DRAFT RESPONSE of the MULTISTATE TAX COMMISSION on UDITPA ISSUES TO CONSIDER FOR REVISION

I. Summary Remarks

Thank you for the opportunity to comment on UDITPA provisions under consideration for revision. Our comments reflect the direction of the Multistate Tax Commission's Executive Committee, based on the results of a membership survey. Forty-seven states and the District of Columbia are members of the Commission.[1] Each member state is represented at the Commission by the head of the state's tax agency or by that person's designee.

At their core, our comments reflect a distinction between the original development of a new model rule and the amendment of an existing model that by-and-large works. This UDITPA effort falls within the latter category. For the most part, UDITPA has held up well. The States have largely adhered to its provisions. And the provisions that have been subject to judicial review have been upheld as constitutional.[2] But a few provisions are in critical need of modernization. Most states will be able to compromise and enact reasonable amendments targeted to provisions that are clearly in need of modernization. Venturing beyond clearly needed changes to tweak reasonably workable rules, even in the interest of conceptual superiority, could result in less uniformity rather than more as some states may be able to enact a bulky but conceptually better package while others will have difficulty overcoming local opposition to change from existing rules that are workable.

Therefore, we recommend the NCCUSL Drafting Committee focus on the apportionment provisions currently contained in UDITPA, and on only those provisions in critical need of modernization. We recommended against risking progress on these critical provisions by attempting to address highly controversial issues beyond the scope of apportionment such as tax base or jurisdiction to tax. Maintaining UDITPA's focus on the critical issue of apportionment enables broader adoption of the uniform rule among states that may have made different policy choices on the issues of tax base, nexus, combination and procedural processes.

We believe the UDITPA provisions with a critical need and maximum potential for successful amendment are:

- Sales factor numerator sourcing for receipts from transactions other than sales of tangible personal property (UDITPA §17)
- Factor Weighting (UDITPA §9)
- Definition of Business Income (UDITPA §1(a))
- Definition of Gross Receipts (UDITPA §1(g))
- Distortion Relief Provision (UDITPA §18)

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[1] For a list of our member states, please see http://www.mtc.gov/AboutStateMap.aspx

[2] See e.g., *Allied Signal v. Dir. Div. of Taxation*, 504 U.S. 765 (1992); *Container Corp. v. Franchise Tax Bd*., 463 U.S. 159 (1983)

II. Specific Recommendations

We have focused our response to the drafting committee's questions on those provisions we recommend be amended. If the committee chooses an expanded scope, we request an opportunity to respond in more detail on those particular provisions.

SECTIONS OF THE EXISTING UDITPA

Section 1.

Section 1(a)

We recommend this provision for review and amendment. Several alternative options should be considered, including apportionment of income to the extent permitted by the U.S. Constitution. If the current framework is maintained, the existence of both a functional and a transactional test, the treatment of gain at liquidation, and other aspects of the current rule should be clarified. The NCCUSL policy criteria should be used to weigh the relative benefits of all alternative options.

Section 1(b)

Issues associated with this provision do not rise to the level of importance or difficulty that would warrant review as part of this project. The potential improvements would not justify the additional time and complexity, or the diminished ability to get critical amendments enacted.

Section 1(c)

Issues associated with this provision do not rise to the level of importance or difficulty that would warrant review as part of this project. The potential improvements would not justify the additional time and complexity, or the diminished ability to get critical amendments enacted.

Section 1(d)

These issues should be dealt with in the context of section 17.

Section 1(e)

Re-definition should focus on business income. Non-business income definition should stay as-is to avoid inadvertent gaps or overlaps.

Section 1(f)

These issues should be dealt with in the context of section 17.

Section 1(g)

We recommend this provision for review and amendment. The current definition of sales should be clarified. "Sales" is defined as "all gross receipts of the taxpayer…." But the term "gross receipts" is not defined. Many states have confronted the question of whether "gross receipts" includes return of investment principal in the case of the repayment of a loan or a short-term investment of working capital.

Section 1(h)

Issues associated with this provision do not rise to the level of importance or difficulty that would warrant review as part of this project. The potential improvements would not justify the additional time and complexity, or the diminished ability to get critical amendments enacted.

Section 2

These issues should be dealt with in the context of section 17.

Section 3 – 8

Issues associated with these provisions do not rise to the level of importance or difficulty that would warrant review as part of this project. The potential improvements would not justify the additional time and complexity, or the diminished ability to get critical amendments enacted.

Section 9.

We recommend this provision for review and amendment. As of January 1, 2007, only eight states exclusively require an equal-weighted formula. Seven of those eight are Compact member states. Thirty-four states now at least double weight the sales factor, and six of those apportion based on the sales factor only.[3] Although States are moving away from the three-factor equal-weighted formula, they are at least moving away in the same direction.

The impetus for this trend appears to be two-fold. First, an equally-weighted formula assigns greater value to the contributions of the production state relative to the market state because two of the three factors—property and payroll, tend to be concentrated where production occurs. When a State double weights the sales factor, it is giving equal weight to contributions of the production and market states.

Second, when a state emphasizes the sales factor and de-emphasizes the property and payroll factors accordingly, it creates an incentive for taxpayers to move property and

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[3] *State Apportionment of Corporate Income;* Federation of Tax Administrators http://www.taxadmin.org/fta/rate/corp_app.html

payroll (facilities and jobs) to that state, bolstering economic development. Of course, this incentive exists only in relation to other states' less heavily weighted sales factor apportionment rules. The comparative incentive disappears if all states uniformly employed a similarly-weighted formula – whether it's an equally-weighted three factor formula, a single sales factor formula, or something in between.

Several alternative options should be considered. The NCCUSL policy criteria should be used to weigh the relative benefits of all alternative options.

Section 10 - 12

Issues associated with the property factor provisions do not rise to the level that would warrant the additional time and complexity, or the diminished ability to get critical amendments enacted. Conceptual questions regarding current rule's exclusion of intangible property are well understood, as are the intractable administrative difficulties any alternative would face. The current rule on this point is uniformly followed. Attempting to revisit these issues could hold up progress and ultimately compromise ability to enact critical amendments.

Section 13 - 14

Although states are facing questions arising from use of "leased" employees, issues associated with the payroll factor provisions do not generally rise to the level that would warrant the additional time and complexity, or the diminished ability to get critical amendments enacted.

Section 15

These issues should be dealt with in the context of section 1(g).

Section 16

These provisions are appropriate and administratively workable. The provisions have not been uniformly interpreted with respect to dock sales, but that issue does not rise to a level of importance or difficulty that would warrant review as part of this project. The potential improvements would not justify the additional time and complexity, or the diminished ability to get critical amendments enacted.

Section 17.

We believe this provision has the highest priority for review and amendment. The provision is outmoded, major service industries are excluded from its application and subject instead to special rules, and states have begun to unilaterally implement non-uniform alternative sourcing. Problems with the cost of performance approach include:

- Weaknesses which were recognized, but acceptable, 50 years ago are no longer tolerable in light of service sector growth and the trend toward overweighting the sales factor.
- It fails to reflect the contributions of the market state, which should be the purpose of the sales factor.
- It is very difficult to determine cost of performance and thus to administer the rule.
- Increasing use of section 18 to deal with these problems is leading to non-uniformity.

Cost of performance should not be retained. Ideally, the rules for services and intangibles would be coordinated with the rule for tangibles and market sourced. The current MTC special rules generally use a market sourcing approach. There are several options for amendment that should be considered. NCCUSL's proposed policy criteria should be used to weigh the various options.

Section 18.

We recommend this provision for review and amendment. The current provision should more clearly allow for adoption of industry-wide or issue-wide apportionment rules. Modernizing Section 17 and clarifying the statutory definitions discussed above will hopefully minimize the need to use section 18 in crafting special industry rules, and presumably relieve much of the pressure currently brought to bear on the Act's equitable apportionment provisions. Nonetheless, the economy will certainly continue to change. There will always be a need to fill statutory gaps in taxation and policy. Ideally, these gaps should be filled uniformly across taxpayers, and not merely on an ad-hoc basis. Authority to do so should be made clearer.

ISSUES NOT COVERED BY EXISTING UDITPA

We recommend the Drafting Committee's charge for review should not be expanded beyond critical UDITPA provisions, and certainly not beyond UDITPA.

UDITPA has been well accepted over the years, in part because it provides a reasonable way to apportion a tax base regardless of how a state defines that base or determines its jurisdiction to tax an apportioned share. This flexibility is important for maintaining uniformity in the area that requires it the most. Uniformity with respect to tax base, treatment of credits, nexus, or procedure, is desirable from an administrative standpoint, but is not critical to avoiding duplicative taxation. Maintaining UDITPA's focus on the critical issue of apportionment enables broader adoption of that uniform rule among states that may have made different policy choices on other issues where uniformity is less critical.

As mentioned above, the controversies surrounding these external issues would impede development of a model and enactment of state statutes on badly needed revisions to the apportionment provisions. The risk of derailing needed changes would be particularly acute if the scope were expanded to include the notoriously controversial subject of nexus. States and taxpayer groups have litigated this issue intensively since the U.S.

Supreme Court's decision in *Quill*.[4] For the last eight years, States have fought back efforts in the U.S. Congress to impose a "physical presence" nexus rule for business activity taxes.[5] It could be very detrimental to bring that controversy into this forum.

Combined reporting carries similar risks. Although some courts have found combined reporting to be implicit in UDITPA, others have not.[6] Recent state legislative efforts to make combined reporting explicit have met determined opposition.[7] Inserting the combined reporting controversy into this forum could be unnecessarily divisive.

There is little to be gained by expanding UDITPA to cover these topics. Nothing in UDITPA prevents combination, and model uniform rules already exist for nexus, combined reporting and treatment of pass-through entities.[8] The Commission suggested

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[4] See, e.g., *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 114 S.Ct. 550 (1993); *Comptroller of the Treasury v. SYL, Inc.*, and *Comptroller of the Treasury v. Crown Cork & Seal Co. (Delaware), Inc.*, 825 A.2d 399 (Md. 2003), *cert. denied*, 124 S.Ct. 961 (2003); *A&F Trademark, et al. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *review denied* (N.C., 2005), *cert. denied*, 126 S.Ct. 353 (2005); *General Motors Corp. v. City of Seattle*, 25 P.3d 1022 (Wash. Ct. App. 2001), *cert. denied*, 122 S.Ct. 1915 (2002); *Kmart Properties, Inc. v. Taxation and Revenue Dept.*, No. 21,140 (N.M. Ct. App. 2001), *cert. quashed* (N.M., 12/29/05); *Lanco, Inc. v. Director, Division of Taxation*, 908 A.2d 176 (N.J. 2006), *cert. denied*, 127 S.Ct. 2974 (U.S., 6/18/07) ; *Geoffrey, Inc. v. Oklahoma Tax Commission*, 132 P.3d 632 (Okla. Ct. Civ. App., 12/23/05), *review denied* (Okla., 3/20/06); *Borden Chemicals and Plastics, L.P. v. Zehnder*, 726 N.E.2d 73 (Ill. App. Ct. 2000), *appeal denied*, 731 N.E.2d 762 (Ill. 2000); *Commissioner v. MBNA America Bank, N.A.*, 640 S.E.2d 226 (W.V. 2006), *cert. denied*, *FIA Card Services, N.A. v. Tax Commissioner of West Virginia*, 127 S.Ct. 2997 (U.S., 6/18/07)

[5] See, e.g., H.R. 5267, the Business Activity Tax Simplification Act of 2008.

[6] See, e.g., *Wal-Mart Stores East, Inc. a/k/a Wal-Mart Stores East I, Inc. v. Hinton*, No. 06-CV-3928, 12/31/07. Courts in other UDITPA states have held that UDITPA does not provide authority for combined reporting. See, e.g., *Polaroid Corp. v. Comm. of Rev.* (Mass., 1984) 472 N.E.2d 259). See, Peters, *State Income Tax Problems of Interstate Business*, 33rd Annual 1975 N.Y.U. Inst. on Fed. Tax. (1975) pp. 899, 939 ("There is nothing in the documented history of the Uniform Act to suggest that the Commissioners envisioned the Act to encompass combined reporting….").

[7] See e.g., legislative testimony by the Counsel on State Taxation (COST) in opposition to combined reporting proposals in Connecticut, Massachusetts, Florida and Maryland.
http://www.statetax.org/StateTaxLibrary.aspx?id=17546

[8] *See* MTC model Factor Presence Nexus Standards:
http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/FactorPresenceNexusStandardBusinessActTaxes.pdf
MTC model rule for pass-through entities:
http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/PropsedStatLanguageReportingOptions.pdf
MTC model Combined Reporting Statute:
http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Combined%20Reporting%20-%20FINAL%20version.pdf
Since the model was developed only West Virginia has newly enacted combined reporting for corporate income tax and it adopted the model virtually word for word. This year, the MTC model provisions have been included in proposed combined reporting legislation introduced in Florida HB 1237; Kentucky HB 302; Massachusetts HB 4645; Tennessee SB 3158.

that because uniform model rules on these topics already exist, and because the controversies surrounding any duplicative effort may delay or impede acceptance of badly needed revisions to the UDITPA apportionment provisions, there is little to be gained and possibly something to be lost by taking on these issues in this forum.

UDITPA ISSUES TO CONSIDER FOR REVISION

The purpose of this paper is to raise a series of issues in order to determine which are worthy of further consideration. Based on our meeting in May, the list will be culled and subsequent meetings will be held to discuss approaches and solutions. Although some discussion on the merits is probably inevitable in May (and some of the questions are phrased in a manner that invites that discussion), the goal of the meeting is simply to develop a list for further discussion, not to resolve the issues raised.

SECTIONS OF THE EXISTING UDITPA

Section 1.

Section 1(a). Section 1(a) currently defines business income.[1]

Several states have amended their statutes to eliminate the distinction between business income and nonbusiness income, choosing instead to tax income on an apportioned basis to the extent permitted by the U.S. Constitution. Is this alternative worth considering? If so, how should a statute implement that approach?

A narrower change that some states have made is to clarify that income arising from assets that were used in the business generates business income. This is similar to a comment to the original section 1(a) of UDITPA[2] that has sometimes been ignored. This change was intended by some states to clarify that the income arising from the cessation of business, or from an extraordinary "once in a corporate lifetime" gain generates apportionable business income. At the least, it would seem some clarification of the language is called for: e.g., confirming whether there is one test or two (i.e., both transactional and functional).

If UDITPA were to confirm that two tests exist, should the phrase "acquisition, management, *and* disposition" be changed to "acquisition, management, *or* disposition."? Are the MTC regulations defining the transactional and functional test workable?

If depreciation on an asset has reduced apportionable income during the period when the asset was used in the business, should there be a recapture of that amount of depreciation on the sale of that asset?

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[1] "'Business income' means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."
[2] "Income from the disposition of property used in a trade or business of the taxpayer is includible within the meaning of business income."

A related question is whether the apportionment formula should be modified to deal with situations in which the apportionable gain has accrued over a period of time. In that case, should the gain be apportioned by the factors existing in the year of realization? Should such gain be apportioned using some averaging mechanism, such as using the average of the prior years' apportionment percentages? Should a separate apportionment formula be used for such gain?

A related question is whether the gross receipts generated by nonrecurring gain, or gain that has accrued over a substantial period of time, should be included in whole or in part in the receipts factor of an apportionment formula (see section 15 below)?

Is clarification necessary to determine when a business asset is converted to a nonbusiness asset?

Section 1(b). Section 1(b) defines "commercial domicile.[3]" This definition summarizes succinctly the existing legal standard.

Could the definition be strengthened/clarified to reduce future litigation? Are there situations when a business might be viewed as having more than one commercial domicile? In combination states should commercial domicile be determined on an entity-by-entity concept or should the commercial domicile be determined for the combined group? In a water's edge return, should commercial domicile be determined taking into account only the U.S. corporations?

Section 1(c). Section 1(c) defines "compensation."[4] (The Comment to UDITPA indicates it is derived from the Model Unemployment Compensation Act, which has been adopted in all states.)

Is the definition of compensation broad enough to include modern forms of compensation?

Should the payroll factor be broadened to include independent contractors? If so, is the existing definition of compensation adequate in that situation?

Section 1(d). Section 1(d) defines "financial organization."[5] The MTC has a model formula for apportioning the income of financials (adopted 11/17/1994). Its

[3] "'Commercial domicile' means the principal place from which the trade or business of the taxpayer is directed or managed."

[4] "'Compensation' means wages, salaries, commissions and any other form of remuneration paid to employees for personal services."

[5] "'Financial organization' means any bank, trust company, savings bank, [industrial bank, land bank, safe deposit company], private banker, savings and loan association, credit union, [co-operative bank], investment company, or any type of insurance company."

definition of “financial organization” does not tie directly to UDITPA but rather suggests starting with the individual state’s definition.

Section 2 (below) removes “financial organizations” and “public utilities” from UDITPA. Presumably, these entities were removed because they operated solely within one state. That is no longer true. Nonetheless, they present unique issues. Should financial organizations and/or utilities be removed from further consideration?

Section 1(e). Section 1(e) defines “nonbusiness income.”[6] See 1(a) above.

Section 1(f). Section 1 (f) defines “public utility.”[7] Some states—e.g., California--do not include this definition. Is this definition relevant in an era of deregulation?

Section 1(g). Section 1(g) defines “sales.”[8] Is this definition satisfactory?

Should anything be done in response to the “treasury function” issue raised by Microsoft?

Section 1(h). Section 1(h) defines “state.”[9] Presumably, no change is necessary.

Section 2.

Section 2 sets forth the requirement for allocation and apportionment.[10]

It excludes financial organizations and public utilities from coverage. If these entities are brought within the UDITPA regime, a conforming change is needed here. The section also excludes an individual rendering purely personal services. Presumably, this exclusion recognizes that individuals are subject to a personal income tax regime, which typically taxes residents on their worldwide income and provides a credit for income taxes paid to other states. Is there any reason to bring individuals within UDITPA?

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[6] “‘Non-business income’ means all income other than business income.”

[7] “‘Public utility’ means [any business entity which owns or operates for public use any plant, equipment, property, franchise, or license for the transmission of communications, transportation of goods or persons, or the production, storage, transmission, sale, delivery, or furnishing of electricity, water, steam, oil, oil products or gas.]”

[8] “‘Sales’ means all gross receipts of the taxpayer not allocated under Sections 4 through 8 of this Act.”

[9] “‘State’ means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof.”

[10] **Section 2.** “Any taxpayer having income from business activity which is taxable both within and without this state, other than activity as a financial organization or public utility or the rendering of purely personal services by an individual, shall allocate and apportion his net income as provided in this Act.”

Section 3.

Section 3 sets forth the rule for when a taxpayer is taxable in another state and, therefore, becomes an apportioning taxpayer.[11]

Arguably, the first clause is unnecessary because it is swallowed by the second. Should there be clarification that mere jurisdiction to tax by a state that does not levy an income tax is sufficient (as contrasted with an actual tax liability)?

Do we need a right to apportion provision at all?

Are the MTC regs governing when a corporation can apportion workable? Reg IV.3.(b)

Should anything be done about a taxpayer that “voluntarily” pays tax in another state in order to avoid a throwback rule?

What rules should be applied to determine if a corporation is taxable by a foreign country?

Section 4.

Section 4 allocates rents and royalties from certain enumerated assets as prescribed by sections 5-8.[12]

What rules apply to assets not enumerated in Sections 5-8?

The rules sometimes allocate the gain on the sale of a nonbusiness asset differently from the way the income generated by that asset is allocated. Does this dichotomy make sense?

Section 5.

Section 5 prescribes rules for allocating nonbusiness rents and royalties from property located in the state.[13] Section 5(a) allocates net rents and royalties from real

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[11] **Section 3.** “For purposes of allocation and apportionment of income under this Act, a taxpayer is taxable in another state if (1) in that state he is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or (2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.”

[12] **Section 4.** Rents and royalties from real or tangible personal property, capital gains, interest, dividends or patent or copyright royalties, to the extent that they constitute nonbusiness income, shall be allocated as provided in paragraphs 5 through 8 of this Article.

property to the state of use. Section 5(b) allocates net rents and royalties from tangible property to the state of use, or to commercial domicile if the taxpayer is not taxable in the state of use (or organized in that state). Section 5(c) allocates mobile property by an apportionment methodology.

Should the default to commercial domicile be retained?

What does a "royalty from real property" refer to? Oil and gas royalties?

Are the rules for determining where property is "utilized" workable?

Section 6.

Section 6 essentially parallels Section 5[14] for capital gains from tangible property (in the state where located if taxable; otherwise commercial domicile). Intangible property is allocated to the state of commercial domicile.

Is it appropriate to retain a commercial domicile rule for tangible property?

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[13] **Section 5.** "(a) Net rents and royalties from real property located in this state are allocable to this state.

(b) Net rents and royalties from tangible personal property are allocable to this state:

(1) if and to the extent that the property is utilized in this state, or

(2) in their entirety if the taxpayer's commercial domicile is in this state and the taxpayer is not organized under the laws of or taxable in the state in which the property is utilized.

(c) The extent of utilization of tangible personal property in a state is determined by multiplying the rents and royalties by a faction, the numerator of which is the number of days of physical location of the property in the state during the rental or royalty period in the taxable year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the taxable year. If the physical location of the property during the rental or royalty period is unknown or unascertainable by the taxpayer tangible personal property is utilized in the state in which the property was located at the time the rental or royalty payer obtained possession."

[14] **Section 6.** "(a) Capital gains and losses from sales of real property located in this state are allocable to this state.

(b) Capital gains and losses from sales of tangible personal property are allocable to this state if

(1) the property had a situs in this state at the time of the sale, or

(2) the taxpayer's commercial domicile is in this state and the taxpayer is not taxable in the state in which the property had a situs.

(c) Capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state."

Should there be rules dealing with the moving of an asset on the eve of its sale in order to minimize the tax?

Section 7.

Section 7 allocates interest and dividends to commercial domicile.[15]

Should commercial domicile be replaced by the state where the underlying intangible property is managed?

Section 8.

Section 8 allocates patent and copyright royalties to the state where they are utilized.[16]

Are the rules on where a patent or copyright is utilized workable?

Does it make sense to allocate to the jurisdiction where utilized when the royalties generate nonbusiness income covered by sections 5 and 8, while continuing to use cost of performance rules when the royalties generate business income and are governed by section 17?

Section 9.

Section 9 sets forth the three-factor formula.[17]

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[15] **Section 7. "**Interest and dividends are allocable to this state if the taxpayer's commercial domicile is in this state."

[16] **Section 8.** "(a) Patent and copyright royalties are allocable to this state:

(1) if and to the extent that the patent or copyright is utilized by the payer in this state, or

(2) if and to the extent that the patent or copyright is utilized by the payer in a state in which the taxpayer is not taxable and the taxpayer's commercial domicile is in this state.

(b) A patent is utilized in a state to the extent that it is employed in production, fabrication, manufacturing, or other processing in the state or to the extent that a patented product is produced in this state. If the basis of receipts from patent royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the patent is utilized in the state in which the taxpayer's commercial domicile is located.

(c) A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the basis of receipts from copyright royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the copyright is utilized in the state in which the taxpayer's commercial domicile is located."

Should the term “allocation” in the heading of Sec. 9 be replaced by “apportionment”?

Should a factor be eliminated if its denominator is zero?

What should be done with the current lack of uniformity with so many states moving to more heavily sales factor weighting whereas the existing UDITPA calls for three equally weighted factors?

What, if anything, should be done about all of the existing industry-specific apportionment formulas?

Section 10.

Section 10 sets forth the property factor rule.[18]

Should intangible property be included in the property factor? If so, where should it be treated as located?

How should property used in each of two (or more) independent unitary businesses be treated for purposes of the formula?

Should property under construction be included in the property factor?

How should property in transit or movable property be handled?

Under what circumstances should property be viewed as being withdrawn from the business and removed from the property factor?

If a taxpayer changes its manner of valuing property or removes property that it still owns from the property factor should it disclose that situation?

How should cars assigned to employees be treated?

Section 11.

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[17] **Section 9.** “All business income shall be apportioned to this state by multiplying the income by a faction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.”

[18] **Section 10.** “The property factor is a fraction, the numerator of which is the average value of the taxpayer’s real and tangible personal property owned or rented and used in this state during the tax period and the denominator of which is the average value of all the taxpayer’s real and tangible personal property owned or rented and used during the tax period.”

Section 11 sets forth the rule that property should be valued at original cost.[19] Is that still the optimal valuation rule? Is original cost to be preferred to original cost less tax depreciation? To original cost less financial accounting depreciation?

Should we clarify that capitalized intangible drilling and development costs are included in the property factor?

How to deal with inventory?

Is a multiplier of 8 still valid for rental property?

How to handle property that is subrented?

Should there be a throwback or throwout rule for property?

How to deal with property that is no longer actively used in the business?

Section 12.

Section 12 uses an opening and closing value of property, divided by two, or a monthly alternative, for determining how to obtain a property factor value.[20] Is any change required?

Section 13.

Section 13 sets forth the payroll factor rule.[21]

Should the factor be broadened to include independent contractors? What if the independent contractor is a corporation? How should such payroll be sitused?

What about management fees paid to related corporations?

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[19] **Section 11.** "Property owned by the taxpayer is valued at its original cost. Property rented by the taxpayer is valued at eight times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from sub-rentals."

[20] **Section 12.** "The average value of property shall be determined by averaging the values at the beginning and ending of the tax period but the [tax administrator] may require the averaging of monthly values during the tax period if reasonably required to reflect properly the average value of the taxpayer's property."

[21] **Section 13.** "The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the tax period by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the tax period."

Should there be a rule for handling affiliated payroll companies? If so, are there circumstances where such a rule should be extended to nonaffiliated independent contractors?

How should compensation paid to employees generating nonbusiness income be treated?

How should compensation paid to persons in states where the taxpayer is exempt from taxation be treated?

How should deferred compensation be treated?

How should stock options be treated?

If a taxpayer modifies its treatment of compensation should it notify the state?

Is a throwback or throwout rule appropriate for payroll?

Section 14.

Section 14 sets forth the rule for determining if payroll is in the state.[22]

Are these rules workable?

Section 15.

Section 15 sets forth the sales factor rule.[23]

What receipts should be included that are now excluded?

What receipts should be excluded that are now included? For example, should the gross receipts from the sale of assets whose gain has accrued over a long period of time

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[22] **Section 14.** "Compensation is paid in this state if:

(a) the individual's service is performed entirely within the state; or

(b) the individual's service is performed both within and without the state, but the service performed without the state is incidental to the individual's service within the state; or

(c) some of the service is performed in the state and (1) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the state, or (2) the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this state."

[23] **Section 15.** "The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period."

be excluded? Compare MTC Reg. Sec. IV.18(c). Should a special apportionment formula be used? What rules should apply for situsing the gross receipts on the sale of intangibles, such as goodwill?

Section 16.

Section 16 sets forth the rule for locating sales from sales of TPP.[24]
Is a throwback or throwout rule appropriate at all?

For combined reporting states, intercompany sales are eliminated and eventually reflected when sold outside the group. Should there be a similar rule for sales to affiliates even in separate return states?

Should there be a special rule for dock sales?

Does the destination rule work for sales to distributors and other intermediaries that will resale the good?

Should there be a double throwback rule?

Should the preconditions that trigger throwback be changed?

Section 17.

Section 17 situses services using a cost of performance standard. At one time, place of performance might have correlated with place of consumption. In today's economy, however, the cost of performance standard is an origin-based standard that is inconsistent with the destination principle used for situsing sales of tangible personal property. How important is it to coordinate the rules for tangibles with those for services and intangibles?

The cost of performance standard situses sales based on the state where the majority of costs occurred, so that a state with 4% of the costs would get 100% of the sales if each of the other states accounted for 3% of the costs. If the cost of performance standard is to be retained, should it be implemented on a proportionate basis rather than a "winner takes all basis," so that sales will be sitused to a state based on its share of the costs of performance?

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[24] **Section 16.** "Sales of tangible personal property are in this state if:

(a) the property is delivered or shipped to a purchaser, other than the United States government, within this state regardless of the f.o.b. point or other conditions of the sale; or

(b) the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser."

How should cost of performance be determined? How to deal with historical costs?

Does a cost of performance rule encourage service providers to locate in low-tax jurisdiction? Is it a problem if it does?

A cost of performance standard ensures that sales will be sitused in jurisdictions that have nexus. What weight should be placed on that feature?

Can a destination-based rule be administered? Should a throwback or throwout rule be adopted for services? How should a destination principle deal with tax avoidance strategies that involve delivering the service or intangible to a low-tax jurisdiction?

Should different rules apply to sales made to related parties?

If a destination rule is adopted, does a different rule have to be developed for specific industries as the MTC now does? Is this tantamount to having different apportionment formulas for different industries?

Which of the various state approaches should be further studied? For example, should sales be sitused in a state if: they are derived from customers in a state; if they are attributable to a state's marketplace; if the benefit of the services are received in a state; if the purchaser received the benefit of the service in a state; if the recipient received the benefit of the services in a state.

Is their useful guidance in the repealed Florida tax on services, the Ohio CAT, the SSTP? Any guidance from the experience of other countries?

Do services require different rules from intangibles?

Section 18.

Section 18 sets forth the authority for alternative apportionment.[25]

[25] **Section 18.** "If the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the [tax administrator] may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(a) separate accounting;

(b) the exclusion of any one or more of the factors;

(c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

(d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."

Can anything meaningful be said about the concept of distortion?

Can the situations where either the taxpayer or tax administrator is entitled to apportionment relief by described with greater precision?

Should the "petition" requirement be eliminated either entirely or for certain types of alternative methods? For example, should a parent automatically be entitled to include the apportionment factors of a subsidiary if the dividends from the subsidiary are included in the parent's apportionable (business) income?

Special formulas: there are now many special formulas covering, for example, airlines, construction contractors, financial institutions, railroads, trucking companies, television and radio broadcasting, publishing, and so forth. Sometimes these special formulas were adopted by statute; other times by regulation. Does Section 18 authorize their adoption?

POSSIBLE ISSUES TO CONSIDER NOT COVERED BY EXISTING UDITPA

1. Some of the “Comments” to the original Act has not been followed. For example, the Comment to Section1 that property used in the business, when sold, generates apportionable income has been ignored in some states. Should it be made clear that the “Comments” are to be considered part of the legislative history of UDITPA and should be considered by decision makers?

2. How do we handle the various state and MTC rules for alternative formulas (e.g., MTC’s Model Uniform Financial Institutions Apportionment Rule, Model Uniform Statute for REITs, Model Uniform Statute for RICs, Proposed Uniform Rule for Apportionment of Income from Telecommunications and Similar Services, etc? Should they be folded into a revised UDITPA? Are some industries so large that rules should be considered?

3. Existing UDITPA has nothing regarding corporations that invest in partnerships (LLCs). A few states have regulations on the subject. Should revised UDITPA deal with this?

4. Mandatory combination. MTC has a model Proposed Model Statute for Combined Reporting, adopted August 17, 2006. The current lack of uniformity among the states using combination seems to be a problem. For example, compare *RR Donnelley* in Arizona (financing subsidiaries whose entire business is from affiliates not unitary) with *Miami Corp.* in Oregon (timberlands in Florida, oil and gas reserves in Louisiana, securities portfolio in Illinois, and a tree farm in Oregon were unitary based on sufficient centralized management, administrative services, and financing), and the new NY rules where combination is based on substantial intercorporate transactions.

5. Should taxpayers be permitted to **elect** combined reporting or the filing of consolidated returns?

6. Are the MTC regulations defining a unitary business workable?

7. If combination is required, should there be a uniform methodology for how to combine entities not subject to the same formula? For example, California regulation 25137-10 sets forth rules for combining a general (nonfinancial corporation) with a financial corporation when the general is the dominant member of the group.

8. Nexus. Should the project take on the issue of economic nexus?

9. Should procedural issues be included?

    a. Model tax court

    b. Pay to play

    c. Are the MTC regulations on Consistency and Uniformity in Reporting workable? Reg. IV.2.(c).

    d. Are there statutes of limitations that are unreasonably too short?

    e. Should interest rates be equalized?

    f. Should federal extensions to file control for state purposes?

    g. Are the periods for filing protests too short?

    h. Should the due date for corporate income tax returns be at least 30 days beyond the federal due date?