

**COST's Comments Concerning the Multistate Tax Commission's
Public Participation Working Group on
Business Income and Unitary Business**

I. Alternative Approach to the PPWG's Current Effort

While the Committee on State Taxation is pleased to participate in the Multistate Tax Commission's Public Participation Working Groups on defining unitary business and business income, COST recommends a change in direction of the PPWG's current effort.

COST recommends investigating other approaches to reduce controversies in the business income/unitary business arena. Due to the varied interpretations of UDITPA by several state supreme courts, it is conceivable that states and taxpayers will not be able to reach a meaningful agreement in defining the constitutional definitions of a unitary business and business income. The current use of varied tests to determine the existence of a unitary business will no doubt contribute to this theoretical morass. Further, even in the unlikely event that an agreement could be reached as to the proper tests used to determine either a unitary business or the existence of business income, it is highly unlikely that consensus can be reached as to the application of such tests. As a result, it would be helpful to begin discussions regarding alternative solutions to reduce the number of controversies surrounding this area similar to the one adopted by the Sales and Use Tax Nexus PPWG (*i.e.*, "Phase II"). For instance, one approach may be to explore the use of a taxpayer election similar to the business income election available in Kansas (Kan. Stat. Ann. section 79-3271) and the combined filing election that has been considered in California. A business income election, for example, could have the following components:

- An election to treat all of the taxpayer's income as business income.
- The election would be required to be made in *all* states accepting the election. This will prevent or limit perceived tax planning opportunities and will result in each state getting a share of the taxpayer's tax liability. Taxpayers and states alike will benefit: taxpayers will be treated to a reduction in double taxation and states will be assured of their apportioned share of income. This approach is an improvement over the winner takes all approach that is currently in place. Further, tax controversies in this area will be reduced allowing states and taxpayers to concentrate their efforts in other areas.
- The election would be made on a standardized form which will contribute to administrative ease.
- Taxpayers choosing not to make the election will be unaffected by the availability of the election and will be forced to follow each state's rules in determining business and nonbusiness income.

Thus, COST recommends an approach that does not limit the PPWG's potential for success on striking an agreement in a historically contentious area.

II. Clear and Cogent Evidence Standard

The clear and cogent evidentiary standard originated in United States Supreme Court jurisprudence concerning fair apportionment and the claimed taxation of extraterritorial values:

As always, of course, the State's taxation of the company's income is presumptively constitutional. To overcome that presumption, ASARCO has the "distinct burden of showing by 'clear and cogent evidence'" that Idaho's scheme "results in extraterritorial values being taxed." *Exxon Corp. v. Wisconsin Department of Revenue*, supra, at 221 (quoting *Butler Bros. v. McColgan*, 315 U.S. 501, 507 (1942) (quoting *Norfolk & Western R. Co. v. North Carolina ex rel. Maxwell*, 297 U.S. 682, 688 (1936))).

ASARCO Inc. v. Idaho State Tax Commission, 458 U.S. 307, 334 (1982). This evidentiary burden is difficult to meet. "Clear" is defined as "Obvious, beyond reasonable doubt." *Black's Law Dictionary* 250 (6th ed. 1990). "Cogent" is defined to mean "convincing or believable by virtue of forcible, clear, or incisive presentation." *Webster's Encyclopedic Unabridged Dictionary of the English Language* 286 (1989). Thus, the clear and cogent evidentiary standard resembles the beyond a reasonable doubt standard used for criminal matters.

The extreme difficulty of satisfying the standard is not the only rationale for objecting to its use in a model state regulation. The standard is meant to grant significant deference to the analysis and decisions reached by state courts in determining the constitutional boundaries of the taxation of extraterritorial values. In *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983), the Court stated that:

the taxpayer always has the 'distinct burden of showing by 'clear and cogent evidence' that the [state tax] results in extraterritorial values being taxed.' *One necessary corollary of that principle is that this Court will, if reasonably possible, defer to the judgment of state courts in deciding whether a particular set of activities constitutes a 'unitary business.'*

463 U.S. at 175 (internally citations omitted) (emphasis added). Further, the Court went on to recognize that "It will do little good if this Court turns every colorable claim that a state court erred in a particular application of [unitary] principles into a *de novo* adjudication, whose unintended nuances would then spawn further litigation and an avalanche of critical comment. Rather, our task must be to determine whether the state court applied the correct standards to the case; and if it did, whether its judgment 'was within the realm of permissible judgment.'" *Id.* at 176 (footnotes omitted).¹ Thus, the Court's standard, which Justices Black and O'Connor have referred to as a heavy burden,² is meant to respect the legal analysis of lower courts and limit the quantity of cases the Supreme Court hears regarding taxpayers' claims of taxation of extraterritorial values.

Because the two rationales that justify the use of the clear and cogent evidentiary standard are not present at the administrative level, incorporating the standard within state regulations concerning the definition of business income or unitary business is wholly inappropriate. Presumably, state taxing

¹ Interestingly, while not providing any rationale, the Court noted that this approach is not used in the context of other U.S. Constitutional jurisprudence. See *Container*, 463 U.S. at 176 n.13.

² *Norfolk & W. Ry. v. Missouri Tax Comm'n*, 390 U.S. 317 (1968) (Justice Black dissenting), *Allied-Signal v. Director*, 504 U.S. 768 (1992) (Justice O'Connor dissenting).

authorities and possibly courts of first impression will apply the standard contained within the regulations. However, these decision making bodies do not rely on decisions made by lower courts. Rather, these authorities will be hearing the initial arguments made by the parties. Further, it is inequitable for an administrative body or a court of first impression to dissuade taxpayers from pursuing legitimate claims. Therefore, under the existing guidelines taxpayers will be forced to fulfill an arduous burden despite the fact that the rationales for the burden's use are nonexistent.³

Thus, COST respectfully recommends replacing the clear and cogent evidence standard used in both the unitary business regulation and business income regulation with the preponderance of evidence standard, which is typically used in civil litigation.⁴ Further, as has been discussed during several PPWG conference calls, the presumptions and evidentiary standards contained in both regulations (*i.e.*, Section IV of the Definition of a Unitary Business, Section IV.1(a)(2)(B) of the Allocation and Apportionment Regulations) should be applied in the same manner to the state and the taxpayer.

III. Consensus

The Business Income/Unitary Business PPWG operates by determining areas of consensus of those participating in its meetings. COST, representing nearly 500 large, multistate companies, is often prevented from espousing a view on these complicated topics due to the varying positions of its members. Similar to state high courts and state taxing authorities, state taxpayers cannot, amongst themselves, reach consensus on several of the issues being discussed by this PPWG. While COST will not take a position with regard to the appropriate tests for determining business income or unitary business, its silence should not be construed as COST's or its members agreement or consensus with a particular proposal or position.

³ Also, it is interesting to note that the creation of the clear and cogent evidence standard is somewhat mysterious. The Supreme Court in *Butler Brothers v. Franchise Tax Commission*, 315 U.S. 501 (1942) cited *Norfolk & Western Ry. Co. v. North Carolina*, 297 U.S. 682, 688 (1936) as support for the clear and cogent evidentiary burden. The *Norfolk & Western* Court, in turn, cites *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 121 (1920) as its support for the clear and cogent evidentiary burden. However, the *Underwood* Court does not mention a clear and cogent evidentiary burden. Rather, the *Underwood* Court held that the taxpayer must show that "its net income is not reasonably attributable" to the taxing state and did not indicate the standard the taxpayer must fulfill in making its showing. *Id.* at 121.

⁴ In fact, the evidentiary standard contained in the California Franchise Tax Board's White Paper on Diverse Business Regulations issued in October 1989 states the following:

"Where the taxpayer contests the determination of unitary combination, it must prove by a preponderance of the evidence that, in the aggregate, the factors relied upon by the Franchise Tax Board in support of its finding are so lacking in substance as to compel the conclusion that a unitary business did not exist."