Comments on the MTC's Proposed Amendments to Article IV Of the Multistate Tax Compact

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Washington, DC
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INTRODUCTION

Sutherland Asbill & Brennan LLP respectfully submits the following comments in response to the Multistate Tax Commission's ("MTC") Proposed Amendments to Article IV of the Multistate Tax Compact ("Proposed Amendments"). These comments address substantive concerns with the Proposed Amendments, and are best understood in the context of the broader policy pressures on state apportionment formulas.

The apportionment provisions of the Multistate Tax Compact ("Compact") are based on the Uniform Division of Income for Tax Purposes Act ("UDITPA"). Drafted in 1957, States initially adopted UDITPA in varying degrees as a basis to apportion corporate income—either as standalone legislation or through the adoption of the Compact. Uniformity grew steadily and reached its zenith in 1978 before the United States Supreme Court decided *Moorman* and held that the states were free to craft unique apportionment regimes that departed from the uniform standard embodied in UDITPA.[1] Since 1978, nearly every state has departed from UDITPA and the Compact—largely driven by the desire of state policy makers to tailor their state's taxing regimes to different circumstances (e.g., economic climate, presence of specific industries, workforce utilization, etc.). The exodus from uniformity in the way states tax business is a reminder that traditions and attitudes do differ from state to state. Indeed, the principles of federalism[2] encourage diverse attitudes to manifest themselves, which is exactly what has happened with state tax apportionment.

The MTC's stated goal in drafting the Proposed Amendments is to create a more uniform system of state income tax apportionment.[3] The Proposed Amendments fall short of offering an attractive and workable uniformity option in a number of respects. We ask that the Uniformity Committee and interested stakeholders be given the opportunity to address the issues discussed below prior to adopting the Proposed Amendments. We also ask that the MTC actively and aggressively seek additional input from taxpayers—either collectively or through industry groups—prior to adopting any revisions to the Proposed Amendments.

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[1] *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978).

[2] Principles of Federalism are often cited by the MTC and state policy makers in the context of limiting Federal involvement in state tax matters.

[3] In fact, one of the purposes of the MTC was described by the U.S. Supreme Court as "promoting uniformity and compatibility in state tax systems." *U.S. Steel Corp. v. Multistate Tax Comm'n*, 434 U.S. 452 (1978).

I. Sourcing of Sales of Other Than Tangible Personal Property

The most significant policy shift in the Proposed Amendments is a dramatic sourcing change to sales of "other than tangible personal property." The Compact sources receipts from sales of other than tangible personal property based on the location of the taxpayer's costs-of-performance. This methodology contemplates sourcing sales based on the location of the income producing activities. The Proposed Amendments ignore all business activities except for the market.

In considering whether to adopt the Proposed Amendments, the MTC should undertake a comprehensive evaluation of whether the proposed market-based sourcing rule is an improvement over costs-of-performance. Among the issues that should be considered are: Will state legislators support and adopt the change in policy? Can taxpayer's easily apply the methodology based on existing business practices and record keeping? Does the proposed methodology fairly apportion income among the states? Does the methodology create the risk of multiple and discriminatory taxation?

Undoubtedly, most sourcing methods have flaws and some difficulties in application. The core question for the MTC should be whether market-based sourcing presents an improvement over the current regime as to warrant a complete change of policy. We believe that the market-based approach raises as many questions as it answers and we encourage the MTC to explore the possibility of preserving some form of costs-of-performance sourcing, before eliminating it in favor of a market-based approach.

A. MTC's Market-Sourcing Approach

To replace costs-of-performance sourcing for services and intangible property, the Proposed Amendments take a market-based sourcing approach that attempts to sidestep many of the sourcing difficulties that have plagued market sourcing in the past. The proposed sourcing rule is contained within a single sentence: "if and to the extent the service is delivered to a location in a state." If delivery of the service cannot be determined, the sourcing location can be "reasonably approximated." If both of these rules fail—or if the taxpayer is not taxable in the state to which a service is sourced—the receipts for the services are "thrown out" of the denominator. The Proposed Amendments also change the sourcing of receipts from intangibles. Receipts from licensing intangibles are sourced based on whether an intangible is "used in" a state. In addition, the Proposed Amendments also adopt a controversial "look through" approach that sources sales of "marketing intangibles" to the location of the taxpayer's customer's customer. Sold intangibles will be sourced according to where the property is used.

B. Difficulties with Market-Based Sourcing Approach

The MTC's stated goal in this process is to develop a basic rule that will "work best for more taxpayers than any alternative rule." However, the proposed market-source rule is new,

vague, and not based on any state's law.[4] The Proposed Amendments falls short of being an adequate multistate model in several respects.

An overarching concern with the MTC's approach is the flawed premise that the sales factor should reflect market activity because the property and payroll factors reflect other business activity. This premise ignores the reality that a large number of states have adopted single sales factor apportionment. The MTC's approach, when coupled with single sales factor, would disregard the contribution of the state where production takes place. In the case of a company that delivers its services remotely to a single state, the proposed approach would result in the "market state" computing tax on 100% of the taxpayer's income and the state where all of the work is done receiving no tax at all. An all-or-nothing result that ignores significant business activities only furthers the inequities that states have cited as a basis for reviewing costs-of-performance sourcing.

1. Sourcing of Services

A memorandum dated July 15, 2010, from MTC staff (and presumably the drafting group for the Proposed Amendments) to the MTC Income and Franchise Tax Subcommittee, classified the market-sourcing approaches taken by states at that time for services into three different categories:

- States that source where the taxpayer's customer receives a benefit from the service: California, Georgia, Michigan, Ohio, Wisconsin, Utah;[5]
- States where the taxpayer's customer receives the services: Maine, Minnesota; and
- States where the taxpayer performs the service: Connecticut, New Jersey, New York, Rhode Island, South Carolina, Texas.[6]

The memorandum concludes that "because the objective of each of these alternatives is to source to the market, the results should not diverge in most circumstances, but certainly could in some." After discussing alternatives, the approach taken in the Proposed Amendments uses the phrase "delivery," which in the view of the Committee, also had the same "market objective" as the other varieties and would have the same consequence. This is simply not the case.

"Delivery" is the key concept embedded in the approach and should be clearly and unambiguously defined. The Working Group discussed scores of examples of how there could be confusion in the application of a delivery rule, yet the language was left simplistic. The drafters admit that regulations may be needed, but that the basic rule could be universally applied in most

[4] Alabama prematurely adopted a version of the Proposed Amendments'' market sourcing rules in 2011. Ala. Code § 40-27-1, Article IV.17.

[5] Utah sources receipts from the performance of a service to the state if the purchaser of the service receives a greater benefit from the service in Utah than in any other state. Utah Code Ann. § 59-7-319(3).

[6] There is some question as to whether some of these states are in fact market states because they use some costs-of-performance concepts. For example, South Carolina sources receipts from services to the state to the extent the income-producing activity is performed in South Carolina. S.C. Code Ann. § 12-6-2295(A)(6).

circumstances. Reexamining a few examples that were considered demonstrate how uncertain it will be to leave tough questions to regulations.

Example A — Software Support: A software company has a call center located in Minnesota, and it provides support services to individual customers using its software in California, Illinois, and Michigan for a set monthly fee specified in its contracts. Fifty percent of the calls originate from California, 10 percent from Illinois, and 40 percent from Michigan. Thirty percent of the customers' billing addresses are in California, 20 percent in Illinois, and 50 percent in Michigan. All three states purport to source using a "market" approach applying a "benefits received" rule. However, because of unique regulations—or the lack thereof—it is not easy to determine how to source these receipts with certainty.

Because the sales are to individuals, California sources the sale to the billing address of the taxpayer's customer.[7] The customer's billing address serves as a safe harbor—taxpayers may choose it as a proxy for the location where the benefit of the service actually is received. As a result, 30 percent of the receipts will be sourced to California as a general rule.

Illinois offers no billing safe harbor in the case of sales to individuals and the only guidance is the statutory language of where the "services are received."[8] Consequently, it would seem that only 10% of the receipts would be sourced to Illinois based on the services received by those making calls, and that 20 percent of Illinois' billing addresses would be irrelevant.

For Michigan tax purposes, sales of services performed within and outside the state are sourced in proportion to the benefit in each state.[9] Michigan Revenue Administrative Bulletin (RAB) 2010-5 provides more guidance to ascertain where the benefit of the service is received. For example, it provides that if a service relates to tangible personal property owned or leased by the purchaser, the service is sourced to Michigan if the tangible personal property was located in Michigan or delivered to a purchaser in Michigan. Thus, Michigan sourcing depends on whether the software is prewritten (tangible property) or custom (intangible property), which is often not defined in any state. If the service relates to prewritten software located in Michigan, the entire benefit of the service received in Michigan is sourced to Michigan. Naturally, it may be difficult for the taxpayer to determine whether that software is located in Michigan, so questions will arise as to whether the billing address or source of call is the best proxy for determining whether the software is located in Michigan. If the service relates to custom software (intangible property), the benefit of the service is sourced to Michigan to the extent that the intangible property is "used" in Michigan. The state likely will look to the origination of the call to determine proportion of use.

Example B — Accounting Services: Acme Accounting Firm provides accounting services to Multistate Manufacturing Corp. (MMC). MMC has facilities in California, Illinois, and Michigan, but its principal place of business and state of commercial domicile is Illinois. MMC ordered accounting services for its entire company from Illinois where most of its in-

[7] Cal. Code Regs. tit. 18, § 25136-2.
[8] 35 Ill. Comp. Stat. Ann. § 5/304(a)(3)(C-5)(iv).
[9] Mich. Comp. Laws Ann. § 208.1305(2)(a).

house accountants are located. MMC's individual state facilities differ greatly. MMC's largest facility is in California, but it is a highly automated factory with the fewest employees. MMC's Michigan facility is its smallest, but it is the location of its R&D engineers who have invented patents that represent 90% of the value of the company. The Illinois facility houses the largest number of MMC employees, many of which manage third-party licenses for the manufacturing of MMC's products overseas. The contract with MMC specifies the nature of the work to be done by Acme—including filing reports with the SEC in Washington, DC—but it does not specify where the benefit of the accounting service is received.

Unlike the rule for transactions with individuals, California has no safe harbor for transactions between businesses. Instead, the regulations provide that the location where a business customer receives the benefit of the service is presumed to be in California to the extent indicated in the contract between the taxpayer and its customer or the taxpayer's books and records, regardless of the customer's billing address.[10] If the taxpayer's contract or books and records do not indicate where the benefit of the service was received, the regulation allows the location to be reasonably approximated. If reasonable approximation is impossible, only then can the source be determined based on the location where the customer ordered the service. The customer's billing address is the last resort; it can be used only after the other rules have been exhausted. Because the contract does not (and perhaps cannot) specify the location of where the services are performed, the taxpayers and the state likely will have to reasonably approximate the location. The reasonable approximation could be based on: value; square footage; number of employees; income; or some other method, but regardless of the method the taxpayer can never be certain of the appropriate method.

The answer is equally unclear in Illinois. Generally, receipts for services provided to a corporation, partnership, or trust may be sourced only to a state where the business customer has a fixed place of business (the customer's address).[11] If the state where the customer receives the service is not readily determinable, or the corporation, partnership, or trust has no fixed place of doing business, the office where the customer ordered the service in the regular course of business is deemed to be the location where the service is received. If that location is not determinable, the services are deemed received at the customer's billing address. The concept of "readily determinable" is distinctly different from the "reasonable approximation" approach used in California and the Proposed model. As a result, the ability to use billing address would occur more quickly in the analysis than in those instances where "reasonable approximation" is allowed. One could easily see how Illinois might source a sale based on billing address, which would provide for a 100 percent Illinois factor.

Example C — Architectural Design Services: Design Corp. is an architectural firm located in Minnesota that is designing a new hamburger restaurant chain for Beef on a Bun. Beef on a Bun is located in California, and plans to franchise its stores in 5 states. Design Corp.'s employees travel frequently to California to meet with Beef on a Bun and discuss the blueprints for the restaurants, and the Beef on a Bun only employees travel to Minnesota to do the same.

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[10] Cal. Code Regs. tit. 18, § 25136-2(c)(2)(A).
[11] 35 Ill. Comp. Stat. Ann. § 5/304(a)(3)(C-5)(iv).

Design Corp. drafts the blueprints in Minnesota. The contract specifies that the location where the service is received is Minnesota.

This example shows how easy it is for states and taxpayers alike to get whipsawed under unclear market rules that are applied differently by states. Under California's cascading approach, the taxpayer may argue that the location specified in the contract controls, which would be Minnesota. However, the FTB may rebut this presumption by arguing that the benefit actually was received in California because the taxpayer met with clients in California. California may also "reasonably approximate" and assign sales to the 5 states in which the design services are ultimately used when the stores are built. However, that method of "reasonable approximation" may be inconsistent with Minnesota, which allows sourcing only to a state where the purchaser has a fixed place of business. Beef on a Bun arguably does not have a fixed place of business because its franchisees are the only entities operating in the 5 states.

2. Sourcing of Intangibles

The application of this proposed test to the licensing of intangibles presents many of the same practical difficulties that are discussed above with respect to the delivery of a service. It is simply too difficult to determine where intangible property is "used."

Additionally, the model provides a special rule for the licensing of "marketing intangibles," receipts from which will be sourced to the location of the underlying tangible property to which it relates. It is virtually impossible for many licensors to track the ultimate sale of property associated with the intangible. For example, a university licensing its logo for the use on drink cozies has no way track the sales of those cozies around the world.

One last concern with the sourcing of sales of intangibles is with the Proposed Amendments' disparate treatment of different types of intangibles. The Proposed Amendments only allow for the inclusion of sold intangibles in the sales factor if the intangibles are associated with a contractual (or governmental) right in a specific geographic area or if they are contingent on the subsequent use of the intangible. Receipts from all other intangible sales are excluded. As a result, many sales of intangibles (e.g., customer lists) will be excluded from the factor. Another commonly sold intangible is a contract. For example, a company that sells extended warranties to repair vehicles may at some point bundle the contracts and transfer them to another for administration. That transfer could result in a gain or loss, but be excluded from the apportionment formula. We fail to see the justification for such exclusion, particularly since the gain from those sales will be reflected in the apportionable tax base. The rule would also be subject to manipulation by taxpayers who could include or exclude geographic contractual restrictions based on a desired outcome.

C. Modernizing Costs-of-Performance

In light of the problems in defining the market and the potential for distortion, the MTC should reconsider its dramatic shift to market-based sourcing for services and intangible receipts. The Uniformity Committee and its working groups too quickly embraced a policy to abandon costs-of-performance sourcing. The simple fact is that costs-of-performance has sourced income for a number of industries for the past 50 years and should not be laid to rest so quickly. This is

particularly true as the nation's economy evolves and it becomes increasingly difficult to determine the "market" for many services and intangibles.

In lieu of complete abandonment of costs-of-performance sourcing, the MTC could consider modernizing the existing costs-of-performance rules to resolve any perceived deficiencies. For example, many of the issues associated with ascertaining where the taxpayers costs of performance are located stems from factual issues like whether income producing activity is measured on a transactional or an operational basis.[12] Similarly, there has been controversy over whether to include the activities of third parties in the calculation of a taxpayer's costs of performance, which the MTC addressed in regulations.[13] A proportional costs-of-performance approach may also be more equitable and administrable in certain circumstances because it avoids an all-or-nothing result. The MTC should examine whether these issues can adequately address perceived problems with the application of costs-of-performance.

An additional alternative to complete abandonment of costs-of-performance is to carve out specific industries. For example, utilities and financial organizations are now generally carved out from all of UDITPA. If the MTC feels that costs-of-performance does not work well work for particular industries, they could similarly carve them out.[14]

D. Throwout Should be Thrown-Out

Another troubling aspect of the Proposed Amendments is the inclusion of a throwout rule. Under the throwout rule, if a taxpayer is not taxable in the destination state or if it is too difficult to tell where the receipts should be sourced, the related receipts are excluded from the numerator and denominator of the sales factor (i.e., sales that are sourced to a state that does not tax the service provider are "thrown out" of the factor altogether). The throwout rule often increases the apportionment percentage by excluding certain receipts from the factor. Income earned in states where the taxpayer is not taxable is redistributed among the states where the taxpayer is taxable, in accordance with those states' apportionment factors.

The MTC apparently believes that if all states adopted throwout, full apportionment would be realized without creating a windfall for the origin state, by spreading the impact of "nowhere sales" among each of the states in which the taxpayer is taxable. As an initial matter, any notion of full apportionment is a myth given the substantial deviation among states in factor weighting. A throwout rule cannot remedy the significant differences between states apportionment rules. The throwout rule is also constitutionally suspect, because the state that applies throwout may have no connection with the sales that are eliminated from the sales factor. For example, state C can benefit if a taxpayer provides a service from State A into State B that is

[12] *Mass. Comm'r of Rev. v. AT&T Corp.*, Dkt. No. 11-P-1462 (Mass. App. Ct. July 13, 2012) (holding that AT&T properly sourced its receipts from its interstate and international telecommunication services using the "operational" approach); *AT&T Corp. v. Dept. of Rev.*, TC 4814 (Or. Tax Ct. January 1, 2012) (requiring AT&T to source its receipts using the "transactional" approach).

[13] MTC Reg. 17(4)(C) and *General Motors v. Virginia*, 602 S.E.2d 123 (2004).

[14] The MTC regulations include special rules for airlines, broadcasters and other industries.

thrown out because the sale is difficult to source. State C gets a windfall from an activity that has no connection State C. Increasing the tax base by ignoring out-of-state activity (i.e., sales) violates the dormant Commerce Clause's fair apportionment requirement, generally, and the external consistency prong of fair apportionment specifically. The MTC should consider the irony that the throwout rule contradicts the very market approach the MTC propounds is the proper way to determine the gross receipts factor

II. Factor Weighting

As currently drafted, Compact Article IV.9 sets forth an equally-weighted three-factor apportionment formula, consisting of the taxpayer's property, payroll, and sales. The Proposed Amendments modify the language to the following:

> All business income shall be apportioned to this State by multiplying the income by a fraction, [State should define its factor weighting fraction here. Recommended definition: "the numerator of which is the property factor plus the payroll factor plus two times the sales factor, and the denominator of which is four."]
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> Proposed Compact Art. IV § 9.

In place of a standard, the Proposed Amendment leaves the option to the state to define its factor weighting fraction. With states already varying widely in the components of the apportionment formula, this option surely will lead to numerous deviations from the suggested Compact language of a three-factor formula with a double-weighted sales factor. States could weigh the factors as they see fit and presumably will consider the introduction of non-traditional factors – perhaps an intangible property factor – and still fall within the supposed uniformity promoted by the Compact. Nowhere else in the Compact are states given the ability to freely craft a rule. At the very least, there should be a menu of options for states to choose from.

It should be noted that the full state option language was the least discussed of any of those included in the Proposed Amendments. The Uniformity Committee, after much discussion, voted to recommend a double-weighted sales factor formula. After a brief discussion at an Executive Committee meeting, the Executive Committee decided to change the language and allow states unfettered discretion in determining the use of factors. This area deserves more attention by the drafting group.

III. Equitable Apportionment

The current version of equitable apportionment provided in Section 18 allows taxpayers and tax administrators to adjust the apportionment formula when the standard formula does not fairly reflect in-state business activities. The use of the equitable apportionment powers was intended to apply to unusual factual situations on a taxpayer-by-taxpayer basis. Section 18 reflects an understandable concern that unfettered use of equitable apportionment would lead to a

"free-for-all" of ad-hoc apportionment methods, undermining the goals of predictability and uniformity.

Although Section 18 allows for deviation from the standard formula, such deviation is permitted only in narrow circumstances involving unusual facts. UDITPA's drafters realized the importance of providing for "some alternative method [that] must be available to handle the constitutional problem as well as the unusual cases."[15] The drafters believed that a narrow interpretation of Section 18 is essential to achieve the fundamental purpose of UDITPA.[16] The drafters also made it clear that Section 18 was "designed to permit the use of methods different from those prescribed in the Act *only in unusual cases* and in cases where the application of specifically prescribed methods might be held unconstitutional."[17] In fact, Prof. William J. Pierce was of the opinion that the fundamental purpose of UDITPA would be seriously undermined if Section 18 "were interpreted to give administrators in the different states broad discretion in the selection of alternative methods."[18] A similar message is embedded in the Multistate Tax Commission's model apportionment regulations, which, in construing UDITPA, provide that Section 18 should apply "only in limited and specific cases . . . where unusual facts situations (which ordinarily will be unique and non-recurring) produce incongruous results under the apportionment and allocation provisions contained [in UDITPA]."[19]

The long-term and severe consequences of a broad interpretation of Section 18 were readily predictable in 1967:

> There are completely compelling reasons for giving the relief provisions a narrow construction. Under a broad construction the purposes of obtaining uniformity through the adoption of the Uniform Act would be defeated. If a choice of methods is permitted, different administrators in different states inevitably will choose different methods. As a result, even if all the states imposing taxes on or measured by income should adopt the Uniform Act, the chaotic condition heretofore existing would continue to exist.[20]

Historically, state courts shared Pierce's and the MTC's narrow view of the scope of Section 18 and have argued that the equitable apportionment provision is "the exception,"[21] and

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[15] William J. Pierce, "The Uniform Division of Income for State Tax Purpose," 35 *Taxes* 747, 781(1957).

[16] *Id.*

[17] *Id.* (Emphasis added.)

[18] *Id.*

[19] Multistate Tax Commission Reg. IV. 18(a).

[20] Frank M. Keesling and John S. Warren, "California's Uniform Division of Income for Tax Purposes Act," 15 *UCLA L. Rev.* 156, 171 (1967).

[21] *St. Johnsbury Trucking Co., Inc. v. State*, 118 N.H. 209 (1978) ("The alternative formula is the exception . . . Merely because the use of an alternative form of computation produces a higher business activity attributable to [the taxing state], is not in and of itself a sufficient reason for deviating from the legislatively mandated formula."); *see also Deseret Pharm. Co., Inc. v. State Tax Comm'n*, 579 P.2d, 1326 (Utah 1978) ("Apportionment under U.D.I.T.P.A. is the prescribed method. The use of any method other than apportionment should be

that it should be applied only in "unusual and limited circumstances."[22] However, in recent years, state tax authorities appear to have expanded the application of Section 18, claiming that it entitles them to a broad grant of authority.[23] Although states certainly have a "wide latitude to devise formulae" for apportioning and taxing income of a multistate enterprise,[24] state taxing authorities cannot rely on Section 18 to adjust a taxpayer's apportionment without a showing of inequity.

Section 18 is limited to unusual circumstances,[25] but how unusual must the circumstances be to warrant Section 18 relief? The Tennessee Court of Appeals recently held that the Tennessee Department of Revenue was justified in requiring a multistate company to apportion its advertising revenue based on an alternative to the legislatively mandated costs of performance apportionment method because the circumstances in the case had "unique quality" in that all of the costs of production occurred outside Tennessee.[26] We question how the provision of advertising services from outside Tennessee can constitute an unusual fact situation. Regrettably, the court did not provide any further explanation of its reasoning.

The Indiana Department of Revenue also asserted Section 18 in ruling that the licensing of broadcasting rights to cable and satellite companies presents a "limited and unusual situation" warranting the application of an alternative apportionment method.[27] Indiana's apportionment regulations require that a departure from the standard costs-of-performance apportionment method is authorized "only in *limited and unusual circumstances* (which ordinarily will be *unique and nonrecurring*) when the standard apportionment provision produces incongruous results."[28] The department did not explain why the licensing of broadcasting rights to cable and satellite companies for a fee is "unique" and "nonrecurring." Rather, the department simply concluded that its alternative apportionment method "effectuate[d] a result that more fairly represent[s] taxpayer's income derived from sources within the state."[29] Tennessee and Indiana

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exceptional.); *Donald M. Drake Co. v. Dep't of Revenue*, 500 P.2d 1041, 1044 (Or. 1972) ("the use of any method other than apportionment should be exceptional").

[22] *American Tel. & Tel. Co. v. Huddleston*, 880 S.W.2d 682, 691-2 (Tenn. App. 1994) ("the variance provision applies only in unusual and limited circumstances and is to be interpreted narrowly in order to carry out the purpose of uniform apportionment under the act."); *see also Roger Dean Enterprises v. State, Dep't of Revenue*, 387 So.2d 358 (Fla. 1980) ("There is a very strong presumption in favor of normal . . . apportionment and against the applicability of relief provisions. . . . The relief provision should be used where the statute reaches arbitrary and unreasonable results . . . Departures from the basic formula should be avoided except where reasonableness requires."); *Union Pacific Corp. v. Idaho State Tax Comm'n*, 139 Idaho 572, 576 (2004) ("There is a very strong presumption in favor of a normal three-factor apportionment and against the applicability of the relief provisions.").

[23] *See generally HMN Financial, Inc., and Affiliates v. Comm. of Revenue*, No. A09-1164 (Minn. 2010).

[24] *Allied-Signal, Inc. v. Dir., Div. of Taxation of New Jersey*, 504 U.S. 768, 779 (1992); *see also Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978) (upholding the constitutionality of a single-sales-factor apportionment formula); *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920) (upholding the validity of a single-property-factor apportionment formula).

[25] Jerome R. Hellerstein and Walter Hellerstein, 1 *State Taxation*, para. 9.20[3]. (3rd ed. rev. 2009).

[26] *Bellsouth Advertising & Publishing Corp. v. Chumley*, 2009 Tenn. App. LEXIS 576 (Tenn. Ct. App. 2009).

[27] Indiana Letter of Findings No. 04-0398, Indiana Dep't of Revenue (Sept. 1, 2006).

[28] 20 45 IAC 3.1-1-62. (Emphasis added.)

[29] *Id.*

provide just two of many examples in which states have run roughshod over the prerequisites to Section 18.[30]

Despite the sound policy objectives underlying the limited use of Section 18, the Proposed Amendments will dramatically allow administrators to broadly invoke Section 18 through regulation. The Proposed Amendments allow for adoption of industry-wide or issue-wide apportionment rules. While many states have adopted industry-wide apportionment, questions linger regarding the authority to issue these regulations on something other than a taxpayer-specific basis. By specifically authorizing states to enact industry-wide apportionment regulations, the amendments take Section 18 from apportionment of last resort to the norm for classes of taxpayers. The original drafters did not intend for Section 18's use in industry-wide instances.[31] We think industry-wide deviations from the norm are better addressed through the legislative process than though regulations. Industry-wide or issue-wide regulations should be used on only rare occasions and the Proposed Amendments should reflect that view.

If the MTC chooses to alter Section 18, we suggest they look at ways to also limit and restrict its application to be consistent with its intent. One common misuse of Section 18 by administrators is to apply it to an individual taxpayer to address a tax result that is widespread but viewed to be unfair. This is nothing more than an attempt to circumvent the legislative and regulatory process by altering the standard apportionment rules one taxpayer at a time. Because administrators have the ability to selectively invoke Section 18 and horse trade the adjustment for other audit issues, there is undoubtedly unequal application of the rules among taxpayers. To address this problem, a workable rule could prohibit widespread application of similar Section 18 adjustments.

Another possible repair to Section 18 is to clarify that it applies only to alternative apportionment and not alternative tax base calculation. In its current form, state tax administrators have applied Section 18 beyond its intended scope in applying the provision of subsection (4), which allows for "the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." State tax administrators and taxpayers, and consequently state courts, have used this provision to alter the state tax base. For example, in *Media General Communications, Inc. v. South Carolina Department of Revenue*, the Supreme Court of South Carolina allowed a taxpayer to apply alternative apportionment to switch to a method of combined reporting in apportioning its income.[32]

The MTC should also consider including clear language about who has the burden to prove the application of Section 18. Although it may seem obvious that the party invoking

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[30] *See Kan. Dep't of Revenue Office of Admin. App.*, Docket No. WFD-P2007-1 (Jan. 8, 2007); *Microsoft Corp. v. Franchise Tax Bd.*, 39 Cal. 4th 750 (Calif. 2006) (sale of investment securities by company's treasury function). Indiana Letter of Findings 01-0063, Indiana Dep't of Revenue (Oct. 1, 2002) and *In re Wal-Mart Stores, Inc.*, No. 06-07, New Mexico Taxation and Revenue Dep't (May 1, 2006) (licensing of trademarks by an intangible holding company to its parent).

[31] William J. Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 TAXES 747, 781 (1957).

[32] 694 S.E.2d 525 (S.C. 2010).

section 18 has the burden, states continue to argue that taxpayers have the burden in every instance.[33]

Section 18 should also prohibit the imposition of penalties in the event a state invokes alternative apportionment. There is perhaps nothing more inequitable in state taxation than the imposition of penalty on a taxpayer that reported income in accordance with the methods proscribed in a statute. Lastly, no state should be allowed to retroactively revoke Section 18 after it was granted to a taxpayer or invoked by a state.

IV. "Business Income" Definition

The definition and scope of apportionable business income (compared to allocable non-business income) lies at the heart of the Compact. Business income is considered by most states as having a transactional and functional test.[34] These tests are not clear or uniformly applied. A few states have expanded the definition of "business income" to be limited only by the U.S. Constitution.[35]

The MTC Uniformity Committee has proposed the following language to clarify the business income definition and promote uniformity across the states:

"Apportionable income" means:

(i) All income that is apportionable under the Constitution of the United States and is not allocated under the laws of this state, including:
   A. Income arising from transactions and activity in the regular course of the taxpayer's trade or business, and
   B. Income arising from tangible and intangible property if the acquisition, management, employment, development, or disposition of the property is or was related to the operation of the taxpayer's trade or business; and

(ii) Any income that would be allocable to this state under the Constitution of the United States, but that is apportioned rather than allocated pursuant to the laws of this state.

The proposal jettisons the term "business income" in favor of "apportionable income." In doing so, the definition is expanded to apportion all income that is apportionable under the U.S.

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[33] *Equifax, Inc., et. al. v. Miss. Dept. of Rev.*, Dkt. No. 2010-CA-01857-COA (Miss. App. Ct. May 1, 2012).

[34] *See, e.g., Hoechst Celanese Corporation v. Franchise Tax Board*, 25 Cal.4th 508 (Cal. 2001); *Gannet Satellite Information Network Inc. v. Montana Dept. of Rev.*, 348 Mont. 333 (2009); *Texaco-Cities Service Pipeline Co. v. McGaw*, 695 N.E. 2d 481 (Ill. 1998); *Polaroid Corp. v. Offerman*, 349 NC 290 (1998); *Willamette Industries, Inc. v. Oregon Dept. of Rev.*, 331 Or 311 (2000); *Kemppel v. Zaino*, 746 N.E. 2d 1073 (Ohio, 2001). On the other hand, some state courts have held that there is only a transactional test. *See, e.g., Uniroyal Tire Co. v. State Dept. of Fin.*, 779 So. 2d 227 (Ala. 2000); *Appeal of Chief Industries, Inc.*, 255 Kan. 640 (1994); *Phillips Petroleum Co. v. Iowa Dept. of Rev. and Fin.*, 511 N.W. 2d 608 (Iowa 1993); *Associated Partnership I, Inc. v. Huddleston*, 889 S.W. 2d 190 (Tenn. 1994).

[35] *See, e.g.*, 35 Ill. Comp. Stat. 5/1501(a)(1); Kan. Stat. Ann. § 79-3271(a); Minn. Stat. § 290.17 Subd.4.(a); N.C. Gen. Stat. § 105-130.4(a)(1); 72 Pa. Cons. Stat. § 7401(3)2.(a)(1)(A).

Constitution. Accordingly, the inquiry as to what constitutes apportionable income is limited only by the Due Process Clause and the Commerce Clause, which is primarily based on a unitary analysis that is highly factual, has been the subject of countless lawsuits and continues to evolve. Such a broad definition will certainly lead to an inconsistent interpretation across the states. In an attempt to provide some structure, the proposed language specifically enumerates the transactional and functional tests as tests that are *included in* the constitutional standard. However, such inclusion is little more than window dressing, as these tests will no longer serve as boundaries when apportioning income.

The Committee intends the "including" language to modernize the functional test in four ways:

- the list of activities under the functional test is expanded to include "employment" and "development."
- the functional test is now a disjunctive test by inclusion of the word "or" instead of "and," thereby clarifying that any one of the listed activities (e.g., …) can integrate property into the business.
- the use of the word "regular" is removed in modifying "trade or business."
- the requirement that the property constitute an "integral part" of the taxpayer's trade or business is relaxed to only require that the property be "related to the operation" of the business.

These revisions attempt to clarify statutory construction issues that courts have struggled with in interpreting the Compact's definition of business income Finally, the proposed language effectively terminates what is commonly referred to as the "cessation of business" exception from business income by (1) broadening the scope of apportionable income, and (2) specifically including the phrase "is *or was*" in defining the functional test. Under the current language, several courts have concluded that the liquidation accompanied by a cessation of business activity is an extraordinary and uncommon corporate event not typically occurring within the regular course of operations, thereby not satisfying the transactional test. [36] By broadening the standard to the reach the limits of what is permissible under the U.S. Constitution, gains from the liquidation of a unitary business may in fact be treated as apportionable income under the new standard.[37]

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[36] *See, e.g., Lenox, Inc. v. Tolson*, 353 NC 659, 548 S.E. 2d 513 (2001) (holding a consumer products manufacturer earned nonbusiness income from the liquidation sale of one of its operating divisions); *Blessing/White, Inc. v. Zehnder*, 329 Ill. App. 3d 714, 768 N.E. 2d 332 (1st. Dist. 2002) (holding that gain realized from complete liquidation of the capital assets of a corporation followed by a distribution of proceeds to shareholders constituted nonbusiness income under the functional test because the corporation did not use the proceeds to continue its business because it had no business to continue); *Kemppel v. Zaino*, 91 Ohio St. 3d 420, 746 N.E. 2d 1073 (2001) (holding that income arising out of the liquidation of assets followed by dissolution of the corporation was not business income under either the transactional or functional test because it was a one-time event that terminated the business); *Laurel Pipe Line Co. v. Pennsylvania*, 537 Pa. 205, 642 A. 2d 472 (1994) (holding that taxpayer's gain from the liquidation of pipeline assets that had been idle for three years, when the proceeds from the sale were not reinvested in the business, gave rise to nonbusiness income under the functional test).

[37] For example, after the decision in *Blessing/White, Inc., supra*, the Illinois legislature amended its definition of business income to all income that may be treated as apportionable business income under the U.S. Constitution, in order to overrule the decision and treat gain from the liquidation of a business as apportionable business income. *See* Ill. Dept. of Rev. Info. Bulletin No. FY 2005-11 (December 1, 2004).

V. Definition of "Sales"

The Compact currently defines "sales" for sales factor purposes as "all gross receipts of the taxpayer not allocated." The MTC Uniformity Committee has incorporated certain aspects of the Compact model regulations in proposing the following definition:

> "Receipts" means gross receipts of the taxpayer that are not allocated under paragraphs of this article, and that are received from transactions and activity in the regular course of the taxpayer's trade or business; except that receipts of a taxpayer other than a securities dealer from hedging transactions and from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities, shall be excluded.
>
> Proposed Compact Art. IV § 1(g).

The Uniformity Committee's purported policy reason for borrowing the transactional test from UDITPA's business income definition, and excluding hedging and treasury receipts from the sales factor, is based on the notion that the purpose of the sales factor is to reflect the taxpayer's market activity, not production activity.

This policy justification has several flaws. First, hedging functions are critical to many taxpayers' business operations. Hedging activity directly relates to some taxpayers' ability to establish and maintain a marketplace. As such, excluding these receipts altogether does not reflect taxpayers' sales. Second, excluding hedging and treasury receipts reflects a disconnect between factor representation and taxable business receipts. Taxpayers would be required to include in apportionable business income derived from hedging or treasury functions that take place in the regular course of a trade or business, but would not be allowed to reflect this activity in the sales factor. This in a systematic mismatch between taxing income and reflecting sales associated with that income in the apportionment factor. The mismatch of factor inclusion and tax base inclusion becomes even more acute when coupled with the expansion of separately proposed expansion the apportionable income. As the base expands to apportion uncommon transactions, the apportionment formula is narrowing to exclude the same transactions. This approach seems inequitable.

VI. Additional Issues

The genesis for this project was a survey of the MTC Member states where the states indicated their level of interest in revising the various parts of the Compact. Based on that survey, the five key issues were selected. Given the significant and historic nature of the changes considered in the Proposed Amendments, we suggest that the Hearing Officer consider whether other aspects of the Compact should be amended in order to either increase uniformity or to perhaps make other parts of the Compact consistent with aspects of the Proposed Amendments. An example of possible amendments is Section16, which governs the sourcing of sales of tangible personal property. There is little uniformity with respect to how states apply Section 16. For example, a number of states, some of which are Compact members, do not

impose the throwback rule because they do not like the policy behind throwback. The throwback rule should be reconsidered. Thought should be given to a way to craft a rule that would be more uniform. There is also inconsistency with how states apply the *Joyce* and *Finnigan* rules. Also, Section 16 sources sales of tangible personal property according to where the "purchaser" is located. Yet the changes to Section 17 will source receipts of "marketing intangibles" to the location of the "consumer" of the underlying "good." That rule implies "looking through" to the customer's customer. It seems inconsistent to source intangibles by looking through to the consumer of the tangible property, but to source the tangible property by looking only to the purchaser.

Almost all of the previous taxpayer input into this project focused on credible doubt that the states will achieve uniformity in how they apportion income. Taxpayer groups made compelling arguments on that issue, yet the Uniformity Committee drafted the Proposed Amendments in a way that presumes uniformity will be achieved. Given the unlikelihood of that occurring, we suggest that the Hearing Officer consider changes to the Proposed Amendments to reflect nonuniformity reality. One way that could be done is with "menu" items that allow states and/or perhaps taxpayers to choose a limited number of options. The Uniform Laws Commission provides options in several of the uniform acts, like the Uniform Electronic Signatures Act.

VII. Conclusion

For all the foregoing reasons, we ask that the MTC reconsider many aspects of the Proposed Amendments.