At its July 2008 meeting in Santa Fe, NM, the Subcommittee directed staff to survey its members on the policy questions raised during the meeting and to schedule a teleconference for the Subcommittee to discuss survey results and determine policy direction. The survey was sent on September 25, 2008. The results were compiled and sent to Subcommittee members on October 10, 2008. A Subcommittee teleconference was held October 22, 2008. At the teleconference, the Subcommittee discussed the survey results and gave direction to the drafting committee on each of the nine policy questions.

The drafting committee for the project to amend Regulation IV.18.(a) did not reach a final determination as to draft language for an amendment to the regulation but has instead decided to present a list of possibilities to the subcommittee for possible action on our next meeting scheduled for Tuesday, November 18, 2008.

Before presenting the proposals, we briefly summarize the results of the Subcommittee survey and the Subcommittee’s subsequent direction to the drafting committee. We also show how the Subcommittee direction was incorporated into the draft language set forth below.

A. Question 2: Should the regulation’s current restriction of Section 18 adjustment provisions to cases with “unusual” factual situations be clarified or eliminated? Twelve of 13 states in their survey responses agreed that the current regulation is too restrictive in limiting use of Section 18 to “unusual” factual situations. The Subcommittee directed the drafting committee to provide an alternative using the current regulation’s language as a starting point. Although states agreed that the current regulation was too restrictive, there was less consensus as to how to remedy that problem. All agreed that the phrase “unusual factual situations (which will ordinarily be unique and non-recurring)” must be modified. All of the proposals listed below accordingly eliminate the language in parentheses.
B. Question 3. Should the regulation’s provisions be amended to clarify that adjustment on a case-by-case basis may be made even where the factual situation giving rise to the distortion is common to an entire business sector or common activity, e.g., factoring accounts receivables or sales of short-term investments? Nine states responded yes to the survey, five responded no. The Subcommittee directed the drafting committee to make the suggested clarification. The first two proposals would eliminate any restrictions on the use of Section 18, even where the circumstances giving rise to distortion are common. Proposals 3 and 4 continue the current regulation’s restriction on using Section 18 to “limited and specific cases”, a phrase which is not defined. Proposal 5 goes further and requires a showing of “unusual” facts before Section 18 may be invoked.

C. Questions 4 & 5: Should the regulation be amended to specify that case-by-case adjustment may be made only in the case of gross distortions of business activity? Should the regulation be amended to specify that case-by-case adjustment may be made even where the distortion of business activity is only moderate? The Subcommittee did not reach a conclusion on the question of whether gross distortion should be required for Section 18 relief. However, the Subcommittee directed the drafting committee not to include a threshold distortion test set at moderate distortion, so the suggestions below do not contain any overt requirement for a showing of gross or moderate distortion.

D. Question 6: Is there a need to broaden the regulation to better enable Section 18’s use in countering tax planning techniques? The state survey results narrowly favored this approach (7 yes, 5 no). After discussion, the Subcommittee directed the drafting committee not to address this issue.

E. Question 7: Should the regulation be amended to specifically address possible distortion from sales throw-out and sales throw-back situations? Subcommittee survey results suggest the States were mostly opposed to this idea (11 no, 2 yes). After some discussion, however, the Subcommittee directed the drafting committee to draft language to make clear that Section 18 should not be used to address distortion caused by sales throw-back or throw-out because that provision of UDITPA was not intended as a means of better reflecting market activity in a state, but as a means of preventing “nowhere” income. A proposed clause to accomplish this direction is included below, but not incorporated into any of the five proposals.

F. Question 8: Should the regulation be amended to specify that the party seeking relief has the burden of proof to show that current formula does not fairly reflect business activity and that an alternative formula is better? Most states reported in the survey results (11 yes, 4 no) that burden of proof should be addressed in a regulation. The Subcommittee directed the drafting group to address this issue. Three possible versions of burden of proof standards are included below, but not incorporated into any of the five proposals. Most states reported that this issue
has already been addressed in case law and administrative practice, putting the burden of persuasion on the proponent of the use of Section 18. An additional question is whether: (a) “clear and convincing”; (b) “preponderance”; or (c) no evidentiary standard should be used. The proposed test from the 20th Century Fox case (C) adds the requirement that the proposed modification does not add to a lack of uniformity among the states. The phrase “the formula as a whole” was taken from several cases suggesting that a distortion in one factor might not trigger a finding of overall distortion if the other factors are fairly reflective of business activity.

G. Question 9: Should the regulation continue to impose restrictions on when and how Section 18 may be invoked? The wording of this question caused great confusion among responding states, since the current regulation does not include procedural limitations. After discussion and clarification, the Subcommittee did direct the drafting committee to draft language on how relief petitions and claims should be handled as a procedural matter. Some responsive language is suggested below.

**Current Model Regulation:**

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 factual situations (which ordinarily will be unique and non-recurring) produce incongruous results under the apportionment and allocation provisions contained in Article IV.

**Proposals for Amendment (Ranked from Least Restrictive to Most Restrictive):**

1. Article IV.18 permits a departure from the allocation and apportionment provisions of Article IV sections 4 through 17 where the extent of the taxpayer’s business activity within the state would not be fairly represented under the allocation and apportionment provisions of those sections. *This regulation merely re-states the statute’s requirements. It is essentially a form of “regulatory silence.”*

2. Article IV.18 permits a departure from the allocation and apportionment provisions of Article IV sections 4 through 17 where the extent of the taxpayer’s business activity within the state would not be fairly represented under the allocation and apportionment provisions of those sections due to the nature of the taxpayer’s business, operations or structure. *This proposed regulation would impose only the most general restrictions on using Section 18—it would allow use of Section 18 on a case-by-case basis even where the business or practice was not “unusual.”*

3. Article IV.18 permits a departure from the allocation and apportionment provisions of Article IV sections 4 through 17 only in limited and specific cases
where application of the allocation and apportionment provisions in those sections would not fairly represent the taxpayer’s business activity within the state because of the nature of its business, operations or structure. [This proposed regulation suggests that the taxpayer must have some unique qualities before Section 18 may be invoked, but is a lower standard than the current regulation.]

4. Article IV.18 permits a departure from the allocation and apportionment provisions of Article IV sections 4 though 17 only in limited and specific cases where application of the allocation and apportionment provisions in those sections produce incongruous results which would not fairly represent the taxpayer’s business activity within the state. [This proposed regulation implies that the taxpayer must have some unique qualities before Section 18 may be invoked, but is a lower standard than the current regulation; the use of the word “incongruous” may add a qualitative standard as well.]

5. Article IV.18 permits a departure from the allocation and apportionment provisions of Article IV sections 4 though 17 only in limited and specific cases where unusual factual situations produce incongruous results under the apportionment and allocation provisions contained in those sections. [This proposed regulation eliminates only the parenthetical phrase “(which ordinarily will be unique and non-recurring)” from the current regulation.]

Additional language regarding burden of proof:

A. The party seeking to vary the statutory apportionment formula must demonstrate by a preponderance of evidence that the apportionment formula [as a whole] [produces incongruous results which] do[es] not fairly represent the extent of the taxpayer’s business activity in the state.

B. The party seeking to vary the statutory apportionment formula must demonstrate by clear and convincing evidence that the apportionment formula [as a whole] [produces incongruous results which] do[es] not fairly represent the extent of the taxpayer’s business activity in the state.

C. The party seeking to vary the statutory formula must demonstrate [by clear and convincing evidence] 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.]

(Burden of Proof language in paragraph (C) taken from 20th Century Fox v. Dept. of Revenue (Oregon), 700 P.2d 1035 (1985).)

Procedural Language:
A. A taxpayer seeking to invoke the provisions of [Article IV, Sec. 18] must file a petition with the [Department] contemporaneously with the filing or an original or amended return, identifying the relief sought and the factual basis under which relief is sought, and must identify the differences in apportionment calculations should the relief be granted.

**Preservation of Throw-Back Language:**

Nothing in this regulation is intended to authorize departure from the rules for apportioning receipts from shipments of tangible personal property set forth in Article IV, Sec. 16(B).