief? The Tennessee Court of Appeals recently held that the Tennessee Department of Revenue was justified in requiring a multistate company to apportion its advertising revenue based on an alternative to the legislatively mandated costs of performance apportionment method because the circumstances in the case had "unique quality" in that all of the costs of production occurred outside Tennessee.[26] We question how the provision of advertising services from outside Tennessee can constitute an unusual fact situation. Regrettably, the court did not provide any further explanation of its reasoning.

The Indiana Department of Revenue also asserted Section 18 in ruling that the licensing of broadcasting rights to cable and satellite companies presents a "limited and unusual situation" warranting the application of an alternative apportionment method.[27] Indiana's apportionment regulations require that a departure from the standard costs-of-performance apportionment method is authorized "only in *limited and unusual circumstances* (which ordinarily will be *unique and nonrecurring*) when the standard apportionment provision produces incongruous results."[28] The department did not explain why the licensing of broadcasting rights to cable and satellite companies for a fee is "unique" and "nonrecurring." Rather, the department simply concluded that its alternative apportionment method "effectuate[d] a result that more fairly represent[s] taxpayer's income derived from sources within the state."[29] Tennessee and Indiana

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exceptional.); *Donald M. Drake Co. v. Dep't of Revenue*, 500 P.2d 1041, 1044 (Or. 1972) ("the use of any method other than apportionment should be exceptional").

[22] *American Tel. & Tel. Co. v. Huddleston*, 880 S.W.2d 682, 691-2 (Tenn. App. 1994) ("the variance provision applies only in unusual and limited circumstances and is to be interpreted narrowly in order to carry out the purpose of uniform apportionment under the act."); *see also Roger Dean Enterprises v. State, Dep't of Revenue*, 387 So.2d 358 (Fla. 1980) ("There is a very strong presumption in favor of normal . . . apportionment and against the applicability of relief provisions. . . . The relief provision should be used where the statute reaches arbitrary and unreasonable results . . . Departures from the basic formula should be avoided except where reasonableness requires."); *Union Pacific Corp. v. Idaho State Tax Comm'n*, 139 Idaho 572, 576 (2004) ("There is a very strong presumption in favor of a normal three-factor apportionment and against the applicability of the relief provisions.").

[23] *See generally HMN Financial, Inc., and Affiliates v. Comm. of Revenue*, No. A09-1164 (Minn. 2010).

[24] *Allied-Signal, Inc. v. Dir., Div. of Taxation of New Jersey*, 504 U.S. 768, 779 (1992); *see also Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978) (upholding the constitutionality of a single-sales-factor apportionment formula); *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920) (upholding the validity of a single-property-factor apportionment formula).

[25] Jerome R. Hellerstein and Walter Hellerstein, 1 *State Taxation*, para. 9.20[3]. (3rd ed. rev. 2009).

[26] *Bellsouth Advertising & Publishing Corp. v. Chumley*, 2009 Tenn. App. LEXIS 576 (Tenn. Ct. App. 2009).

[27] Indiana Letter of Findings No. 04-0398, Indiana Dep't of Revenue (Sept. 1, 2006).

[28] 20 45 IAC 3.1-1-62. (Emphasis added.)

[29] *Id.*

provide just two of many examples in which states have run roughshod over the prerequisites to Section 18.[30]

Despite the sound policy objectives underlying the limited use of Section 18, the Proposed Amendments will dramatically allow administrators to broadly invoke Section 18 through regulation. The Proposed Amendments allow for adoption of industry-wide or issue-wide apportionment rules. While many states have adopted industry-wide apportionment, questions linger regarding the authority to issue these regulations on something other than a taxpayer-specific basis. By specifically authorizing states to enact industry-wide apportionment regulations, the amendments take Section 18 from apportionment of last resort to the norm for classes of taxpayers. The original drafters did not intend for Section 18's use in industry-wide instances.[31] We think industry-wide deviations from the norm are better addressed through the legislative process than though regulations. Industry-wide or issue-wide regulations should be used on only rare occasions and the Proposed Amendments should reflect that view.

If the MTC chooses to alter Section 18, we suggest they look at ways to also limit and restrict its application to be consistent with its intent. One common misuse of Section 18 by administrators is to apply it to an individual taxpayer to address a tax result that is widespread but viewed to be unfair. This is nothing more than an attempt to circumvent the legislative and regulatory process by altering the standard apportionment rules one taxpayer at a time. Because administrators have the ability to selectively invoke Section 18 and horse trade the adjustment for other audit issues, there is undoubtedly unequal application of the rules among taxpayers. To address this problem, a workable rule could prohibit widespread application of similar Section 18 adjustments.

Another possible repair to Section 18 is to clarify that it applies only to alternative apportionment and not alternative tax base calculation. In its current form, state tax administrators have applied Section 18 beyond its intended scope in applying the provision of subsection (4), which allows for "the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." State tax administrators and taxpayers, and consequently state courts, have used this provision to alter the state tax base. For example, in *Media General Communications, Inc. v. South Carolina Department of Revenue,* the Supreme Court of South Carolina allowed a taxpayer to apply alternative apportionment to switch to a method of combined reporting in apportioning its income.[32]

The MTC should also consider including clear language about who has the burden to prove the application of Section 18. Although it may seem obvious that the party invoking

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[30] *See Kan. Dep't of Revenue Office of Admin. App.*, Docket No. WFD-P2007-1 (Jan. 8, 2007); *Microsoft Corp. v. Franchise Tax Bd.*, 39 Cal. 4th 750 (Calif. 2006) (sale of investment securities by company's treasury function). Indiana Letter of Findings 01-0063, Indiana Dep't of Revenue (Oct. 1, 2002) and *In re Wal-Mart Stores, Inc.*, No. 06-07, New Mexico Taxation and Revenue Dep't (May 1, 2006) (licensing of trademarks by an intangible holding company to its parent).
[31] William J. Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 TAXES 747, 781 (1957).
[32] 694 S.E.2d 525 (S.C. 2010).

section 18 has the burden, states continue to argue that taxpayers have the burden in every instance.[33]

Section 18 should also prohibit the imposition of penalties in the event a state invokes alternative apportionment. There is perhaps nothing more inequitable in state taxation than the imposition of penalty on a taxpayer that reported income in accordance with the methods proscribed in a statute. Lastly, no state should be allowed to retroactively revoke Section 18 after it was granted to a taxpayer or invoked by a state.

IV. "Business Income" Definition

The definition and scope of apportionable business income (compared to allocable non-business income) lies at the heart of the Compact. Business income is considered by most states as having a transactional and functional test.[34] These tests are not clear or uniformly applied. A few states have expanded the definition of "business income" to be limited only by the U.S. Constitution.[35]

The MTC Uniformity Committee has proposed the following language to clarify the business income definition and promote uniformity across the states:

"Apportionable income" means:

(i) All income that is apportionable under the Constitution of the United States and is not allocated under the laws of this state, including:
   A. Income arising from transactions and activity in the regular course of the taxpayer's trade or business, and
   B. Income arising from tangible and intangible property if the acquisition, management, employment, development, or disposition of the property is or was related to the operation of the taxpayer's trade or business; and

(ii) Any income that would be allocable to this state under the Constitution of the United States, but that is apportioned rather than allocated pursuant to the laws of this state.

The proposal jettisons the term "business income" in favor of "apportionable income." In doing so, the definition is expanded to apportion all income that is apportionable under the U.S.

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[33] *Equifax, Inc., et. al. v. Miss. Dept. of Rev.*, Dkt. No. 2010-CA-01857-COA (Miss. App. Ct. May 1, 2012).

[34] *See, e.g., Hoechst Celanese Corporation v. Franchise Tax Board*, 25 Cal.4th 508 (Cal. 2001); *Gannet Satellite Information Network Inc. v. Montana Dept. of Rev.*, 348 Mont. 333 (2009); *Texaco-Cities Service Pipeline Co. v. McGaw*, 695 N.E. 2d 481 (Ill. 1998); *Polaroid Corp. v. Offerman*, 349 NC 290 (1998); *Willamette Industries, Inc. v. Oregon Dept. of Rev.*, 331 Or 311 (2000); *Kemppel v. Zaino*, 746 N.E. 2d 1073 (Ohio, 2001). On the other hand, some state courts have held that there is only a transactional test. *See, e.g., Uniroyal Tire Co. v. State Dept. of Fin.*, 779 So. 2d 227 (Ala. 2000); *Appeal of Chief Industries, Inc.*, 255 Kan. 640 (1994); *Phillips Petroleum Co. v. Iowa Dept. of Rev. and Fin.*, 511 N.W. 2d 608 (Iowa 1993); *Associated Partnership I, Inc. v. Huddleston*, 889 S.W. 2d 190 (Tenn. 1994).

[35] *See, e.g.*, 35 Ill. Comp. Stat. 5/1501(a)(1); Kan. Stat. Ann. § 79-3271(a); Minn. Stat. § 290.17 Subd.4.(a); N.C. Gen. Stat. § 105-130.4(a)(1); 72 Pa. Cons. Stat. § 7401(3)2.(a)(1)(A).

Constitution. Accordingly, the inquiry as to what constitutes apportionable income is limited only by the Due Process Clause and the Commerce Clause, which is primarily based on a unitary analysis that is highly factual, has been the subject of countless lawsuits and continues to evolve. Such a broad definition will certainly lead to an inconsistent interpretation across the states. In an attempt to provide some structure, the proposed language specifically enumerates the transactional and functional tests as tests that are *included in* the constitutional standard. However, such inclusion is little more than window dressing, as these tests will no longer serve as boundaries when apportioning income.

The Committee intends the "including" language to modernize the functional test in four ways:

- the list of activities under the functional test is expanded to include "employment" and "development."
- the functional test is now a disjunctive test by inclusion of the word "or" instead of "and," thereby clarifying that any one of the listed activities (e.g., …) can integrate property into the business.
- the use of the word "regular" is removed in modifying "trade or business."
- the requirement that the property constitute an "integral part" of the taxpayer's trade or business is relaxed to only require that the property be "related to the operation" of the business.

These revisions attempt to clarify statutory construction issues that courts have struggled with in interpreting the Compact's definition of business income Finally, the proposed language effectively terminates what is commonly referred to as the "cessation of business" exception from business income by (1) broadening the scope of apportionable income, and (2) specifically including the phrase "is *or was*" in defining the functional test. Under the current language, several courts have concluded that the liquidation accompanied by a cessation of business activity is an extraordinary and uncommon corporate event not typically occurring within the regular course of operations, thereby not satisfying the transactional test. [36] By broadening the standard to the reach the limits of what is permissible under the U.S. Constitution, gains from the liquidation of a unitary business may in fact be treated as apportionable income under the new standard.[37]

[36] *See, e.g., Lenox, Inc. v. Tolson*, 353 NC 659, 548 S.E. 2d 513 (2001) (holding a consumer products manufacturer earned nonbusiness income from the liquidation sale of one of its operating divisions); *Blessing/White, Inc. v. Zehnder*, 329 Ill. App. 3d 714, 768 N.E. 2d 332 (1st. Dist. 2002) (holding that gain realized from complete liquidation of the capital assets of a corporation followed by a distribution of proceeds to shareholders constituted nonbusiness income under the functional test because the corporation did not use the proceeds to continue its business because it had no business to continue); *Kemppel v. Zaino*, 91 Ohio St. 3d 420, 746 N.E. 2d 1073 (2001) (holding that income arising out of the liquidation of assets followed by dissolution of the corporation was not business income under either the transactional or functional test because it was a one-time event that terminated the business); *Laurel Pipe Line Co. v. Pennsylvania*, 537 Pa. 205, 642 A. 2d 472 (1994) (holding that taxpayer's gain from the liquidation of pipeline assets that had been idle for three years, when the proceeds from the sale were not reinvested in the business, gave rise to nonbusiness income under the functional test).

[37] For example, after the decision in *Blessing/White, Inc., supra*, the Illinois legislature amended its definition of business income to all income that may be treated as apportionable business income under the U.S. Constitution, in order to overrule the decision and treat gain from the liquidation of a business as apportionable business income. *See* Ill. Dept. of Rev. Info. Bulletin No. FY 2005-11 (December 1, 2004).

V. Definition of "Sales"

The Compact currently defines "sales" for sales factor purposes as "all gross receipts of the taxpayer not allocated." The MTC Uniformity Committee has incorporated certain aspects of the Compact model regulations in proposing the following definition:

> "Receipts" means gross receipts of the taxpayer that are not allocated under paragraphs of this article, and that are received from transactions and activity in the regular course of the taxpayer's trade or business; except that receipts of a taxpayer other than a securities dealer from hedging transactions and from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities, shall be excluded.
>
> Proposed Compact Art. IV § 1(g).

The Uniformity Committee's purported policy reason for borrowing the transactional test from UDITPA's business income definition, and excluding hedging and treasury receipts from the sales factor, is based on the notion that the purpose of the sales factor is to reflect the taxpayer's market activity, not production activity.

This policy justification has several flaws. First, hedging functions are critical to many taxpayers' business operations. Hedging activity directly relates to some taxpayers' ability to establish and maintain a marketplace. As such, excluding these receipts altogether does not reflect taxpayers' sales. Second, excluding hedging and treasury receipts reflects a disconnect between factor representation and taxable business receipts. Taxpayers would be required to include in apportionable business income derived from hedging or treasury functions that take place in the regular course of a trade or business, but would not be allowed to reflect this activity in the sales factor. This in a systematic mismatch between taxing income and reflecting sales associated with that income in the apportionment factor. The mismatch of factor inclusion and tax base inclusion becomes even more acute when coupled with the expansion of separately proposed expansion the apportionable income. As the base expands to apportion uncommon transactions, the apportionment formula is narrowing to exclude the same transactions. This approach seems inequitable.

VI. Additional Issues

The genesis for this project was a survey of the MTC Member states where the states indicated their level of interest in revising the various parts of the Compact. Based on that survey, the five key issues were selected. Given the significant and historic nature of the changes considered in the Proposed Amendments, we suggest that the Hearing Officer consider whether other aspects of the Compact should be amended in order to either increase uniformity or to perhaps make other parts of the Compact consistent with aspects of the Proposed Amendments. An example of possible amendments is Section16, which governs the sourcing of sales of tangible personal property. There is little uniformity with respect to how states apply Section 16. For example, a number of states, some of which are Compact members, do not impose the throwback rule because they do not like the policy behind throwback. The throwback rule should be reconsidered. Thought should be given to a way to craft a rule that would be more uniform. There is also inconsistency with how states apply the *Joyce* and *Finnigan* rules. Also, Section 16 sources sales of tangible personal property according to where the "purchaser" is located. Yet the changes to Section 17 will source receipts of "marketing intangibles" to the location of the "consumer" of the underlying "good." That rule implies "looking through" to the customer's customer. It seems inconsistent to source intangibles by looking through to the consumer of the tangible property, but to source the tangible property by looking only to the purchaser.

Almost all of the previous taxpayer input into this project focused on credible doubt that the states will achieve uniformity in how they apportion income. Taxpayer groups made compelling arguments on that issue, yet the Uniformity Committee drafted the Proposed Amendments in a way that presumes uniformity will be achieved. Given the unlikelihood of that occurring, we suggest that the Hearing Officer consider changes to the Proposed Amendments to reflect nonuniformity reality. One way that could be done is with "menu" items that allow states and/or perhaps taxpayers to choose a limited number of options. The Uniform Laws Commission provides options in several of the uniform acts, like the Uniform Electronic Signatures Act.

VII. Conclusion

For all the foregoing reasons, we ask that the MTC reconsider many aspects of the Proposed Amendments.

UDITPA, however, was designed for a different and, almost assuredly, simpler economic and business environment. As time has past states have departed from its provisions in response to the different ways in which business has been conducted and by the desires of the states to encourage economic development. Some parts of UDITPA remain in place but in other areas there have been departures by the states so it no longer reflects the practices of a majority of the states or serves the purpose of promoting or reflecting uniformity . It is time to revisit UDITPA and to bring it into conformity with the practices of the majority of the states.

MY CRITERIA FOR EVALUATING PROPOSED CHANGES

There are six principles which I believe were involved in the original drafting of UDITPA and which I believe have continuing vitality for purposes of considering changes.

State taxation of multijurisdictional taxpayers is subject to Constitutional limitations, principally the Due Process Clause of the Fourteenth Amendment. The unitary business principal is the constitutional touchstone.[1]

The income of a multijurisdictional business is difficult, if not impossible, to precisely assign geographically or functionally. As Justice Brennan said, assigning income is akin to slicing a shadow.[2] As a result, precision is not possible and all that is required of the methods is a rough, but fair, approximation.

There should be full accountability. That is, 100 percent of the business's income should be assignable to a jurisdiction that can tax it. While from some perspectives it might be simpler if the rule of full accountability were satisfied only when actual taxation existed, that is not required. States should be allowed to not assess tax if they determine that is appropriate. This should not provide justification for other states to tax such income.

The factors in an apportionment formula is not what is being taxed. The factors are only a means to measure activity, which in turn is used to assign income. Not every activity needs to be reflected in the formula and not every possible item that fits within a factor needs to be included.

The method, both in terms of calculation and application, must be administrable. It is self-defeating to pick the most accurate measurement of activity or an activity if the information to make the calculation is not readily available.

Uniformity by itself can be a solution to many problems. Issues of under-taxation or over-taxation are addressed by uniformity. With uniformity, what is over-

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1 *Mobil Oil Corporation v. Vermont* (1983) 425 U.S. 445, 439

2 *Container Corporation of America v. Franchise Tax Board* (1980) 463 U.S. 159, 192.

taxed in one jurisdiction will be commensurately under-taxed in another jurisdiction if all jurisdictions use the same rule and the test of internal consistency[3] is met.

PROPOSED CHANGES

There are five proposed changes that address four basic areas. The areas are 1) what income is subject to assignment by apportionment (Business Income, Art. IV.1.(a) and Nonbusiness income, Art. IV. (e)) ; 2) the sales factor with two subparts, what are sales (definition of sales, Art. IV.1.(g)) and how to assign sales other than those involving the sale of tangible property (Art. IV.17); 3) factor weighting (Art. IV.9); and 4) the use of alternative apportionment methods (Art IV.18).

BUSINESS NONBUSINESS INCOME
Art. IV.1.(a) and (e)

The proposed changes involve 1) changing the word "business" to "apportionable" in Art IV.1.(a) and Art. IV. 1.(e), 2) including reference to Constitutional requirements for apportionability 3) recognizing that income that could be Constitutionally allocated, assigned to a single state, can be treated as apportionable by the state, 4) affirming that the tests for apportionment include both a transactional and a functional component, and 5) providing further explication of the functional component.

The first problem in this area, proposed changes Art. IV. 1.(a) and (e), seems to be engendered by the title attached by UDITPA to the type of income, Business or Nonbusiness. This has been particularly apparent in those cases involving the classification of gain or loss on the cessation of business or the sale of going business by its owner. I agree with and endorse the replacement of the word "business" with "apportionable." **This change should promote uniformity.**

With respect to the second item, proposed change Art. IV.1.(a)(i), I recognize that that a state's right to subject an item of income to apportionment is governed by the Due Process Clause of the Fourteenth Amendment of the Constitution under the jurisprudence of the United States Supreme Court. This change reflects reality. **It is consistent with the analysis promulgated by the United States Supreme Court.**

I, nonetheless, would reject a definition of apportionable income referencing Constitutional principles. I do not believe that such a standard provides any real guidance. Determinations under the Due Process Clause are inherently fact related. The Constitutional standard would be subject to continual change based upon the vagaries of the facts of the most-recently litigated case.

An illustration of this is the decisions of the United States Supreme Court in *Mobil Oil Corp. v. Vermont,*[4] *ASARCO, Inc. v. Idaho State Tax Comm'n,*[5] and *Allied Signal Inc. v.*

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[3] A tax is internally consistent if no more than 100 percent of the income was taxed if every jurisdiction applied the same rules. *Container, supra,* at 169.

Dir., Tax'n Div.[6] In *Mobil* the court held that dividends from the ownership of a minority interest in a related entity were apportionable income. In *ASARCO* the Court held that dividends from non-controlling interests in entities that were not combinable were not apportionable. In *Allied-Signal* the Court referred to its analysis in *ASARCO* that only dividends from combinable entities was a "foot-fault."

A standard for apportionability based solely upon Due Process analysis would not provide firm guidance to either taxpayers or tax administrators. Such a standard would provide a prescription for continuing and unending litigation. **This change raises concerns about administerability and uniformity.**

With respect to the third item, proposed change Art. IV.1.(a)(ii), I support this change. This proposed change recognizes that with respect to a particular item of income that a state could Constitutionally choose to allocate, assign it to itself and tax accordingly, it may choose to forgo that choice and include the item of income in apportionable income. By choosing to apportion such an item of income which other states could only apportion it promotes uniformity. An argument can be made that, in the interests of uniformity, if an item of income could be apportioned by any state then all states should apportion it. Such a provision, however, would impinge upon state sovereignty and is not Constitutionally required. **This change promotes uniformity.**

With respect to the fourth item, proposed changes dividing Art. IV.1.(a)(i) into subparts (A) and (B), I strongly support this change. These changes make it clear that there are two separate tests for determining apportionable income the transactional test and the functional test. **This change promotes uniformity.**

This change reflects the position of most states. There is now general agreement as to what should be apportionable income and general acceptance that it should be a broad definition. The states that have formally indicated that they recognize both a transactional and functional test are: Alabama,[7] Alaska,[8] Arkansas,[9] California,[10] Florida,[11] Georgia,[12] Hawaii,[13] Idaho,[14] Indiana,[15] Iowa,[16] Kansas,[17] Kentucky,[18]

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4 445 U.S. 425 (1980)

5 458 U.S. 307 (1982).

6 504 U.S. 768 (1992)

7 Sec. 40-27-1.1

8 AS 43.19.010 Art. IV(1)(a) ; 15 AAC 19.011(a)(1)

9 Sec. 26-51-701(a), A.C.A.

10 *Hoechst Celanese Corp. v. Franchise Tax Board* (2001) 25 Cal.4\th/ 508, 532

11 Florida has not adopted UDITPA but has adopted the transactional and functional test for determining business income. Rule 12C-1.003

12 Georgia treats all income as apportionable except for certain types of income that are allocable. The Georgia view is broader than business income under UDITPA

13 Haw Rev Stat Sec. 235-21

14 IC Sec. 63-3027(a) ; Rule 35.01.01.331.01

15 IC 6-3-1-20 ; 45 IAC 3.1-1-29 ; 45 IAC 3.1-1-30 ; *The May Department Stores Company v. Indiana Department of Revenue,* 749 N.E.2d 651 (2001)

16 Sec. 422.32(1)(b), Code of Iowa

Mississippi,[19] Missouri,[20] Montana,[21] New Jersey,[22] New Mexico,[23] North Dakota,[24] Oregon,[25] Tennessee,[26] Utah,[27] Vermont[28] and West Virginia.[29]

State courts have wrestled with business/nonbusiness classification issues and the UDITPA definition for more than four decades with decidedly mixed results. There appears to be little controversy that income arising from the day-today operation of the business should be apportioned. The areas of controversy largely involve income that is generated from ancillary activities or from the disposition of the assets that were used in the operating business. Court decisions discuss whether the wording of the UDITPA definition includes two independent clauses, transactional and functional, or one clause, transactional, with a subordinate clause.

In several of the states where courts have construed the UDITPA definition as including only a transactional test, there has been a relatively immediate legislative response to broaden the definition. Unfortunately, in some jurisdiction this response has been one-sided; domiciliaries are able to elect to treat most items as apportionable income and non-domiciliaries can elect to treat contested items as allocable. **This does not promote uniformity but recognizes the sovereign character of states.**

Finally, with respect to the fifth item, proposed change Art.IV.1.(a)(i)(B), I strongly endorse these changes. These changes provide additional clarification as to what constitutes income that is apportionable under the functional test. In particular, the proposed change makes it clear that income arising on the <u>disposition</u> of property that is or <u>was</u> an asset of a unitary business gives rise to apportionable income. The majority of the disputes in state courts have arisen on the disposition of assets that were used in the business and, in particular, when the assets were disposed of in terminating a line of business or activities in a state. From my perspective, there are several compelling justifications for treating the results of these dispositions as apportionable income. The expenses related to such assets were taken into account in determining apportionable income in preceding years. The assets involved have been reflected in the apportionment

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17 <u>Sec. 79-3271(a), K.S.A.</u> That section also allows a taxpayer to elect to treat all income as business income

18 <u>103 KAR 16:060</u>

19 <u>Miss Code Ann Sec. 27-7-23(a)(2)</u> ; Miss Reg. 35.III.8.06 301

20 <u>12 CSR 10-2.075</u>

21 <u>*Gannett Satellite Information Network, Inc. v. Montana Department of Revenue*</u>, 348 Mont. 333, 201 P.3d 132 (2009

22 New Jersey divides income into operational and nonoperational and then applies the transactional and functional tests to make the classification. Instructions, Schedule O, New Jersey Nonoperational Activity Packet

23 <u>NM Stat Ann Sec. 7-4-2(A) (1978)</u>

24 <u>Sec. 57-38.1-01(1), NDCC</u> ; <u>Rule 81-03-09-03, NDAC</u>

25 <u>OAR 150-314.610(1)-(A)</u>

26 <u>Sec. 67-4-2004(3), T.C.A.,</u>

27 <u>Rule R865-6F-8(2), Utah Admin. Code</u>

28 <u>32 V.S.A. Sec. 5833</u>. Vermont does not follow the normal business\nonbusiness rules, nonbusiness income is generally limited to passive or portfolio income.

29 <u>W.Va. Code Sec. 11-24-3a(a)(2)</u>

formula for years. Finally, the sale or disposition of assets reflects the final culmination of business activities. **This change will promote uniformity.**

SALES FACTOR

DEFINITION OF SALES
Art. IV.1.(g)

The sales factor as originally contemplated in UDITPA was intended to represent the contribution of the market to the earning of income. As such the sales factor should reflect activities of the taxpayer with its customers. The current broad all encompassing definition of sales defeats the purpose of the sales factor.

The Multistate Tax Commission (MTC) has proposed a regulation defining gross receipts for purposes of the sales factor that would exclude such proceeds and a number of other items from the sales factor.[30] The proposed changes to the statutory definition of sales conforms to the MTC's proposed regulation.

The problems with the overly broad definition of sales is illustrated by cases that have been and or are currently being litigated. These cases reflect efforts to inflate the denominator of the sales factor. Interestingly these efforts to inflate the denominator of the sales factor have only been made in those states where the activity would not be included in the numerator of the sales factor. **If successful these efforts result in "nowhere" income in violation of one of the basic premises of UDITPA.**

The earliest effort in this area involved the question of whether proceeds from the short-term investment of liquid assets should be included in the denominator of the sales factor. This issue was first raised in the seventies and appeared to be put to rest by a series of decisions involving AT&T. It resurfaced in California in the nineties as the result of a decision involving a securities dealer.[31] California defended these cases on two grounds. First, the return of principal when these short-term investments are held to maturity does not constitute a gross receipt, and, second, that including such proceeds in the sales factor does not fairly represent the extent of the taxpayer's activity in California. The first ground was rejected by the California courts on the basis that these receipts were encompassed by the UDITPA definition of sales. The determination of this question varied between the states. California was generally successful in avoiding this attempt at denominator inflation under its powers under Section 18 of UDITPA.[32] Other states

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[30] MTC reg. IV.2 (a)(5).

[31] Appeal of *Merrill*, Lynch, Pierce, Fenner & Smith, Inc, California State Board of Equalization, 89-SBE-017 (1989).

[32] *General Motors Corporation v. Franchise Tax Board*, 39 Cal. 4th 773, 47 Cal. Rptr. 3d 233, 139 P.3d 1183 (2006); and *Microsoft Corporation v. Franchise Tax Board*, 39 Cal. 4th 750, 47 Cal. Rptr. 3d 216, 139 P.3d 1169 (2006).

which have not been successful defending against this denominator inflation by the definition of sales have also been successful under Section 18.
California recently had a case involving an attempt to inflate the denominator of the sales factor by including the receipts from hedging activity of commodities.[33] Other variants of the this strategy involve including hedging of foreign currency transactions. Section 18 has been used to combat these efforts at denominator inflation.

Another example of a strategy to inflate the denominator of the sales factor was presented in the case of *Union Pac. Corp. v. Idaho.*[34] In that case, Union Pacific included in the sales factor the receipts it generated from providing transportation services, and then attempted to include the receipts it generated from selling the receivables arising from providing transportation services. Idaho successfully thwarted this strategy by arguing that such treatment would not fairly reflect the taxpayer's activity in Idaho.

Reliance on Section 18 does not promote uniformity. A better solution than having to rely on section 18 of UDITPA would be to define sales more narrowly. The proposed amendment to the definition of sales adopts this approach. **This promotes uniformity and protects against "no-where" income.**

The argument is frequently made that if an item is classified as business income, it must be in the sales factor. I believe this argument is incorrect. It appears to be based upon the underlying assumption that the factor itself is being taxed. The United States Supreme Court has rejected this type of argument.[35] If the definition of sales were limited to include only sales to customers in the normal course of business, the purpose of the sales factor to represent the market would be fulfilled, and issues arising from other types of sales would be eliminated. If additional receipts need to be counted, then including interest income and net gains and losses on the sales of intangibles should provide sufficient weight in the sales factor for all but financial corporations or brokers. **Limiting the definition of what is included in the sales factor will result in a more accurate reflection of the intended purpose of the sales factor.**

SALES OF OTHER THAN TANGIBLE PROPERTY
Art. 17

Under UDITPA the sales factor was to be a balance to the property and payroll factors, which represented the contributions of capital and labor respectively. Under UDITPA, the sales of tangible property are assigned generally to the location of the customer, where the market is for the goods. For all other receipts UDITPA treats those receipts as sales and assigns those sales to the state of principal income- producing activity.[36]

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33 *General Mills, Inc. v. Franchise Tax Board*, 146 Cal.Rptr.3d 475, 208 Cal.App.4th 1290 (2012)

34 *Union Pac. Corp. v. Idaho State Tax Comm'r* (2001) 136 Idaho 34; 28 P.3d 375.

35 *Trinova Corporation v. Michigan Department of Revenue* (1991) 498 US 358.

36 Section 17.

Income-producing activity involves either the employment of property or individuals. It replicates the property and payroll factors. It does not represent the market. **Changes in Art. IV.17 to represent the market are appropriate and will better reflect the intended purpose of the sales factor.**

All-or-Nothing Assignment

A problem with respect to the assignment of sales of other than tangible property is the all or nothing rule of UDITPA. These sales are assigned to the state with the preponderance of income-producing activity.[37] Not only is there no division of the sales between states, but also strict application of this rule could result in the total sales being assigned to a state where 2.1% of the activity occurred if the remaining 97.9% of the activity was divided evenly among the other forty-nine or fifty jurisdictions. A number of states have departed from the UDITPA rule and provide for a proportional assignment of sales while retaining assignment pursuant to income producing activity. Other states have abandoned the use of income producing activity to assign such receipts and use assignment rules such as the "point of delivery" or "where the benefit is received." Finally, other states have dealt with this issue through the use of their powers under Section 18 of UDITPA. The MTC's current regulations in this area provide a partial solution to this problem by stating that when the activities occur within and without the state, the activities in each state will be considered a separate income producing activity.[38] **Abandoning the all-or-nothing assignment rule will allow the sales factor to better reflect the market and will promote uniformity.**

Other Receipts from Tangible Property

The sales covered by Art. 17 include a variety of receipts, everything that is not covered by Art. 16. Art. 16 deals only with the sales of tangible property. Art. 16 does not deal with other receipts generated from tangible property both real and personal, such as rents. Art. IV.17 covers receipts from tangible property other than actual sales. These receipts include the leasing of tangible property, both real and personal. Many of the receipts generated by such activities had traditionally been treated as income that was specifically allocated to a single jurisdiction under the MTC regulations. Those assignments have generally been accepted but are subject to challenge as not being contemplated by the statute. The changes proposed in ArtIV.17(a)(1) and (2) incorporate the rules included in the current regulation. I strongly endorse these changes.

Receipts not Involving Tangible Property

Art. 16 does not apply to receipts from intangibles and it does not apply to receipts from the providing of services. When UDITPA was promulgated, sales, other than sales of tangible property were not significant. Such sales represented a minority of the sales of

37 Section 17(b).
38 MTC reg. IV.17.4 (B)(c).

business generally. Our economy has changed in 50 years, and receipts other than from the sale of tangible property represent the majority of the sales of the United States and world businesses. If the sales factor is to represent the market the UDITPA rules in this area need to be revised to reflect the location of the customer who is purchasing the service or the intangible. **Changing the assignment rule for receipts from intangibles will better reflect the purpose of he sales factor.**

Receipts from Services

The changes in Art.IV.17.(a)(3) assign receipts from services to the extent the service is delivered to a location in a state. I strongly endorse changes that make the assignment of receipts from providing services on a market basis. **This change will reflect the purpose of the sales factor, reflection of the market.**

The choice of a standard by which to make a market assignment, however, is difficult. Delivery can be an imprecise term in some circumstances but it is information that should be available to the taxpayer. If services are rendered to a multistate business there may be issues as to where they are delivered. Is it the home office of the business, or a particular location of the business? If the latter it may be apparent from a contract or a mailing address. If the location to which it is delivered is a home office and the service relates to something that occurs in only one location or a different location that may not accurately reflect the market. As an example, if the home office of a multistate business asks for legal advice from a national law firm regarding tax matters in a state other than where the home office is located where does "delivery" occur.

An alternative standard for assigning such sale might be "where the benefit of the service is received." This standard has been adopted by a number of states. That standard may also be difficult to apply in many cases and, most importantly, may require a determination on the basis of information that is not available to the taxpayer. Assignment based on delivery may be the best that can be done. It should be information that is available to the taxpayer. **Use of delivery is consistent with administerability.**

Receipts from Intangibles

Art. IV.17.(a)(4) deals with the assignment of receipts from intangible property. It breaks the receipts into two classes. Subparagraph (i) assigns receipts from the rental, leasing or licensing of an intangible to the extent the property is used in this state. Subparagraph (ii) assigns receipts from the sale of intangible to the state where it is used with two additional subparagraphs dealing with particular sales transactions.

With respect to receipts from intangibles , other than from sales, where the intangible property is used reflects the market and is similar to the current rule for the allocation of such receipts from intangibles which constitutes what UDITPA presently calls nonbusiness income.

The rule utilizes proportionality. The use of the property in this context would typically be continuing so where it is used may vary over time. Issues may arise with respect to a taxpayer knowing the place where an intangible is used. It is fairly common, however, for a taxpayer to have the ability to audit the use of an intangible to ensure that it is receiving proper compensation of its use. This ability should allow it to determine where use occurs. **The standard meets the criteria of administerability.**

With respect to sales of intangible property there is typically no continuing responsibility to make payments. The ability to make a determination where property is used at the point of time of the sale should generally be determinable. A special rule is provided in subparagraph (B) for sales where the price is dependent on continuing use. Again a taxpayer's ability to audit records to determine the actual continuing use should allow for the determination of where that use occurs. A special rule is also provided with respect to a franchise or license is set forth in subparagraph (A) which is specifically tied to the geographic area covered by the agreement. **The rules meet the criteria of administerability**.

The difficulties with administration are addressed by Art. IV.17.(b) which allows for the use of approximations if an assignment cannot be made pursuant to Art. IV.17(a). It is hoped that reference to this provision would not occur frequently. It would appear there need to be regulations adopted to implement this provision.

Art.IV.17(c) and Art. IV.(a)(4)(ii)(C) provide a throwout rule if assignments cannot be made by reference to other provisions of Art.IV.17. Specific authority for throwout rule if it is to exist should be provided.

Art.IV.17(d) provides specific authority for the adoption of regulations to implement this and the other provisions. Providing specific authority may raise the level of authority with respect to such regulations, characterizing them in some jurisdictions as being "legislative" actions. **This should promote uniformity and administerability.**

In most cases the specific sourcing rules are workable. It must be recognized that the sourcing of some receipts, in particular those received from multistate entities, maybe difficult to determine precisely. In some circumstances that necessary information may not be readily available to the taxpayer because it is dependent on the uses made of an item by the taxpayer's customer. The use of approximations, while lacking precision, appears to be an appropriate effort to reach a workable result.

The proposed changes to Art.IV.17 are to be commended. The adoption of market based sourcing for the various receipts comports with the purpose of the sales factor and as should abandonment of the all or nothing rule.

FACTOR WEIGHTING
Art.IV.9

UDITPA uses an equally weighted, three-factor formula.[39] The UDITPA formula has been referred to by the United States Supreme Court as "something of a benchmark,"[40] though the Court also indicated that the weighting assigned to the factors is "essentially arbitrary."[41] The UDITPA factors are tangible property, payroll, and sales. But the United States Supreme Court has also accepted single-factor formulas.[42] Pre-UDITPA formulas included a variety of other activity measurements.

There is nothing sacrosanct about the three factors used in UDITPA, but the United States Supreme Court has stated that the UDITPA formula reflects a rough sense of how income is earned.[43] The Supreme Court's jurisprudence requires that an apportionment formula must have "external consistency," that is, the factor or factors used must reflect a reasonable sense of how income is generated.[44] The equally weighted, three-factor formula clearly passed muster. I believe, from a theoretical perspective, the use of a multi-factor formula is superior to a single-factor formula. The use of multiple factors has the advantage of averaging. That is, anomalies that might occur with respect to a single factor will tend to be offset by the other factors, and the significance of any individual factor will be lessened by the use of other factors.

The states have been moving to a double-weighted, or more, sales factor or a sales factor only apportionment formula. The trend to double weighting the sales factor in the traditional three-factor formula has some justification in that the sales factor represents the "market" and the property and payroll factors represent the production side of the income equation. The use of a sales-only apportionment factor, however, seems suspect. An example I have frequently used to demonstrate the problem which a sales factor formula only is a two-state oil company that has wells in one state, A, and sells the product in another state, B. In a sales factor only environment all the income would be assigned to state B. This result seems unreasonable and would be unlikely to survive a constitutional challenge. Arguments have also been raised that the apparent motivation behind the use of a sales factor only may be constitutionally suspect as being discriminatory.

Given the current trends, it would appear to me that this is an area in which a compromise between theoretical purity and political expediency will have to be made in the interest of uniformity. If uniformity can be achieved, the overall result may be acceptable.

The current proposal seems to contemplate two options. The first is just a statement that apportionable income is to be apportioned by the formula employed by the state. The

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39 Section 9.
40 *Container, supra*, at 170.
41 *Ibid.* at 184, fn. 20.
42 *Moorman Manufacturing Company v. Bair* (1978) 437 U.S. 267 and *Underwood Typewriter Co. v. Chamberlain* (1920) 254 U.S. 113.
43 *Ibid.* at 186.
44 *Ibid.* at 169.

second recommends a double-weighted sales factor. The first option does not mandate uniformity, the second option is already out-of-step with the current trend and is unlikely to achieve uniformity.

I believe a multi-factor formula is the superior approach. The relative weighting of the factors appears to be arbitrary. Double-weighting sales, however, has the attribute of balancing supply and demand.

If uniformity in terms of language is the goal then the first option will achieve a degree of "uniformity" in that every state could adopt it and continue to have flexibility in designing its own formula .

If theoretical purity is the goal then endorsing a multi-faceted formula would be best. I see no theoretical reason that double-weighted sales should, or should not, be the formula of choice.

Given the current trends, it would appear to me that this is an area in which a compromise between theoretical purity and political expediency will have to be made in the interest of uniformity. If uniformity can be achieved, the overall result should be acceptable.

ALTERNATIVE METHODS
Art.IV.18

UDITPA currently provides for variations from the standard provisions if the statutory rules "do not fairly reflect the activity within the state."[45] Clearly there needs to be a provision for relief from the standard rules. Even if one rule could be written to handle all existing business arrangements and activities, it is unrealistic to expect that such rules would be uniformly appropriate forever. There are, however, a number of questions that arise with respect to such a safety valve.

One issue not addressed by the proposed amendments is whom should have the burden of showing the need for a variation? It appears to be generally accepted that whichever party is seeking to vary should have the burden therefore there may not be a need to address this question. I would suggest making this explicit in the statute.

What is the correct standard? Some have suggested that constitutional distortion should be required. In my opinion, this would be too high a threshold and might require that every request for variation would be resolved through litigation. I would endorse continuing with the current standard or some variation which is the recommendation in the proposed amendment. I would not recommend attempting to establish a specific threshold for determining the need for a variation. Many of the cases involving questions of unfair reflection attempt to perform mathematical analyses. I believe the use of a mathematical standard or threshold would be improper. The question of fairness is one of qualitative relationships, not quantitative ones.

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[45] Section 18.

Should variations be uniform? To achieve an appropriate level of uniformity, variations should be made uniform. This principle of uniform variations could have particular application in the case of apportionment rules for particular industries or to deal with commonly occurring situations, an area that states now deal with through specific statutes or regulations. At least there should be uniformity within a state. This type of uniformity can best be achieved through the formal rule making process of adopting regulations. A presumption of correctness should be attached to a rule adopted through the regulatory process.[46] The proposed amendments deal with this in Art.IV.18(b)(1) and (2). Subparagraph (2) allows variations from rules adopted by regulation under the general provisions of Art.IV.18(1). **This change will promote uniformity.**

[46] See *Appeal of Fluor Corporation*, SBE, 95-SBE-016, (1995)

McDermott
Will&Emery

New York

MEMORANDUM

Date: March 7, 2013

To: Multistate Tax Commission

From: Peter L. Faber

Re: Proposed Amendments to Apportionment Provisions

I have some technical comments on the draft amendments to Article IV. These comments are submitted in my individual capacity and do not necessarily reflect the views of my firm or of any of our clients.

Let me preface these comments by saying that I take no position on whether it is appropriate or desirable to amend the provisions. These comments are technical in nature.

Proposed Article IV.1(a)(i) provides that apportionable income means "all income that is apportionable under the Constitution of the United States and is not allocated under the laws of this state..." The language then goes on to specifically discuss income from transactions in the regular course of business and income from tangible and intangible property. If the operative provision is that any income that is constitutionally apportionable will be apportioned, you do not need subparagraphs (A) and (B). In fact, those paragraphs could be viewed as limiting the generality of the basic proposition that all income that is constitutionally apportionable should be apportioned. As you know, this and similar language has given rise to extensive litigation over the years. Under the "constitutional" approach, it is unnecessary and could be viewed as watering down the comprehensiveness of the constitutional principle with the result that taxpayers and revenue departments will be encouraged to argue that there should be other limitations. I would delete subparagraphs (A) and (B).

If, notwithstanding this recommendation, the subparagraphs are included, I question whether it is appropriate to include in apportionable income income that "was" related to the operation of the taxpayer's trade or business. Is there no time limit on this? If property had been used in the taxpayer's business operations fifty years ago but had been held purely as an investment since then, its sale should not produce business income. I realize that it is hard to decide where to draw the line, but surely the line should be drawn somewhere.

Article VI.17(a) provides that intangible property will be treated as used in the taxing state "if the geographic area includes all of part of this state." This could result in sufficient multiple counting if the geographic area of use included five states and each state took the position that the property was being used within its borders.

Article IV.18 contains the alternative apportionment provisions. I do not comment on the proposed changes, but I suggest that it would be appropriate for the statute to provide, as is well established in the case law, that the burden of proof rest with any party asserting alternative apportionment, including the department of revenue, and that the alternative apportionment methodology should generally be consistent with the spirit of the statutory apportionment methodology.

McDermott
Will & Emery

Washington, DC

MEMORANDUM

Date: March 10, 2013

To: Professor Richard Pomp, Hearing Officer

From: State Tax Policy Coalition

Re: Proposed Recommended Amendments Multistate Tax Compact Article IV

These comments reflect only questions about the effect of the Multistate Tax Commission adopting the Multistate Tax Compact Article IV Recommended Amendments through the current process. The absence of comments as to the substance of the Recommended Amendments should not be assumed to reflect anything about the commentators support of or opposition to the Amendments.

Since the beginning of this uniformity project, counsel for the Coalition have asked two questions: (1) What is the procedure for amending the Compact and does it differ from the standard procedure for the Commission adopting a uniformity proposal and (2) what is the effect on Compact members of amendments to the Compact. Neither of these fundamental questions has been publically answered. Particularly in light of on-going litigation regarding the enforceability of the Compact,[1] a considered and public analysis of these questions is important.[2] Furthermore, the Commission is itself a creation of the Compact and only came into being once seven states had adopted the Compact.[3] It is not clear whether seven states must remain Compact members for the Commission to continue. The Coalition believes it is premature to consider the substantive amendments because it remains unclear how these amendments may be adopted by the Commission and what such adoption means to the member states.

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[1] *Compare Gillette Company et al. v. Franchise Tax Board*, No. A130803 (Ct. App., July 24, 2012)(Compact is enforceable multistate compact and individual state can not unilaterally overrule one provision without withdrawing entirely from the Compact) *with IBM v. Michigan Department of Treasury*, Mich. Ct. of App, Dkt No. 306618 (November 20, 2012)(Legislature not bound by previous legislature's decision to adopt Compact).

[2] Based on *amicus briefs* filed by the Commission in *Gillette* and *IBM*, the Commission currently takes the view that the Compact provisions are not binding on Compact members. However, this position has been rejected by at least one state (*see Gillette*) and fails to address what, in the absence of a binding interstate compact, it means to be a Compact member as well as what authority the Commission itself enjoys absent a binding organizational document.

[3] Multistate Tax Compact, Article X(1),

Procedure for Amending Compact is Unclear

The Compact seems to be a formation document which creates both an interstate compact and the Commission to administer the Compact. The Compact specifically controls when the Compact becomes enforceable[4] and provides the rules for the organization and management of the Commission.[5] The Compact also specifically explains the powers of the Commission.[6] The Compact may be similar to the articles of incorporation for a corporation. Neither the Compact nor the Commission's By-Laws provide for a process to amend the Compact. (The By-Laws do contain a process to amend the By-Laws).

The Commission appears to assume that its standard procedure for adopting a uniformity recommendation applies equally to a recommendation to amend the Compact. One of the powers specifically granted in the Compact to the Commission is to "[d]evelop and recommend proposals for an increase in uniformity or compatibility of State and local tax laws with a view toward encouraging the simplification and improvement of State and local tax law and administration."[7] However, if the Compact is the formation document of an interstate compact and/or does govern under what conditions the Commission exists, it is not clear that the standard uniformity process is the proper process for adopting such amendments.

Thus, the Coalition recommends that before ostensibly adopting the Recommended Amendments, the Commission should review and publicize its determination as to what are the legal requirements for making such amendments.

Effect of Amendments on Compact Member States

It is not at all clear what effect amending the Compact will have on Compact member states. Will the amendments require Compact members to enact legislation adopting the amendments in order to remain members of the Compact? Will an amendment be assumed to apply in Compact member states absent an affirmative legislative withdrawal from the Compact? What effect will the amendments have on the Article III election? What effect will the amendments have on existing uniformity regulations interpreting UDITPA as adopted by the Uniform Law Commission? What effect will a failure of seven states to enact the Compact, with the Amendments, have on the existence of an interstate compact and/or the Commission? All of these issues are of fundamental importance to a multistate taxpayer's decision whether to support the substantive provisions of the amendments or not.

Given the importance of these issues to the legislative community and the views that have previously been expressed by the National Conference of State Legislatures and the American Legislative Exchange Council, the Coalition recommends that before ostensibly adopting the Recommended Amendments, the Commission should review and publicize the effects on Compact member states and the Commission of the adoption.

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[4] *See* Article X: Entry Into Force and Withdrawal. 1. The compact shall enter into force when enacted into law by any seven States. Thereafter, this compact shall become effective as to any other State upon its enactment ...

[5] Compact, Article VI. The Commission.

[6] Article VI(3).

[7] Article VI(3)(b).

AMY PITTER
COMMISSIONER

MICHAEL T. FATALE
CHIEF

The Commonwealth of Massachusetts
Department of Revenue
Rulings and Regulations Bureau

P.O. Box 9566
Boston, MA 02114-9566

March 12, 2013

Loretta King
444 North Capitol Street, NW, Suite 425
Washington DC 20001

Re: Public Hearing on Proposed Amendments to Multistate Compact Article IV

Dear Ms. King:

I am writing in support of the Multistate Tax Commission's (MTC) proposed amendments to the model multistate tax compact that would explicitly source receipts from "other than sales of tangible personal property" using a market approach for purposes of sales factor apportionment as applied in the context of the corporate income tax. The rule to be amended as set forth in the Compact and currently in use in many states, which is dependent upon determinations as to "income producing activity" and "costs of performance," has proven to be generally unworkable and often-times distortive in practice. For example, the current rule often serves merely to duplicate a state's property or payroll factor and not to reflect a corporation's in-state market, contrary to the intention behind the rule. In contrast, the proposed rules would address taxpayer questions that arise in this area by fostering state tax equity and state tax uniformity.

The Governor of this state has proposed legislation that would revise this state's sales factor apportionment statute as applied for corporate income tax purposes to include rules that are similar to those being considered by the MTC. Those state proposals have looked to the work that has previously been done by the MTC as part of this project, and further legal developments in this state would benefit from the adoption of the MTC amendments.

The proposed MTC amendments include rules that would, for sales factor purposes, source proceeds received from the license of intangible property based upon the in-state use of such property. These proposed MTC amendments resemble rules that are currently used in this state, and I specifically support the MTC effort to include such rules in the MTC proposals.

Very truly yours,

Amy Pitter
Commissioner of Revenue

Telephone: (617)626-3250 Deliveries: 100 Cambridge Street, Boston, MA 02114 Fax: (617)626-3290

IDAHO
State Tax Commission
PO Box 36 • Boise ID 83722-0410
800 Park Blvd., Plaza IV • Boise ID 83712-7742

March 22, 2013

Multistate Tax Commission
Attn: Loretta King, MTC Executive Assistant
444 North Capitol Street, N.W.
Suite # 425
Washington, DC 20001

Dear Ms. King:

The Idaho State Tax Commission is in favor of the proposed amendments to Article IV. Most of the proposed amendments reflect and support Idaho's current interpretation and application of Article IV. The only significant change to Idaho law would be the repeal of the "costs of performance" method. The proposed amendment for sourcing sales, other than sales of tangible personal property, would provide a sourcing method that better reflects what Idaho believes to be the purpose of the receipts factor. If the Multistate Tax Commission adopts the proposed amendments, the Idaho State Tax Commission will likely suggest that these amendments be adopted by the Idaho legislature.

Richard W. Jackson

David R. Langhorst

Tom Katsilometes

Kenneth A. Roberts

pns/ljd

Additional Comment by Benjamin F. Miller with Respect to Testimony
Offered at the Hearing of March 28, 2013 in Washington D.C.
Proposed Amendment to Section 17 of Article IV

At the hearing of March 28, 2013 the hearing officer inquired of me as to how the place of delivery would be determined under proposed Section 17(a)(3) relating to the delivery of a service. In my oral comments I stated that billing address would be used. I would like to amend my oral statement.

The touchstone for determining where delivery is should be information that is available to the taxpayer. It would be my recommendation that a hierarchy needs to be established with respect to where delivery occurs. This hierarchy can be established through regulations. Suggestions for this hierarchy are:

1) In the case of a service is being provided for an activity that is primarily or exclusively associated with a state such as the providing of legal services for a suit brought in a particular jurisdiction or with respect to providing services with respect to the construction of something within a particular jurisdiction delivery would be in that state.

2) If the recipient of the service is located in a single state, delivery would be in that state. This would normally be particularly appropriate with respect to an individual.

3) Delivery would occur at the location of the office which ordered the service.

4) Delivery would occur at the address where the bill is sent.

With respect to 3) and 4) it could be appropriate to rely upon approximations in the case of a service provided to a multijurisdictional entity where the service would be utilized throughout the jurisdictions in which the recipient of the service does business.

From: HUMPHREY Gary D [mailto:gary.d.humphrey@state.or.us]
Sent: Thursday, March 28, 2013 6:04 PM
To: Loretta King
Subject: Written Comments -- MTC Article IV Recommended Amendments

Loretta,

The MTC and participating states have developed and refined the recommended amendments to Article IV of the Compact for the past few years. Members of the public and representatives of business have participated in discussions of the proposed amendments and their input has been helpful in drafting the proposed amendments. The amendments are ready for consideration by the states and I urge the Executive Committee to approve the proposed amendments for the next step of the adoption process.

Gary D. Humphrey
Corporation/Estate Section Manager
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Data Classification: Level CL2 - Limited

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April 4, 2013

Delivered by Electronic Transmission

Professor Richard D. Pomp
Hearing Officer for the Multistate Tax Commission
Alva P. Loiselle Professor of Law
University of Connecticut School of Law
Hartford, Connecticut

Re: Comments on Multistate Tax Compact Article IV Recommended Amendments

Dear Hearing Officer Pomp:

Please accept these comments concerning the Multistate Tax Commission's "Multistate Tax Compact Article IV Recommended Amendments."

These comments focus in the first instance not on the substance of any specific provision, but instead on the standards for evaluating any proposal relating to the apportionment of the income of multijurisdictional enterprises. These initial comments seek to clarify the meaning of uniformity and how success in achieving uniformity can be measured. Following this initial discussion of uniformity, I provide comments on certain portions of the proposed Article IV amendments.

The Meaning and Measurement of Uniformity

Recommendation: The Multistate Tax Commission and its Hearing Officer should evaluate amendments to Article IV using a definition of uniformity as fairness in taxation. Achieving uniformity means applying corporation taxes uniformly to all corporate taxpayers—large and small, in-state and multijurisdictional—in proportion to the business activity that each taxpayer conducts within a state. Legal consistency should not be used as the test of achieving uniformity because such a limited test can yield inequitable or non-uniform tax results. Further, the range of comparison of the impacts of any given amendment should include corporations whose activities are entirely within the boundaries of a state in addition to various types of multijurisdictional taxpayers in order to understand properly the equity or fairness effects of any given proposal.

News reports at the hearing on March 23 indicate that commentators frequently discussed whether or not a particular approach would advance the purpose of uniformity. A careful reading of those comments indicates that uniformity was often used to mean the degree to which states consistently adopt the same legal provision applying to multistate taxpayers. From this perspective, legal consistency is taken to be the equivalent of achieving uniformity in taxation. That view is erroneous. Legal consistency can be a helpful, but not always necessary, tool to achieving uniformity in taxation—but it does not constitute uniformity in and of itself.

Uniformity in corporate income taxation is something much more fundamental than mere rote consistency in state laws. Uniformity in corporate taxation occurs when taxpayers in a given jurisdiction are taxed in a uniform or equitable manner. It is a circumstance in which a multijurisdictional enterprise is as fully and equally accountable for reporting the income it earns in a state as is a small business that operates entirely within that same state. The "income earned in the state" is determined in a manner to fairly represent the extent of the multijurisdictional taxpayer's business activities in the state (the overarching Article IV/UDITPA policy standard). The taxes paid by taxpayers, small and large, will be proportionate to the business activities they conduct in the state. Thus, the taxes will be fairly related to the benefits the taxpayers receive from public services that support the conduct of their business activities in the state. The principle of uniformity in taxation requires that no corporation be able to artificially shift income away from the state to be reported elsewhere or nowhere through various elections, tax planning strategies, evasion schemes or other artificial mechanisms. Uniformity is achieved when corporations subject to the tax are fully and fairly accountable for the income they earn in relation to the extent of business activities conducted in each jurisdiction.

Legal consistency often supports uniformity in taxation, but not always. One example is the original "greater cost of performance" provision for the sourcing of certain sales receipts among jurisdictions. That provision has allowed some service sector taxpayers to manipulate the assignment of income among the states using diverse accounting methods with the net result of generating large quantities of "nowhere income." As originally written and generally enacted, did this provision achieve legal consistency? Yes. Did it achieve uniformity in taxation properly understood as fairness? No. A bad law that is consistently enacted in state after state that allows some multijurisdictional taxpayers to manipulate income reporting in ways that other corporations cannot fails the standard of uniformity in taxation.

Nor is legal consistency always necessary to achieve reasonable uniformity among corporate taxpayers, large and small. In a number of cases, modest variations in legal provisions do not produce substantial variations in the uniform and equitable taxation of corporations.

Uniformity in taxation arises from provisions in the state constitutions and laws, the U.S. Constitution and extensive federal and state case law. Broadly speaking, this body of law requires uniform, equal or fair treatment of taxpayers in relation to each other. Thus, this concept of uniformity as fairness in taxation is much richer and more complete than the superficial "uniformity" reduced to mere legal consistency.

Implicit in the discussion above, is that the frame of reference for discussions of multijurisdictional tax issues is often too narrow. For example, participants in the March 28 hearing typically evaluated proposals and issues in terms of how they might affect only multijurisdictional taxpayers. Left out of the discussion are in-state taxpayers who would be required to pay for services enjoyed by multijurisdictional taxpayers if the latter do not pay their proportionate share of taxes. Treating apportionment issues as "inside baseball" involving only state tax experts and multijurisdictional companies and their hired advocates is a mistake. Fair and effective apportionment exists not for the private benefit of multijurisdictional enterprises. Rather, it exists to serve the public interest in tax equity and to protect in-state taxpayers from having to unfairly pay for public services required by multijurisdictional economic activity and vice versa. When experts and policy-makers make comparisons of how of certain apportionment provisions affect different multistate taxpayers, they should include in-state businesses in those comparisons as well. One cannot understand the uniformity (fairness) impact of various policy scenarios without comparing how an in-state taxpayer is taxed in relation to multistate taxpayers.

For example, single sales factor apportionment is often discussed in terms of comparing the tax treatment of a multistate taxpayer that produces but does not sell within a state with the tax treatment of another multistate taxpayer that sells into but does not produce in the state. This comparison leaves out the in-state corporation that bears a greater tax on business activities than a multistate taxpayer engaging in production, but few or no sales, in the state—even though the multistate taxpayer conducts comparable or more extensive business activities. Failure to include the in-state corporation in the analysis of the single sales factor ignores the inequitable, non-uniform treatment of the in-state corporation as compared to the multistate taxpayer with production activities, but few if any sales, in the state.

Factor Weighting

Recommendation: The Multistate Tax Commission should not, in the present policy environment, attempt to move states in the direction of a commonly adopted formula that advances uniformity in taxation. Any such attempt will be futile and likely counterproductive. If the Commission recommends to states any amendments to Article IV, the amendments should allow states to choose their own factor weighting—perhaps limited to a defined period such as ten years or twelve years. The Commission should address factor weighting by initiating a systematic study process that also engages a broader range of state officials with tax administrators in research, evaluation and dialogue on the factor weighting issue.

Two Less Desirable Options: If the Commission judges it necessary to make a factor weighting recommendation, one option would be to propose language that would permit states to choose either the traditional single factor formula or a double-weighted sales formula. Increasing the sales factor weighting beyond double-weighting increases the degree of inequitable or non-uniform tax results among taxpayers engaging in comparable levels of business activity within a state—with the greatest lack of uniformity (fairness) in taxation occurring with a single sales factor formula. Another option would be for the Commission to recommend language that allows states to choose any factor weighting, but require specific taxpayers to adjust their income apportionment if the tax results vary too greatly from an acceptable standard of uniform results. For example, the language could require a taxpayer to use a double-weighted sales, three-factor formula in all states where it does business if either of these circumstances arises:

1. The total income it reports to all states is less than 90% or more than 110% of the double-weighted apportionment result, or
2. Its apportioned income to any single state is less than 80% or more than 120% of the double-weighted result for that state.

Reject Taxpayer Election: Under no circumstances should the Commission recommend that factor weighting be subject to election by multijurisdictional taxpayers.

Discussion: State legislatures have over the last decade or so switched rapidly to diverse apportionment formulas that overweight or rely solely on the sales factor. Lobbying by select corporate interests has succeeded in creating the perception that single sales factor apportionment, in particular, would increase manufacturing jobs. Aiding this trend were predictions by economist Austan Goolsbee that single sales factor apportionment was a magic economic elixir that would dramatically boost manufacturing jobs in any given state—until most or all states adopted it, at which point the elixir would suddenly lose its stimulating effects.

This perception is not supported by reality. The predictions of increasing manufacturing employment were already disproven by the experience of Iowa, the state that pioneered single sales factor apportionment. From 1970 to 2010, manufacturing jobs declined in Iowa in both absolute and relative terms.[1] There were fewer manufacturing jobs in Iowa in 2010 than in 1970. In 1970, manufacturing jobs were 17.1% of total Iowa employment, and 10.6% in 2010. The decline in the share of Iowa manufacturing jobs was not as great as in the rest of the nation. However, that fact is due in part to the slow growth in the Iowa workforce compared to the U.S. workforce (Iowa population grew by 7.9% from 1970 to 2010, while the U.S. population grew by 51.9%) and to the slower growth of Iowa jobs in other sectors compared to the rest of the nation.

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[1] Center for Industrial Research and Service (CIRAS), Manufacturing in Iowa 2012 Iowa State University Extension and Outreach.

As single sales factor apportionment has spread, manufacturing job trends do not provide any clear and convincing support for the economic claims promised by advocates of the measure. Data compiled by the Center on Budget and Policy Priorities (CBPP) for changes in manufacturing jobs by state from 2001 to 2011 indicates no major difference between states using a single sales factor and states using the equally weighted formula throughout the period. States in both groups are distributed comparably across the range from best to worst records of changes in manufacturing jobs (with overall decline being the dominant trend).

The fact that states continue to adopt single sales factor apportionment despite no substantial economic support for it is a measure of the uphill challenge the Commission would face if it attempted to convince states to return to a common, multifactor formula. The better course is to systematically gather corporate tax data and conduct research to document facts about the economic and tax equity effects of varying apportionment formulas. The Commission is uniquely positioned to work with states using tax return data to bring clear facts to the discussion about factor weighting. Further, in a process that should be publicly funded to ensure its independence, the Commission should structure a dialogue with executive and legislative branch officials appointed by relevant state authorities on the evidence of the impacts of diverse factor weighting schemes. This process could be timed to end in a sufficient number of years prior to the expiration of a period during which Article IV would be silent on the subject of factor weighting so that states could then consider implementing, perhaps in stages, a common factor approach that achieves uniform tax results.

If the Commission judges it necessary to address factor weighting, there are options along the lines suggested above that could permit some variation among the states while limiting the adverse effects of single sales factor apportionment has on the uniform and equitable treatment of different types of corporations. If options of this type are pursued, the Commission would need to accompany those recommendations with documentation that the single sales factor approach unfairly burdens in-state companies and some multijurisdictional corporations, while granting near-charity status to a favored few—all without any convincing economic benefits. However, the misperceptions created about the positive economic effects of single sales factor apportionment are likely to be hard to overcome in the immediate future, which is why the original recommendation is the better course.

Finally, taxpayer elections of factor weighting would sacrifice the public interest in tax equity and uniformity to private interests in tax minimization. The tax results even among electing multijurisdictional taxpayers would be non-uniform and inequitable. Moreover, because only multijurisdictional taxpayers would enjoy the benefit of elections, in all cases smaller, in-state only corporations would unfairly pay a proportionately greater amount of tax. Existing taxpayer elections that are limited to multijurisdictional taxpayers and that substantially allow certain corporate taxpayers to reduce their tax liabilities are already problem. Further, elections of this type deserve greater scrutiny under the state constitutional prohibitions against the surrender of a state's sovereign taxing authority to private parties. Elections that are potentially questionable under the standards of some state constitutions and that undermine tax equity should be firmly rejected.

Extent of Apportionable Income

Recommendation: The Commission should adopt the proposed language that makes the boundaries of apportionable income coterminous with the constitutional limit.

Discussion: If the Commission were to recommend new language defining the boundaries of apportionable income that did not correspond to the constitutional limit, new problems would arise. Where the boundaries were perceived by the tax practitioner community to be less than the constitutional limit, efforts would be undertaken to explore new opportunities for tax planning that will create greater inequities among taxpayers. Taxpayers would increasingly assert new positions to widen the perceived gap between the new language and the constitutional limits—and a new round of litigation would arise over the explorations of new tax planning territory. On the other hand, if the taxpayer community perceived that any portion of the new language ventured beyond the constitutional limit, another separate line of litigation would emerge. Extended litigation over the boundaries of "business" and "non-business" income has in recent years finally achieved a state of quiet equilibrium. It should not be disturbed by new language that could be perceived as drawing new boundaries inside or outside the constitutional limit. Thus, conforming the boundaries of apportionable income to the constitutional limit is the best course of action.

If there are ambiguities about the constitutional limits, the Commission and the states have available to them educational mechanisms and regulatory authority to address specific items that require greater clarity from time to time.

Sourcing of Sales of Services and Intangibles

Recommendation: Replacing the "greater cost of performance" rule with language that is oriented to assigning sales to a market location is perhaps the greatest area of need in updating Article IV. While private sector commentators at the March 28 hearing raised some issues that the Hearing Officer needs to weigh, none of those issues appear to justify rejecting a market-based sourcing rule for services and intangibles that corresponds to the purpose of the sales factor, which is to measure the contribution of the market to the earning of income. The Commission should adopt the proposed language with necessary technical adjustments that the Hearing Officer may recommend that do not interfere with the overall direction and purpose of the proposed amendments.

Discussion: The "greater cost of performance" rule for sourcing services and intangibles has for decades invited egregious manipulation of income reporting by some multijurisdictional taxpayers that significantly undermines the equitable and uniform application of corporate tax law. The need to put an end to manipulative income reporting by some taxpayers is great and overweighs the issues raised around the edges of the proposed language by some in the tax practitioner community.

This letter covers all of the comments on the proposed Article IV amendments that I have at this time. I would be glad to respond to any questions concerning any portion of these comments. I would also do my best to respond to questions on additional issues not covered here.

Thank you for this opportunity to comment on these important issues.

Sincerely,

Dan R. Bucks

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