MEMORANDUM

TO: Wood Miller, Chair
MTC Income & Franchise Tax Uniformity Subcommittee

FROM: Bruce Fort, Counsel, Multistate Tax Commission

DATE: 3/3/08

RE: **Possible Amendments to Model Regulation IV.18.(A)**

At the July 30, 2007 meeting of the Uniformity Income Tax Subcommittee, a vote of approval was given to move forward with a project to propose possible amendments to Model Regulation IV.18.(a) to allow greater utilization of the "equitable adjustment" apportionment provisions ("Section 18") of the Uniform Division of Income for Tax Purposes Act (UDITPA).[1] The subcommittee expressed general agreement that the current regulation may unduly hamper application of equitable principles in some circumstances where the inappropriateness of the standard apportionment formula is manifest but not necessarily the result of an "unusual" factual situation.

Ted Spangler, Richard Cram, Leonore Heavey and Wood Miller volunteered to participate in a drafting group for that proposal. Some proposed alternatives are suggested below for the drafting group's consideration.

Regulation IV.18.(a) provides:

"Special Rules: In General. 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 the apportionment and allocation provisions contained in Article IV."

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[1] Section 18 reads in full:

If the allocation and apportionment provisions of the Uniform Division of Income for Tax Purposes Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for, or the [Department] may require, with respect to all or any part of the taxpayer's 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.

Possible Alternative Amendments to Regulation:

1. 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 only be invoked only in cases where the fact situations produce incongruous results under the apportionment and allocation provisions contained in Article IV.

2. Article IV.18 permits a departure from the allocation and apportionment provisions of Article IV where the extent of the taxpayer's business activity within the state would not be fairly represented under the allocation and apportionment provisions of Article IV because of the nature of the taxpayer's business, operations or structure.

3. Article IV.18 permits a departure from the allocation and apportionment provisions of Article IV only in limited and specific cases where unusual factual situations (which ordinarily will be unique and non-recurring) produce incongruous results or where application of the allocation and apportionment provisions in Article IV would not fairly represent the taxpayer's business activity within the state because of the nature of its business, operations or structure.

4. The party seeking to vary the statutory apportionment formula must demonstrate that the apportionment formula as a whole does not fairly represent the extent of the taxpayer's business activity in the state. In addition, the party seeking to vary the statutory formula must demonstrate that its proposed alternative (a) would not result in multiple taxation of the same income if adopted by all taxing jurisdictions applying the formula; (b) that the formula more clearly reflects the extent of the taxpayer's business activity in the state; and (c) that adoption of the formula would not unnecessarily foster a lack of uniformity among the states.

The first proposal removes the limitation that the cases must "unusual factual situations", but retains the language conditioning application to "limited and specific" cases. Limited and specific cases could include cases involving only certain industries (e.g., financial institutions, trucking, etc.) or fact patterns (e.g., churning).

The second proposal is more open-ended in allowing application to a group of affected taxpayers, but limits that application to situations where the "nature of [the taxpayers'] business operations or structure" is the cause of the standard formula's failure to fairly represent the taxpayer's business activity.

The third proposal retains the restrictive language in the current regulation but allows a broad exception for businesses which are not appropriately apportioned under the standard statute.

The fourth proposal, adopted from the test established in *20th Century Fox v. Dept. of Revenue (Oregon)*, 700 P.2d 1035 (1985), incorporates the goal that the alternative formula not interfere unreasonably with uniformity, and further assigns the burden of proof to the party seeking a variation.

It is hoped that these proposals can provide a starting point for discussion.

The Case for Amending Regulation IV.18.(a):

Because of Art.IV.18's inherent flexibility in an otherwise static statutory framework, a more dynamic utilization of state equitable adjustment authority on an industry-wide or issue basis, rather than a case-by-case basis, under Art.IV.18 may be necessary for states to properly and effectively administer their corporate income tax systems in the face of three trends: (1) increased use of tax minimization strategies; (2) rapid changes in business structure, operations and practices; and (3) rapid growth of entirely new areas of business, products and services.

Art.IV.18 contain just two limitations on its application: (1) there must be a showing that the allocation and apportionment provisions of the remainder of Article IV do not fairly represent the extent of the taxpayer's business activity in the state; and (2) the alternative method of allocation and apportionment must be reasonable.

Although Art.IV.18 by its own terms provides a broad grant of equitable powers to tax administrators (and provides a correspondingly broad grant of equitable rights to taxpayers) many states have adopted a uniform regulation which significantly curtails the circumstances under which Section 18 may be invoked. In 1973 the MTC adopted proposed model Regulation IV.18.(a)., which limits the use of Section 18's equitable apportionment powers to: "limited and specific cases…where unusual factual situations (which ordinarily will be unique and non-recurring) produce incongruous results…"[2]

Many compact-member states adopted the model regulation. Currently, at least 15 states have adopted some version of Regulation IV.18.(a) by regulation, while a 16th state, Nebraska, has incorporated the standard into statute.[3]

The regulation reflects an understandable concern that unfettered use of equitable apportionment would lead to a "free-for-all" of ad-hoc tax adjustments, undermining the goals of predictability and uniformity. The policy considerations underlying Regulation IV.18.(a)'s limitations find support in subsequent cases and commentary. *See, e.g., Deseret Pharmaceuticals v. State Tax Comm.*, 579 P.2d 1322 (Utah 1978)(upholding application of Section 18 based on distortion caused by high incidence of sales in states where taxpayer was immune from income tax); Kessling & Warren, *California's Uniform Division of Income for Tax Purposes Act, (Part I)*, 15 U.C.L.A. L. Rev. 156, 171 (1967).

Other cases have established guidelines based on the reasonableness of the three-factor formula when applied to a particular industry, without any suggestion that the taxpayer's factual circumstances within the industry itself must be unique. *See*, *Twentieth-Century Fox Film Corp. v. Department of Revenue*, 299 Or. 220, 700 P.2d 1035 (Oregon

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[3] The fifteen states are: Alabama, Arizona, California, Colorado, Connecticut, Florida, Georgia, Idaho, Indiana, Kansas, Montana, New Mexico, North Dakota, Oregon and Tennessee.

1985)(Section 18 invoked to add intangible value of films located in Oregon added to property factor). The willingness to extend Section 18 to more accurately reflect how a non-traditional commercial or industrial activity generates income, without any showing of unique circumstances within that industry, may be closer to the original intent of the legislatures that adopted UDITPA.[4]

While uniformity and predictability are the cornerstones of UDITPA, a statute based on the economic models and practices that existed fifty years ago may need some flexibility if it is to remain effective in the face of changing practices and economies. Obviously, use of equitable adjustment authority requires tax administrators to maintain a delicate balance between the competing goals of flexibility and predictability. An issue for the Subcommittee to consider is whether the regulation should be amended so that Section 18 authority may be used more explicitly to respond to tax minimization techniques. Tax administrators may wish to consider other regulatory alternatives to allow use of Section 18 in a wider variety of situations, including more realistic apportionment of new industries or industry structures prior to adoption of industry-wide regulation, and more equitable apportionment of the income of special-purpose affiliates and subsidiaries.

One of the obvious dangers inherent in expanded use of Section 18 authority is that administrators may face additional challenges based on differing views of how much income was earned in a particular jurisdiction. Some early equitable apportionment cases arose out of attempts by taxpayers or tax administrators to utilize Section 18 based solely on large disparities between tax liability under separate accounting and apportionment. *See, e.g., Donald M. Drake v. Department of Revenue,* 263 Or. 26, 500 P.2d 1041 (Or. 1972)(rejecting administrator's attempt to impose separate accounting on in-state portion of unitary business based on profits); *Amoco Production Co. v. Arnold*, 213 Kan. 636, 518 P.2d 453 (Kan. 1974)(same). Section 18 has also been invoked to exclude gains from an out-of-state capital gain, an issue which would have been more appropriately addressed based on application of unitary business principles and the application of the tests for business income. *Stan Musial & Biggies, Inc. v. State,* 363 So. 2d 375 (Fla. Dist. Ct. App. 1978); *Roger Dean Enterprises Inc. v. State,* 387 So.2d 358 (Fla. 1980)(Section 18 relief provisions inapplicable to exclude gain). It seems inevitable that if Section 18 were applicable whenever economists might disagree on the appropriateness of the standard apportionment formula, without any limitations based on exceptionality, relief petitions and litigation would increase in frequency. *See, e.g., Colgate-Palmolive Company, Inc. v. Bower*, Ill. Cir. Ct. No. 01 L 50195, 2002 WL 31628400 (2002)(denying Section 18 claim that a fourth factor representing contribution of international trademarks should be added to formula); *Pacific Coca-Cola Bottling Co. v. Department of Revenue,* 307 Or. 667, 773 P.2d 1290 (1989)(denying factor adjustment

[4] *See, e.g.,* Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 Taxes 747, 749 (1957)(stating Act was designed specifically for manufacturing and mercantile industries). The official comments to the 1957 draft for the National Conference of Commissioners on Uniform State Laws might also be viewed as an appropriate source of legislative intent. Those comments provided with respect to Section 18 that it: "is intended as *a broad authority*, within the principle of apportioning income fairly among the states which have contact with the income, to *the tax administrator* to vary the apportionment formula…where the provisions of the act do not fairly represent the extent of the taxpayer's business activity within the state." (emphasis supplied.)

for value of trade names, finding that value already reflected in costs of tangibles); *Tambrands, Inc. v. Assessor*, 595 A.2d 1039 (Me. 1991)(requiring factor adjustments for value of international operations); *NCR Corporation v. Comptroller of the Treasury*, 313 Md. 118, 544 A.2d 764 (1988)(denying factor relief claim for foreign-source income absent gross disparity in tax liability).

I. **<u>Use of Section 18 to Combat Tax Minimization Strategies</u>**

Of the three possible uses of Section 18 authority, limiting the effectiveness of tax planning techniques should present the least controversy. In the last decade, state courts have generally been sympathetic to the efforts of tax administrators to address deliberate tax minimization strategies or filing positions which take advantage of perceived weaknesses in application of UDITPA terms, most notably, the broad definition of "gross receipts." Art IV.1.(g). Many courts and administrative law judges have upheld the use of Section 18 authority in such situations, or have declared that any construction of UDITPA which produces absurd or incongruous results should be avoided. *See, e.g., Walgreen Drug Company v. Arizona Department of Revenue,* 209 Az. 71, 97 P.3d 896 (Ct. App. 2004)(declining to reach equitable relief issue); *Sherwin-Williams Co. v. Indian Department of Revenue,* 673 N.E. 2d 849 Tax Ct. 1996)(same*); Sherwin-Williams Co. v. Johnson, 989 S.W.2d 710 (Tenn. App. 1998)(applying equitable relief statute); Kmart Properties, Inc. v. Taxation and Revenue Department*, 139 N.M. 177, 131 P.3d 22 (2001), *cert. quashed in part*, *rev'd in part*, 131 P.3d 17 (2005)(applying equitable relief); *Geoffrey, Inc. v. Oklahoma Tax Commission*, 132 P.3d 632 (Okla. 2006)(no appeal of ALJ's use of Section 18); *Gore Enterprise Holdings v. Director of Revenue, Missouri,* No. 99-2865, 2002 WL 200918), *rev'd on other grounds*, 96 S.W.2d 72 (Mo. 2002)(applying equitable relief statute).

To date, only three reported cases have addressed the issue of whether Regulation IV.18.(a) precludes use of Section 18 authority to address common tax minimization schemes. *Union Pacific Corp. v. Idaho State Tax Commission*, 139 Idaho 572, 83 P.3d 116 (2004)(*Union Pacific II*); *Microsoft Corporation v. Franchise Tax Board*, 39 Cal. 4th. 750, 47 Cal. Rptr. 3d 216 (Ca. 2006); *In Re Protest of Wal-Mart Stores, Inc*., No. 2006-07, N.M. Tax. & Rev. Dept., 2006 WL 2038698 (6/1/06). The states have prevailed in using Section 18 in all three of those cases, but in each case, the courts or administrative hearing officer used different reasoning to explain why Regulation IV.18.(a) did not apply. While these decisions should provide strong authority for tax administrators to continue using Section 18 to undo inappropriate tax minimization strategies, it cannot be guaranteed that subsequent courts will follow the lead.

The heart of the problem is the regulations limitation of section 18 authority to "unusual fact situations (which ordinarily will be unique and non-recurring)." The term "ordinarily" serves to lessen the "unique and non-recurring" stricture. However, it is not clear in what sense a "fact situation" must be "unusual." The three cases above essentially found that a fact situation may be "unusual" in the context of UDITPA – i.e., the fact situation was not contemplated or addressed under UDITPA. But there is some risk that a Court may interpret "unusual fact situation" to mean "unusual" in the context of current business practices. Many tax minimization schemes are now so commonly encountered that they can no longer be considered "unique and non-recurring" in the current economy, and some tax reporting positions which produce distortion, most notably including the gross amounts of overnight treasury sales in the sales factor, are not unusual factual situations in today's economy at all.

Regulation IV.18.(a), when read in conjunction with state statutes and administrative law doctrines requiring prior notice and other due process protections for administrative rule-making authority, may yet provide taxpayers with a successful argument that tax minimization schemes may only be addressed prospectively through regulation. *See Comptroller of the Treasury v. SYL, Inc.*, 375 Md. 78, 825 A.2d 399, 418 (Md. 2003)(holding that no prior regulation was necessary to apportion income of intangible holding company based on parent company's factors, because such entities were of "relatively recent origin"), *distinguishing, CBS v. Comptroller*, 319 Md. 687, 575 A.2d 324 (Md. 1990)(state prohibited from using audience market share for sales factor absent prior rulemaking).

By clarifying the circumstances under which Section 18 may be invoked, the prospective-rulemaking only arguments can be significantly weakened. Standing alone, Section 18 should constitute the prior rule-making which give taxpayers sufficient "due process" notice that taxes may be imposed regardless of how widespread the tax-driven manipulation is or what the outcomes would be under an excessively literal interpretations of the rules of apportionment. Limiting the use of the statute to "unusual factual situations" - if interpreted as "unusual" in terms of number of occurrences, and not in terms of the context of UDITPA - may unnecessarily deprive the states of a valuable tool to correct systematic attempts to use the inflexibility of the apportionment system to reduce taxes.

A. Union Pacific v. Idaho

The case of *Union Pacific Corp. v. Idaho State Tax Commission*, 139 Id. 572, 83 P.3d 116 (2004), appears to be the first reported case in which taxpayers raised Regulation IV.18.(a) as a defense against application of the equitable apportionment rules. In *Union Pacific*, the taxpayer inflated the sales factor by counting freight sales to customers on an accrual basis, and then including the same receipts again on a cash basis when the accounts receivables were "factored". The taxpayer argued that the Regulation IV.18.(a) limited the relief provisions to unusual factual situations—not unusual legal positions, and there as nothing unusual about a corporation factoring its accounts. The Idaho Supreme Court responded by pointing out that using two different accounting methods was itself an unusual factual situation, i.e., the facts of this situation were "unusual" in the context of UDITPA, if not "unusual" in terms of number of occurrences:

> UPC argues that the fact situation to be scrutinized is the underlying transaction-the sale of receivables-which is neither unique nor nonrecurring, not the reporting method *per se.* UPC contends that the

> reporting method of including freight sales accrued as income before being collected and again as cash proceeds upon the discounted sale of the receivables to a third party cannot be viewed as an "unusual fact situation," as contemplated by the Rule. The absence of evidence of an "unusual fact situation," argues UPC, precludes the alternative apportionment authorized by the statute. For the district court to find an "unusual fact situation" under Tax Commission Rule 27,4.18.a, argues UPC, would nullify the prior rulings of the Court and allow the Commission to make *ad hoc* decisions that certain reporting methods were "unusual" even where they are legally permitted.
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> UPC also suggests that "unusual fact situations" is ambiguous and argues that the parenthetical following that language cannot logically refer to a taxpayer's reporting method. However, UPC also argues that the obvious intent of the Rule is to address transactions and other fact situations that occur in a business that may give rise to items of taxable income. UPC posits that the sale of accounts receivable is a common business practice and as such cannot be construed as an unusual fact situation.
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> Although a definition of "sales" is to be found in I.C. § 63-3027, which has been held to include the sale of accounts receivable, *see UPC I, supra*, the statute is silent with regard to accounting systems. The Court now holds that the mixing of the two accounting systems to represent but one group of sales is the unusual fact situation that led to incongruous results in UPC's application of the standard formula.

B. Microsoft v. Franchise Tax Board

The *Microsoft* case is instructive in several areas. First, the court distanced itself from decisions in other states which applied an "absurdity" test to interpret the definition of gross receipts as excluding return of principal associated with short-term investments, finding that the statute must be allowed to speak for itself. Second, the court appears to suggest that California Regulation 25137(a) [almost identical to Regulation IV.18.(a)] would unduly restrict the legislative purpose of Section 18 if its application were limited to "unique and non-recurring" situations:

> Microsoft further argues that Revenue and Taxation Code section 25137 can apply only to unique, nonrecurring situations. (See Regs., § 25137, subd. (a) ["[Revenue and Taxation Code s]ection 25137 may be invoked only in specific cases where unusual fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results under the apportionment and allocation provisions"].) The frequency with which the issue of large corporate treasury department receipts arises, it contends, renders the issue nonunique and disqualifies this situation from treatment under Revenue and Taxation Code section 25137. Again, we disagree. *Systematic* oversights and undersights are equally a matter of statutory

> concern. Nothing in the language of Regulation section 25137 persuades us otherwise.
> (emphasis supplied.)

The court the goes on to explain why the regulation does not contravene the statute, focusing on the predicate clause beginning with “ordinarily”:

> While Revenue and Taxation Code section 25137 "ordinarily" applies to nonrecurring situations, it does not apply only to such situations; the statutory touchstone remains an inquiry into whether the formula "fairly represent[s]" a unitary business's activities in a given state, and when it does not, the relief provision may apply. (See *Crisa Corp., supra,* Cal.Tax Rptr. (CCH) ¶ 403-295, at pp. 30,358-30,360; *Pacific Telephone & Telegraph, supra,* Cal.Tax Rptr. (CCH) ¶ 205-858, p. 14,907-36; *Union Pacific Corp. v. Idaho State Tax Com.* (2004) 139 Idaho 572, 83 P.3d 116, 120-121 [applying relief provision to recurring situation, sales of accounts receivables].)

One can hope that such a strong decision from the California Supreme Court will put to rest the notion that Regulation IV.18.(a) will present an obstacle in future attempts to use Section 18 to combat tax planning.

C. Wal-Mart Stores, Inc. v. New Mexico

The approach taken by the New Mexico hearing officer in the *Protest of Wal-Mart Stores, Inc.,* No. 2006-07, to determine “unusualness” may be the most satisfying from an historical and economic standpoint. The hearing officer determined that “unusualness” must be measured “within the context of UDITPA”. As the hearing officer noted, if UDITPA contemplated special rules for airlines and other industries, “unusualness” must refer not to the number of taxpayers engaged in a certain activity but to how closely those taxpayers’ businesses conform to the income-generating attributes of the manufacturing and mercantile industries for which UDITPA was essentially designed. Citing *Container Corporation v. Franchise Tax Board,* 463 U.S. 159 (1983), in which the Court held that the three factor formula worked well to capture the income-generating activities of a broad spectrum of taxpayers, it follows that where those factors do not capture the income-producing activities of a particular taxpayer, that taxpayer is factually “unusual” enough to warrant a application of an equitable alternative formula under Section 18.

Despite the persuasiveness of the hearing officer’s approach, other courts may conclude that Regulation IV.18.(a) must be read more broadly to foreclose Section 18’s application except in “unique and non-recurring” factual situations, regardless of the exceptionality of the industry itself.

II. Use of Section 18 as a Response to Rapidly Changing Patterns of Business Organization and Structure.

In addition to ameliorating the intentional consequences of tax minimization strategies, amending Regulation IV.18.(a) could also clarify that states may, when appropriate, respond on an issue-wide basis to changes in industry practices (the reg already clearly allows us to address behavior of an individual business), structures and methods which may not have been intended to secure a tax advantage, but which may nonetheless distort apportionment percentages. Changes in industry practices which may be difficult to anticipate and thus regulate in advance include: (a) predominate use of contract labor or sales force subsidiaries to market products; (b) putting title to equipment, inventory, stores or facilities in the name of LLC's, REIT's or other affiliates; (c) use of multiple layers of pass-through entities, such as partnerships and LLC's, to transfer income multiple times from in-state entities to a taxable C corporation; (d) transfer of intangible property such as accounts receivables to nexus remote or bankruptcy-remote affiliates; and (e) addressing incongruous results arising from combination in a single formula of unitary but dissimilar types of property or streams of income, e.g., combining the total receipts from low-margin, high dollar amount wholesale trading or hedging transactions with retail sales.

While adoption of regulations addressing changes in industry behavior is good tax administration, the difficulty of doing so rapidly enough to avoid a "tax gap" from unanticipated business developments is obvious. The frequency of many practices will come to the attention of policy-makers only after audit or through less direct means. Taxpayers frequently choose not to seek revenue rulings even when application of UDITPA to a particular industry is unclear. The U.S. Supreme Court addressed the issue of prospective rule-making in *Securities and Exchange Commission v. Chenery,* 322 U.S. 194, 202-203 (1947):

> The function of filling in the interstices of the Act should be performed, as much as possible, through the quasi-legislative promulgation of rules to be applied in the future. But any rigid requirement to that effect would make the administrative process inflexible and incapable of dealing with many of the specialized problems which may arise.
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> Not every principle essential to the effective administration of a statute can or should be cast immediately into the mold of a general rule. Some principles must await their own development, while others must be adjusted to meet particular, unforeseeable situations.
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> In those situations, the agency must retain power to deal with the problems on a case-by-case basis if the administrative process is to be effective.

Regulation 18.IV.(a) in its current form may unduly hamper state tax administrators from responding to unforeseen changes in industry behavior and practices through adjudication.

III. Use of Section 18 as a Response to Rapidly-Changing Economy

A third and somewhat related reason to consider amendment to Regulation IV.18.(a) is to make the regulation perfectly clear that states do have the latitude to impose appropriate apportionment formulas for specialized industries which have not been subjected to prior industry-wide regulation in that state. This use of Section 18 authority has the potential of being the most controversial but may be necessary in light of the rapid changes in the economy and the arguable anachronism of some aspects of UDITPA when applied to the service economy and industries dealing in intangible property.

The MTC has proposed model regulations for six industry sectors: construction, railroads, airlines, trucking companies, financial institutions, broadcasting and publishing. The member states have adopted many of those proposed regulations. In addition, some member states have adopted their own regulations addressed to specific industries such as film-making and franchising. The rate of promulgation and adoption of special industry regulations has unfortunately not kept up with the rate of change in the economy. As a result, uniformity may be decreasing and the effective rate of tax on newer sectors of the economy may be lagging behind the effective rate now imposed on older industries.