MULTISTATE TAX COMMISSION

Working Together Since 1967 to Preserve Federalism and Tax Fairness

To: **Charles A. Trost, Chair**
Study Committee on Revisions of UDITPA

From: **Joe Huddleston, Executive Director, Multistate Tax Commission**

Date: **May 2, 2007**

Subject: **Recommendations Regarding Proposed Project to Amend UDITPA**

The Multistate Tax Commission appreciates this opportunity to respond to the Study Committee's questions posed in its memorandum of April 3, 2007 regarding a possible project to review and amend UDITPA. The Committee asks for input on whether to undertake such a project and, if so, its proper scope. Specifically, the Committee asks whether the project should be limited to the intangibles and services issues under Section 17 or should include a broader and more comprehensive review of UDITPA. The Committee also invites comments on a proposed list of 10 criteria for evaluating UDITPA revisions. This memorandum provides our response to those questions.

In addition, we note that Section 3 of the NCCUSL Policy Establishing Criteria and Procedures for Designation and Consideration of Acts requests that when a responsible non-affiliated organization recommends a subject for consideration, it should also submit substantive recommendations. As the MTC is the organization that recommended the project, this memo provides preliminary conceptual substantive recommendations. We will provide additional recommendations once the scope of the project is determined.

I. Should NCCUSL Undertake a Project to Review UDITPA?

The MTC strongly encourages NCCUSL to undertake a review of UDITPA. We have begun our own project to draft model uniform amendments to Article IV.17 of the Multistate Tax Compact. Article IV of the Compact incorporates UDITPA nearly word for word. Twenty states have adopted UDITPA through the Compact, and twenty-five have adopted UDITPA as a separate act. Some have done both. In the interest of preserving the broadest uniformity possible, we invite NCCUSL to work with us to review and draft model proposed amendments to UDITPA and Article IV of the Compact. (See MTC Letter of September 6, 2006, attached.)

We believe it is essential to act quickly. After 40 years, our Compact states are facing inevitable pressure to change their methods of apportionment. A number of states are in various stages of addressing these changes unilaterally, either by statute or by regulation.[1] The MTC is concerned that stand-alone, state-by-state amendments can quickly result in substantial nonuniformity. In the context of income tax apportionment, nonuniformity inevitably results in excessive administrative costs for both taxpayers and states, and the risk of either multiple or less than full apportionment for taxpayers.[2]

Model amendments will help states modernize their apportionment laws in a consistent manner and are critical to preserving the original uniformity goals of UDITPA and the Compact. Thus, a project to develop these amendments would satisfy the NCCUSL criteria set out in Sections 1(b), (c)(i), (d) and (e) of its Policy Establishing Criteria and Procedures for Designation and Consideration of Acts by taking a necessary step toward promoting uniformity where uniformity is desirable and practicable. We believe the remaining NCCUSL criteria for new projects would also be satisfied. The subject matter is obviously appropriate for state legislation, as the purpose is to propose amendments to existing state law. (Section 1(a)) And, amendments would produce significant benefits to taxpayers by reducing the burden of non-uniformity on interstate commerce, reducing the potential for multiple taxation, and restoring tax neutrality for multistate businesses. (Section 1(c)(iii)) Although various aspects of the apportionment rule will certainly be controversial, nonetheless there is a reasonable probability that amendments, like the original Act, can be accepted and enacted into law. (Sections 1(f) and (c)(ii))

II. What should be the Scope of Review?

Many aspects of UDITPA merit some level of reconsideration. But there is widespread agreement that a review of Section 17, regarding sales factor sourcing for transactions other than sales of tangible goods, is critical to uniformity. Three other provisions – the factor weightings, definition of business income and definition of gross receipts – may merit review to better reflect existing state practices.

A. Primary Concern - Sales Factor for Intangibles/Services

Under UDITPA receipts from sales of intangible property and services are sourced to the one state with the greatest cost of performance. From the beginning, the drafters acknowledged Section 17 of UDITPA was given short shrift.[3] This fact reflects the practical realities of the time. In 1957 most of the economy was mercantile and manufacturing. The

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[1] *See*., Minn. Stat. § 290.191 (where services are received); Ga. Code. Ann. § 48–7–31(d)(3)(C) (attributable to the state's marketplace); Md. Regs. Code tit. 3, § 04.03.08C(3)(c) (derived from customers domiciled in the state); 34 TAC 3.549(e)(30)(B) (location of payor); Ct. Code § 12-218(c)(3) (interest receipts if interest managed or controlled in state); IL, MA, TN (where intangible is used); NJ (situs of income). From research performed by Mark Arrigo, KPMG.

[2] When lack of uniformity reached a crisis point in the mid-1960's, the Willis Commission, sanctioned by Title II of Pub. L. 86-272, 73 Stat. 555, 556 (1959), made extensive recommendations for federally pre-empting key aspects of state taxation of interstate and foreign commerce. (H.R. REP. NO. 952, 89th Cong., 1st Sess., Pt. VI, at 1139*ff* (1965). States then rallied to ratify the Multistate Tax Compact and enact the present version of UDITPA.

[3] *UDITPA – A Historical Perspective*; John S. Warren; presentation to the Multistate Tax Commission Annual Meeting; July 28, 2005.

few major service industries of the time, financial organizations and public utilities, were excluded from UDITPA altogether. Regarding what was left of the service economy, the primary drafter wrote in 1957 that he expected frequent resort to the equitable relief provision of Section 18.[4]

The pressure on this provision has grown significantly. Service sector income has increased much faster than income from other sectors.[5] Thus, a considerably higher percentage of the economy is subject to UDITPA §17 today than was the case in 1957. The rationale for excluding the financial industry and public utilities has eroded over the years with deregulation. In addition, state legislatures have modified the model Act to overweight the sales factor, thereby intensifying its significance in determining how income from services will be apportioned. These trends are combining to place increasing emphasis on what was recognized from the beginning to be a weak provision. Shortcomings in UDITPA §17, which states could live with in the 1950's, now present an unacceptable risk of uncertainty, nonuniformity, administrative burden and revenue losses.

B. Secondary Concerns - Factor Weighting, Business Income Definition, Gross Receipts Definition, Relief Provision

The MTC believes model amendments for UDITPA §17 are the only amendments crucial to preserving uniformity at this time. But if the Act is going to be amended, it would be important to consider three additional changes to modernize the Act by reflecting the states' overwhelming movement, albeit in a uniform direction, away from certain provisions. These three provisions are the equal weighting of the factors, the definition of business income and the definition of gross receipts. A fourth change to clarify relief provisions of Section 18 may also be reasonable.

- *Factor Weighting*

UDITPA §9 calls for equal weighting of the three apportionment factors: property, payroll and sales. But over the years there has been a pronounced legislative trend toward overweighting the sales factor. As of January 1, 2007, only eight states exclusively require an equal weighted 3 factor formula. Thirty-four states now at least double weight the sales factor, and six of those apportion based on the sales factor only.[6] NCCUSL may wish to consider modernizing UDITPA to reflect the current situation in most states.

- *Definition of Business Income*

Today, a majority of states have interpreted UDITPA §1(a) to provide two tests for identifying apportionable business income: a transactional test and a functional test.[7] But the

[4] *The Uniform Division of Income for State Tax Purposes*; William J. Pierce; TAXES, Tax Magazine; Vol. 35, No. 10, p. 780; October, 1957.

[5] The service industry alone created more than half of all new jobs nationally between 1992 and 1997; see U.S. Census Bureau, 1997 Economic Census: Comparative Statistics, 1987 SIC Basis.

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

[7] See e.g., *Hoechst Celanese Corp. v. Franchise Tax Board,* 25 Cal.4th 508 (2001).

language of the Act is not very clear and some states have held UDITPA provides only a transactional test.[8] In states where the courts found only a transactional test, the legislature often followed up with a statutory amendment to clearly add the functional test.[9] A number of states that had not incorporated the functional test have added it recently.[10] In addition, there has been a trend over the last few years for states to adopt legislation defining business income as all income apportionable under the U.S. Constitution.[11] NCCUSL may wish to consider clarifying the definition of business income in Section 1(a) to reflect the current treatment and the trend toward defining business income as co-extensive with U.S. Constitutional restraints.

- *Definition of Gross Receipts*

Under Section 1(g) of UDITPA, "sales" is defined as "all gross receipts of the taxpayer…." But the term "gross receipts" is not defined and many states have dealt with the question of whether "gross receipts" includes return of investment principal such as the repayment of a loan or the return of principal when a business entity makes a short-term investment of its working capital. The MTC has promulgated two model regulations interpreting the existing language of UDITPA to exclude returns of principal, consistent with the current rule of law in the overwhelming majority of states.[12] NCCUSL may wish to clarify UDITPA to reflect this uniform interpretation.

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[8] See e.g., *In re Tax Appeal of Chief Industries, Inc*., 255 Kan. 640, 647, 875 P.2d 278 (1994).

[9] See, e.g., Tenn. Code Ann. §67-4-2004, Ala. H.B. 7 (Dec. 28, 2001).

[10] Mississippi, A.B. 1695 (2001); Oregon, OAR 150-314.610(1)-(A)(2) (2004) ; Kentucky, 103 KAR 16:060E (2006).

[11] Minn. §290.17 (1999); Alabama, H.B. 7 (2001); Pennsylvania, H.B. 334 (2001); New Jersey, A.B. 2501 (2002); North Carolina, S.B. 1115 (2002); Illinois S.B. 2207 (2004); Georgia, H.B. 488 (2005).

[12] According to research performed by the California Franchise Tax Board, the following states do not treat returned principal as a receipt in a sales factor or a factor equivalent to a sales factor: Arkansas (Ark. Code Ann. § 26-51-1403, subds. (f)(1) and (m)(1)(A)); Colorado (Colo. Rev. Stat. § 39-22-303, subd. (4)(b)); Connecticut (Conn. Gen. Stat. § 12-218, subd. (c)(3)); Florida (Fla. Stat. § 220.15, subd. (5)(a)); Georgia (Ga. Code Ann. § 48-7-31, subds. (c)(1), (d)(1)(C)); Hawaii (Code of Hawaii Rules § 18-235-38-03, subd. (f)); Idaho (Idaho Admin. Rules 35-01.01.570, subd. .03); Illinois (Ill. Admin. Code 100.3380, subd. (c)(5); Indiana (*Sherwin-Williams Co. v. Indiana Dep't of State Revenue* (Ind. Tax 1996) 673 N.E.2d 849.); Iowa (Iowa Admin. Code §§ 701-54.2.2(422), subd. (2)(f), 701-59.28 (422)); Kansas (Kan. Stat. Ann. § 79-1130, subds. (f), (m)); Kentucky (Ky. Revenue Cabinet Tax Policy 41P170, 06/01/1983.); Louisiana (La. Rev. Stat. § 47:287:92, subd. (B)(2)); Maine (Me. R. 80 (18-125 CMR 801), subds. .08(B)(1), (2)); Maryland (Md. Regs. Code 03.04.03.08, subd. (C)(3)(d)); Massachusetts (Mass. Gen. L. § 38, subd. (f)); Michigan (*H.J. Heinz Co., Inc. v. Dep't of Treasury* (Mich. 1992) 494 N.W.2d 850); Minnesota (Minn. Stat. § 290.191, subd. (5)(a)(5)); Mississippi (Miss. Income Tax R. 806, subd. (III)(B)(9)(c)); Nebraska (Neb. Rev. Stat. § 77-2734.10, subd. (1)); New Hampshire (N.H. Admin. Rules, Rev. 304.05, subds. (b), (c)); New Jersey (N.J. Admin. Code 18:7-8.9; *AT&T v. Director, Division of Taxation* (N.J. Sup. Ct. App. Div. 1984) 476 A.2d 800); New Mexico (N.M. Admin. Code 3.5.19.11, subd.(A)(4)); North Carolina (N.C. Gen. Stat. § 105-130.4, subd. (a)(7)(d)); New York (N.Y. Tax Law §§ 208, subd. (d), 210, subd. (3)(b) [for investment activities of non-investment company, such investment activities assigned on the basis of an investment allocation percentage determined by activities of securities issuer and not by the taxpayer's activities]); Ohio (Ohio Rev. Code Ann. § 5733.05, subd. (B)(2)(c)); Oklahoma (Okla.

- *Clarification of Section 18 Relief Provisions.*

Section 18 of UDITPA has been used as the statutory basis for many industry specific special apportionment regulations. These regulations often apply to service industries where the general rule of Section 17 is simply not workable and does not produce a fair result. While there is not a specific mention of the potential to use Section 18 in this manner, it is the statutory ground upon which many of the shortcomings of Section 17 have been remedied. Hopefully, an amended Section 17 will produce a general rule that can apply to many of these industries, but there will undoubtedly still be some industries for which a Section 18 rule will be necessary. Section 18 should be clarified to specifically support industry wide special rules as well as ad-hoc adjustments on a case-by-case basis.

C. Other Provisions of Lesser Concern

The remaining UDITPA provisions – other definitions, assignments of non-business income, the property factor, payroll factor and sales factor for sales of tangible property - may merit some level of review. But these provisions are, by and large, workable. Certainly they have been the subject of litigation, but they do not have the serious administrative and philosophical problems of Section 17 and they are still interpreted relatively uniformly among the states. The controversy that could be generated by including these provisions within the scope of review could slow work on other, critical provisions and may not be worth the relatively small addition to existing uniformity.

III. Comments on the Proposed 10 Criteria for Evaluating UDITPA Revisions

The MTC believes it is very important to establish criteria that will enable the committee to evaluate and compare a myriad of possible amendments. The suggested 10 Criteria for Evaluating Proposed UDITPA Revisions would provide a reasonable basis for that evaluation. We would recommend the following changes to the list:

1. Is the proposal a **simple and workable** way to compute the tax base?

    a. Can the elements of the proposed factor be **located geographically**?

    b. Will the proposal **facilitate** transparency and **compliance** with tax laws?

    c. Will the proposal minimize **cost of administration** for both taxpayers and the state?

2. Does the proposal help assure that income is taxed once and only once - avoiding “nowhere income” ~~- and only once~~and duplicative taxation? The

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Admin. Code 710:50-17-71, subd. (1)(A)(i)); Oregon (Or. Rev. Stat. § 314.665, subd. (6)(a); Or. Admin. R. 150-314.665(6)(c), subds. (1)(a), (b)); Pennsylvania (Pa. Stat. Ann. § 7401, subd. (3)(2)(a)(1)(E); *Commonwealth v. General Electric Co.* (1963) 412 Pa. 123, 194 A.2d 139); Rhode Island (R.I. Gen. Laws § 44-11-14, subd. (2)(v); R.I. Reg. CT 04-04, subd. (2)(d)); Texas (Tex. Admin Code 3.549, subds. (b)(5), (e)(27)); Utah (Utah Admin. Code R865-6F, subd. (8)(1)(J)(3)(a)(2)); Virginia (Va. Public Document Ruling nos. 91-272, 91-212); Washington (Wash. Rev. Code § 82.02.080); West Virginia (W.Va. Admin. Dec. no. 93-233 RN [Aug. 11, 1997]); and Wisconsin (Wis. Stat. § 71.04, subd. (7)(f)(5)).

"internal consistency" test, described by the U.S. Supreme Court in *Container* asks the question: If all states had the same apportionment system as the taxing state, would more than 100% of the taxpayer's income be apportioned to all states in which the taxpayer does business? (*Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, 169 (1983)).

3. Does the proposal reasonably reflect the manner in which income is earned? Under the "**external consistency**" test, also described in the *Container* case, an apportionment formula must be based on activities which reflect a reasonable sense of how income is earned.

4. Will the proposal reasonably reflect the **level and nature of business activity** in the state? In *Allied Signal*, the U.S. Supreme Court held there must be a rational relationship between the item of income subject to apportionment~~,~~ and the activity conducted in the taxing state. (*Allied Signal v. Dir., Div. of Taxation*, 504 U.S. 765 (1992))

5. Will the proposal promote apportionment of income in **relation to the benefits**, opportunities, services and protection firms receive from the state; such as the provision of highways, police, fire protection, schools, waste disposal, a legal infrastructure and other public sector goods and services? The Supreme Court noted the current three-factor formula "can be justified as a rough, practical approximation of the distribution of either a corporation's sources of income or the social costs which it generates." (*General Motors Corp. v. District of Columbia*, 380 US 553, 561 (1965))

6. Is the proposal **non-discriminatory** ~~against either out-of-state~~ with respect to both interstate commerce ~~or~~ and purely in-state commerce?

7. Does the proposal minimize the opportunity for **manipulation** of the apportionment result?

8. Will the proposal have ~~a limited~~ an acceptable **fiscal impact** to the states and ~~limited revenue impact to~~ taxpayers?

9. Does the proposal produce an **equitable** apportionment of the tax base?

    a. Will the proposal promote **horizontal equity** by treating taxpayers in the same situation similarly? For example, will taxpayers with similar value of business activity in the state report a similar amount of taxable income to the state?

    b. Will the proposal promote **vertical equity** treating taxpayers who are not in the same situation differently, in an equitable manner? For example, will firms with a larger amount of business activity in the state apportion a larger share of their income to the state?

10. Is the proposal **economically neutral**? Will it avoid creating economic distortions by giving firms incentives to use one type of production process over

another, or to locate property and/or payroll in one geographic area as opposed to another?

IV. Substantive Recommendations

The Multistate Tax Commission will submit specific substantive recommendations for Section 17 and other UDITPA provisions once the full scope of the project is determined. At this time, we can provide preliminary, conceptual recommendations regarding UDITPA §17.

The current UDITPA §17 assigns receipts from transactions other than sales of tangible personal property to the state where "the greater proportion of the income-producing activity is performed … based on costs of performance."

The major conceptual problem with the cost of performance rule for sales factor sourcing is that it tends to duplicate the property and payroll factors, rather than reflect the contributions of the market state. We believe the purpose of the sales factor should be to reflect the market state and that UDITPA §17 should be amended to do so. With respect to assigning gross receipts from the sale of intangible property, the value of that property is often based on its employment by others; it makes little sense to assign value to the geographic locations where the intangible property is sold or managed instead of to the locations where the property generates receipts. See for example UDITPA §8 which uses such a rule for nonbusiness income derived from intangibles.

The cost of performance rule has been difficult to administer when applied to taxpayers performing multistate services and may sometimes produce anomalous results. While UDITPA does not define "cost of performance," the MTC's model uniform regulations define the term to be "direct costs determined in a manner consistent with generally accepted accounting principles…"[13] "Direct costs" are not defined.

In practice, the income producing activity rule has a number of shortcomings. First, although the boundaries of "income producing activity" are critical to the apportionment outcome, they are nearly impossible to objectively identify. And of course one must know what the income producing activity is before one can identify the costs associated with it. Furthermore, some have argued that with many intangibles there is no income producing activity at all. Rather, it is the asset that produces the income and not the taxpayer's limited and sometimes insignificant activity necessary to put the asset to productive use.

Even if income producing activity is capable of being identified, its calculation through cost of performance is riddled with difficulty. The terminology is vague and difficult to define. For example, to what extent should transactions and activities be aggregated when determining costs of performance? Should costs of performance and direct costs include fixed costs or only variable costs? Should depreciation be included? Should common costs be included and if so how should they be sourced? Categorizing costs as fixed, variable, common or otherwise would be very difficult.

If the cost of performance could be reasonably determined, the rule assigning receipts to the state with the greater cost of performance can produce arbitrary results in situations where income-producing activities are spread over many states. One example might be a

[13] Multistate Tax Commission Model Allocation and Apportionment Regulation IV.17(3)

telecommunications company with a multistate network. If there are 32 states with 3% of the network cost and 1 state with 4%, the entire receipt may be sourced to the one state with only slightly more cost of performance. A similar example might be a web-based information-service provider with a database and primary server located on a mainframe in one state, a research and content provider in a second state and customer training and support in multiple states. Assigning all receipts to any one state under the greater cost of performance rule will not reflect how and where this taxpayer earns its income. The sourcing issues are further complicated if the taxpayer relies on affiliates in some states to provide services on its behalf to its customers.

The sales factor assignment rules for sourcing sales of tangible property have a "throwback" rule if the taxpayer is not taxable in the market state. A "throwback" rule is not needed in the current UDITPA §17 because the presence of tangible property or employees which generate the costs of performance is accepted as a basis for taxability. If this sourcing rule is changed to reflect the market, then we should consider the need for a "throwback" provision to ensure full accountability.

In response to these administrative and conceptual shortcomings in UDITPA §17, states have adopted industry-specific sourcing rules pursuant to Section 18 for many industries where the problems were most acute, including broadcasting, publishing, and franchising. States have also increasingly relied on the equitable apportionment provisions of Section 18 to avoid some of the arbitrary results which would otherwise obtain under Section 17's "all-or-nothing" approach to assigning receipts. Both of these approaches by individual states have increased the possibility of nonuniformity in the apportionment of receipts from the sale of intangible property and services under UDITPA §17.

V. Consideration of Other Issues Affecting Corporate Income Tax

UDITPA addresses how states should apportion and allocate income on a uniform basis, and generally does not touch upon questions concerning the determination of the tax base (including conformity to federal taxable income determinations), jurisdiction to tax (nexus), combination of related entities for purposes of apportionment (combined reporting), or the myriad issues arising from the utilization of limited liability companies (LLC's) and other "pass-through" entities. The MTC suggests that while such areas of concern could benefit from uniformity, uniform models have already been developed in other forums and the controversies surrounding these topics may delay or impede acceptance of any revised Act, making their inclusion inappropriate under NCCUSL criteria 1(c)(ii) and 1(f)(ii).

VI. Conclusion

The Multistate Tax Commission appreciates this opportunity to respond to the Study Committee's questions and comments and looks forward to working with the committee on this project. Please feel free to contact us with additional questions or concerns you may have regarding this memorandum or any other issues related to UDITPA.