



MULTISTATE TAX COMMISSION

Working Together Since 1967 to Preserve Federalism and Tax Fairness

Hearing Officer's Report

Recommendation Concerning Proposed Amendment to Multistate Tax Commission's Model Allocation and Apportionment Regulation IV.18.(a): Equitable Adjustment of Standard Allocation and Apportionment Rules

I. Introduction.

On December 3, 2009, the Executive Committee of the Multistate Tax Commission ordered a public hearing to be held pursuant to Article VII (2) of the Multistate Tax Compact regarding a proposed amendment to Model Allocation and Apportionment Regulation IV.18.(a), setting forth general rules for the application of the equitable apportionment and allocation provisions of Article IV, Section 18 of the Compact. On January 25, 2010, a telephonic public hearing was held and all interested parties were invited to submit oral and written comments and testimony on the proposed amendment. The timelines for submission of comments and testimony was subsequently extended through March 3, 2010.

Bylaw No. 7 of the Multistate Tax Commission ("the Commission") requires the hearing officer to submit a report to the Commission containing a synopsis of the hearing proceedings and a detailed recommendation for Commission action, including a proposed draft of the regulation which is the subject matter of the hearing. This report will summarize the procedural history and background for the proposed amendment to the regulation, identify the substantive issues involved and the hearing officer's recommendation.

II. Procedural History of the Proposed Amendment.

The Multistate Tax Commission ("the Commission") initially adopted regulations concerning the allocation and apportionment of income on February 21, 1973. The regulations have been amended over the years, but the general regulation concerning the use of Article IV, Section 18, "Special Rules: In General" has never been amended since its adoption in 1973. Regulation IV.18(a) has three components. The regulation first repeats the substantive provisions of Article IV, Section 18 of the Compact. Section 18 provides for the use of alternative methods of apportionment and allocation where the standard methods of allocation and apportionment do not "fairly represent the extent of

the taxpayer's business activity in this state.”¹ The second component of Regulation IV.18.(a), and the subject of this proposed amendment, sets forth limitations on the use of alternative apportionment methods under Section 18, proscribing use of alternative methodologies to “limited and specific cases” involving “unusual factual situations (which ordinarily will be unique and non-recurring).” The final component of the regulation contains an acknowledgement that the standard apportionment and allocation rules may not be appropriate for certain industries, and provides that for those industries, the tax commissioner should have authority to develop alternative formulas, so long as those formulas are applied uniformly across the affected industries. The Commission has adopted “special rules” for apportionment and allocation of income applicable to six different industries, and has adopted a “Recommended Formula” for the allocation and apportionment of a seventh industry, financial institutions.²

In July of 2007, the Income and Franchise Tax Uniformity Subcommittee (“the subcommittee”) first heard a presentation with respect to whether the limitations on the use of alternative apportionment in Regulation IV.18.(a) were consistent with the language of Article IV, Section 18. In its meeting in November 2007, the subcommittee heard additional presentations and voted to undertake the project. The subcommittee also voted to form a drafting group to work on proposed amendments to the regulation.³

The subcommittee heard proposals for amendments in March of 2008. In July, 2008, the subcommittee directed the MTC staff to survey the states with respect to their practices and preferred policy direction for alternative language. The survey was sent to the states in September of 2008. Fifteen states responded to the survey and provided detailed comments. Those responding to the survey expressed different opinions on how Section 18's authority should be applied, especially in the context of new business practices and industries which had not been the subject of an industry-wide special regulation. The survey results indicated a general consensus, however, that the current regulation is too restrictive. A teleconference was held on October 22, 2008, at which time the subcommittee directed the drafting group to work on specific alternatives that would expand the circumstances under which Section 18 could be invoked. Draft amendments were presented to the subcommittee at its November 2008 meeting in San Antonio, Texas. The issue was presented again to the subcommittee in March of 2009, and at a

¹ Section 18 provides in full: “If the allocation and apportionment provisions of this Article 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.”

² Those Special Rules are applicable to the following industries: IV.18.(d), Construction Contractors (1980); IV.18.(e), Airlines (1983); IV.18.(f), Railroads (1981); IV.18.(g), Trucking Companies (1986); IV.18.(h), Television and Radio Broadcasters (1990); IV.18.(j), Publishing (1993).

³ The drafting group consisted of Wood Miller of Missouri, Richard Cram of Kansas, Ted Spangler of Idaho, and Leonore Heavey of Louisiana. Bruce Fort, MTC counsel, was the staff member assigned to the project.

telephonic meeting held on June 3, 2009. On July 27, 2009, the subcommittee voted to recommend the proposed amendment to the full uniformity committee. The Uniformity Committee, meeting the same day, voted to approve the amendment for recommendation to the Executive Committee.

Bruce Fort was assigned as Hearing Officer. On December 18, 2009, a notice of hearing was sent by e-mail to the public notice list maintained by the Commission, and to parties requesting notice, pursuant to Bylaw No. 7(c) and (d), and was posted on the Commission's website. A copy of the notice of hearing is attached as Exhibit A.

III. The Proposed Amendment.

Proposed Amendment to Model Regulation IV.18.(a):

(omitted text in bold with strike-through; new text is underlined)

Reg. IV.18.(a). Special Rules: In General. Article IV.18. provides that if the allocation and apportionment provisions of Article IV 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:

- (1) separate accounting;
- (2) the exclusion of any one or more of the factors;
- (3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
- (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Article IV.18. permits a departure from the allocation and apportionment provisions of Article IV only in limited and specific cases. ~~Article IV.18. may be invoked only in specific cases where unusual fact situations (which ordinarily will be unique and non-recurring) produce incongruous results under~~ where the apportionment and allocation provisions contained in Article IV produce incongruous results.

In the case of certain industries such as air transportation, rail transportation, ship transportation, trucking, television, radio, motion pictures, various types of professional athletics, and so forth, the foregoing regulations in respect to the apportionment formula do not set forth appropriate procedures for determining the apportionment factors. Nothing in Article IV.18. or in this Regulation IV.18. shall preclude [the tax administrator] from establishing appropriate procedures under Article IV.10. to 17. for determining the apportionment factors for each such industry, but such procedures shall be applied uniformly.

IV. Background of the Proposed Amendment.

Soon after the Uniform Division of Income for Tax Purposes Act (UDITPA) was approved by the National Commission on Uniform Laws as a Model Act in 1957, the principal drafter of the Act, Professor William Pierce, wrote a law review article explaining the intent behind Section 18:

departures from the basic formula should be avoided except where reasonableness requires. Nonetheless, some alternative method must be available to handle the constitutional problems as well as the unusual cases, because no statutory pattern could ever resolve satisfactorily the problems for the multitude of taxpayers with individual business characteristics.

Peirce, *The Uniform Division of Income for State Tax Purposes*, 35 *Taxes* 747, 751 (1957).

In a later article commenting on California's adoption of the Act in 1966, Frank Keesling and John Warren summed up the challenge of applying Section 18 in the context of ensuring uniformity among states:

The question arises whether the relief provisions should be interpreted broadly to permit the Board to use separate accounting or other methods extensively or whether they should be interpreted narrowly so as to permit the Board to deviate from the rules only in rare and unusual situations.

There are completely compelling reasons for giving the relief provisions a narrow construction. Under a broad construction the purpose of obtaining uniformity through the adoption of the Uniform Act would be defeated.

Keesling & Warren, *California's Division of Income for Tax Purposes Act*, 15 *U.C.L.A. L. Rev.* 156, 171 (1967).

In the same article, however, the authors acknowledged that, “[i]n the allocation of income, unusual situations, which should be excepted from the application of general rules, frequently arise.” *Id.* at 170. The proposed model regulation adopted by the Commission in 1973 certainly sided with the suggestions of Messrs. Keesling, Warren and Pierce that Section 18 should be construed narrowly. The model regulation thus provides that the use of Section 18 should be allowed only in “limited and specific cases where unusual fact situations (which ordinarily will be unique and non-recurring)” produce incongruous results. Such limitations on the use of Section 18 may have valid, indeed “compelling” policy justifications, but the regulation’s restrictions are not found within the language of Section 18 itself.

The hearing officer notes that when the regulation was originally proposed in 1971, the use of equitable apportionment was still a new concept in many states, and the regulation may have been intended to reinforce the idea that “separate accounting” was no longer the appropriate means of measuring a multi-state taxpayer’s in-state earnings. *See, e.g., Donald Drake Construction Co. v. Oregon DOR*, 500 P.2d 1041 (Or. 1972)(tax agency

argued that use of separate accounting was appropriate where such accounting method suggested the contractor was three times more profitable in Oregon than in other states). The regulation has been adopted by thirteen states and is incorporated by statute into Nebraska's tax code.

While the utilization of alternative apportionment methods under Section 18 has been a source of continuing controversy between states and taxpayers, relatively few court decisions have considered the application of Regulation IV.18.(a). More recently, however, taxpayers have argued that the state could not rely on Section 18 to impose alternative apportionment principles because their factual situations were not "unusual" or "unique and non-recurring" as specified by the regulation. *See, e.g., Union Pacific Corp. v. Idaho state Tax Commission*, 139 Idaho 572, 83 P.3d 116 (Id. 2004)(holding that inclusion of both original sales and amounts from factoring accounts receivables in sales factor was an "unusual" factual situation); *Microsoft Corporation v. Franchise Tax Board*, 39 Cal. 4th. 750, 139 P.3d 1169 (2006)(upholding use of Section 18 authority despite taxpayer's insistence that short-term reinvestment of working capital are not "unusual", "unique" or "non-recurring" treasury functions); *Toys "R" Us, Inc. v. Franchise Tax Bd.*, 41 Cal.Rptr.3d 285 (Cal. App. 3rd Dist. 2006)(same); *Bell South v. Chumley*, __S.W.3d __, 2009 WL 2632773 (Tenn. App. 2009), *review den.*, __S.W.3d __ (3/1/10)(taxpayer derived income from telephone book advertisements delivered into taxing state for use in that state); *See also, In re Wal-Mart Stores, Inc.*, New Mexico Admin. Decision No. 2006-07, http://www.tax.state.nm.us/d&o/dno2006_07.pdf. (holding that "unusualness" of factual circumstances should be viewed in the context of common business activities at the time UDITPA was adopted).

In each of these cases, the courts upheld the use of Section 18 over objections that the terms of Regulation IV.18.(a) prohibited the states from employing alternative apportionment methods. Although the decisions correctly allowed utilization of Section 18 authority to fairly attribute income, the taxpayers' arguments do call into question whether the current regulation may unduly hamper the ability of tax administrators (and taxpayers) to equitably apply UDITPA's apportionment principles to rapidly changing business practices and new industries. The court cases also suggest that states need Section 18 to prevent distortions of in-state business activity measures in circumstances where a literal application of UDITPA's definitions produce "incongruous" results, such as the overstatement of the sales factor resulting from inclusion of the gross amounts of overnight treasury receipts.

The subcommittee's purpose in proposing these amendments is to ensure consistency in application of Section 18, retain the necessary flexibility for states and taxpayers to respond to changing circumstances, while still promoting uniformity among states in allocation and apportionment practices. The subcommittee recognized that Section 18 could be used in inappropriate ways if all restrictions on its use were lifted. But the subcommittee did express a belief that the current regulation was too restrictive, even though the great majority of decisions interpreting Section 18 to date have reached appropriate results. The subcommittee accordingly took an incremental approach to the amendment of the regulation, retaining the requirement for application to "limited and specific cases" where the factual situations produced "incongruous results." The concept

of use of section 18 to prevent “incongruous results” is brought home by the four cases identified above. In each case, an overly-literal application of the UDITPA sourcing rules would have resulted in a clear mis-allocation of income away from the taxing state. In *Microsoft*, for instance, a handful of employees handling overnight investments of working capital would have generated a sales factor denominator that exceeded the sales factor attributable to the efforts of thousands of employees in California and elsewhere.

V. Public Comments:

Written and oral comments were submitted by two law firms on behalf of undisclosed interested parties. Diann Smith, counsel with the Southerland law firm, submitted written comments, attached as Exhibit B. Written comments were also submitted by Jeffrey L. White, an attorney with the law firm of Coving and Burling, LLP, attached as Exhibit C.

- ***Timing***

Ms. Smith’s comments are initially addressed to the timing of the project, suggesting that any proposed changes to the model regulation should be delayed until the Uniformity Committee completes its work to study and recommend changes to five sections of Article IV of the Multistate Tax Compact, including Section 18. As Ms. Smith points out, changes to Section 18 may well require a revision of the Commission’s model regulation, and postponing action on the model regulation could save state and taxpayer resources in the event Section 18 is substantially rewritten. While the hearing officer appreciates the spirit in which the suggestion is made, neither the timing nor the content of any proposed changes to Section 18 is certain at this point. Currently, the Uniformity Committee is considering changes to Art. IV, Section 17 of the Compact, and has not established a schedule for undertaking review of other sections of the Compact. The Uniformity Committee could well conclude that no substantive changes Section 18 are required, and may instead limit its efforts to clarifying the parameters for adoption of specific industry regulations.

- ***Constitutional Standard vs. Statutory Standard***

Ms. Smith also suggests that the proposed regulatory provision clarify that alternative apportionment under Section 18 should be available even though the level of “distortion” might not rise to the level of over-attribution of income found to be unconstitutional in *Hans Rees & Sons, Inc. v. Commissioner*, 283 U.S. 123 (1931). See also, *Moorman Manufacturing v. Bair*, 437 U.S. 27 (1978); *Container Corporation of America, Inc. v. Franchise Tax Board*, 463 U.S. 159 (1983)(14% difference in tax liability based on apportionment versus separate accounting would not support due process and commerce clause claim that California’s formula taxed extra-territorial values). Some early cases suggested in *dicta* that equitable relief should only be available in cases of gross distortion sufficient to make out a due process or commerce clause claim that the state’s tax as out of all proportion to the taxpayer’s activities within the state. See, e.g., *Rodgers Dean Enterprises, Inc. v. Department of Revenue*, 387 So.2d 358 (Fla. 1980). Ms. Smith correctly notes that more recent cases, including *Twentieth Century-Fox v. Department of Revenue*, 700 P.2d 1035 (Ore. 1985) and *Union Pacific Corp. v. Idaho State Tax*

Commission, 83 P.3d 116 (Id. 2004) have rejected that standard. In California, however, the state's highest court adopted a test for applying Section 18 that considers both quantitative and qualitative measures of distortion. *Microsoft, supra*, 39 Cal. App. 4th. at 757, 766. The subcommittee considered at some length the question of whether the amended regulation should include a threshold limit below which no Section 18 adjustment should be allowed, including a reference to "gross distortion." The subcommittee concluded that because Section 18 already incorporates a standard for relief--"does not *fairly represent* the taxpayer's business presence in the state" (emphasis supplied)--it would be inappropriate to adopt a different standard, such as "gross distortion", through regulation. The subcommittee was also cognizant of the difficulty in defining appropriate measures of either quantitative or qualitative distortion. For example, the Court in *Container Corporation, supra*, rejected that taxpayer's argument that California's three-factor apportionment formula had overstated the taxpayer's in-state profits as compared to results measured by separate accounting principles, noting:

The problem with this argument is obvious: the profit figures relied on by appellant are based on precisely the sort of formal geographic accounting whose basic theoretical weaknesses justify resort to formula apportionment in the first place.

463 U.S. at 181.

It would be difficult to adopt a quantitative definition of "gross distortion" that does not reference other accounting measures which might be inappropriate to the circumstances. In keeping with the subcommittee's adoption of an incremental approach to amending the current regulation, the subcommittee retained the regulation's purposely flexible standard that Section 18 should be invoked to avoid "incongruous results" under application of the standard formula.

In addition, the subcommittee concluded that the effort and expense of pursuing an adjustment would discourage most petitions and audit adjustments based on minor levels of "distortion" in measuring business activity within the states

The hearing officer does not recommend a change to the proposal based on this comment.

- ***Explicit Burden of Proof***

Ms. Smith also suggests that any amendment to the current regulation include a provision specifying that the party seeking to vary from the general allocation and apportionment rules would have the burden of proof (and the burden of persuasion) that the general rules result in a distortion of business presence and the proposed modification more accurately reflects business presence. As Ms. Smith notes, this allocation of the burden of proof and burden of persuasion to the party seeking to invoke Section 18 is now commonly-accepted. The hearing officer believes that the regulation should not include a burden of proof/persuasion provision because use of Section 18 can arise in a variety of situations, including as a filing position on a return, as an audit adjustment, as a defense to an audit adjustment, or in the context of seeking a variance from an industry-wide regulation. In

some situations, a court or hearing officer may find that it is appropriate to place the burden of proof/persuasion on the party with the greatest knowledge of the particular industry or a taxpayer's business. Establishing a special burden of proof/persuasion rule for Section 18 cases may also complicate the application of more general presumptions and procedural rules applicable in tax cases, including the presumption of correctness that often attaches to assessments. It would be difficult to formulate a general rule which could take into consideration all of the states' varying approaches to how tax litigation should be conducted. In addition, because this is a matter of procedure and not substance, there are less compelling reasons to seek uniformity among taxing jurisdictions. In particular, varying procedural rules should not lead to inconsistent determinations with respect to how a taxpayer's income should be allocated and apportioned among competing jurisdictions.

- ***Limiting the Scope of Section 18 Adjustments***

The third suggestion by Ms. Smith is that any proposed regulation should specify that Section 18 cannot be invoked to vary "fundamental" choices by state legislatures with respect to sourcing income. Ms. Smith gives as an example the use of Section 18 to impose a market-based approach to sourcing income from services when the legislature has specified that such income should be apportioned according to the location where "income-producing activity" takes place. The conceptual problem with Ms. Smith's suggestion is that Section 18 is as much a part of UDITPA as Section 17, and nothing in Section 18 suggests that the availability of relief should be limited to incidental or collateral policy choices. In particular, the hearing officer notes the scope of possible remedies available under Section 18 is sweeping, including elimination of factors, use of separate accounting, inclusion of additional factors and employment of "any other method to effectuate an equitable allocation and apportionment..." Had the legislatures intended a smaller role for Section 18, confined to fixing marginal inequities in the application of the usual sourcing rules, it is likely that the scope of permissible remedies would have been correspondingly restrained. The hearing officer finds no support in the language and structure of Section 18 for an argument that equitable relief should be unavailing where a "fundamental" aspect of UDITPA's standard formula are inappropriate to the taxpayer's situation. The hearing officer also suggests that the most "fundamental" aspect of UDITPA is the preference of formulary apportionment over separate accounting as the best means of sourcing income which arises from integrated activities in multiple geographic locations, using easily quantifiable measures of activity in each location as a proxy. This "fundamental" policy choice is reflected in Section 18's mandate to fairly reflect business activity in each state. Even the fundamental principle of formulary apportionment, however, could be jettisoned under Section 18 (e.g., through use of separate accounting) if necessary to achieve an income attribution that fairly reflects the taxpayer's activity in the state. The hearing officer believes that Ms. Smith's proposal would require a re-writing of Section 18 itself, and would not be an appropriate subject matter for a regulation.

- ***List of Industries That Merit Special Rule***

Mr. White suggests a proposed change of quite a different character. He expresses concern with that section of the current regulation which provides that: “[i]n the case of certain industries such as air transportation, rail transportation, ship transportation, trucking, television, radio motion pictures, various types of professional athletes, and so forth, the forgoing regulations do not set forth appropriate procedures for determining the apportionment factors.” Mr. White notes that the Commission has not promulgated regulations pertaining to two of those industries, specifically professional athletes and ship transportation, and that many states have not adopted all six of the Commission’s special industry regulations, leaving those industries and similar types of industries without any guidance at all as to what formula should be employed.⁴ Mr. White suggests an addition to the regulation making clear that in the absence of specific industry guidance, taxpayers should have a right to utilize the standard apportionment formula “provided that these provisions fairly represent the extent of the taxpayer’s business activities in the state.”

The hearing officer is sympathetic to the concerns raised by Mr. White but believes that the proposed addition to the regulation offers little in the way of additional guidance or protection to taxpayers engaged in those specified industries. While the Executive Committee might consider removing the reference to all of the special industries, or removing the reference to shipping and professional athletics, the hearing officer believes that the regulation should remain unchanged, to signal taxpayers in such industries that they are more likely to be subjected to special apportionment formulas. The hearing officer notes that taxpayers can seek guidance from tax agencies as to the appropriate formula which should be employed, both under general tax administrative provisions and specifically under the petition procedure identified in Section 18. The absence of specific industry regulations in many states may suggest that taxpayers are content with the current state of the law and have not sought special regulations establishing alternative apportionment and allocation rules.

VI. Hearing Officer’s Recommendation.

The hearing officer recommends adoption of the proposed amendment to Model Regulation IV.18.(a) as set forth in Section III of this report without modification.

Respectfully submitted,

Bruce Fort
Hearing Officer

March 29, 2010

APPENDIX TO HEARING OFFICER’S REPORT

⁴ See, e.g., *Boston Professional Hockey Ass’n, Inc. v. Commissioner of Revenue*, 443 Mass. 276, 820 N.E.2d 792 (Ma. 2005).

1. Exhibit A: Notice of Telephonic Hearing dated December 18, 2010.
2. Exhibit B: Written Comments from Diann L. Smith, Esq., Southerland, Asbill & Brennan, LLP.
3. Exhibit C: Written Comments from Jeffrey L. White, Esq., Covington & Burling, LLP.