CCH Expert Treatise Library: State Taxation of Income and Other Business Taxes, ¶9.01, Overview

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Every state with a corporate income tax or tax measured by income has a general apportionment formula applicable to most corporations. The apportionment formula may be based upon the three-factor UDITPA[1] formula or it may use only a sales factor. Every state with an apportionment formula also recognizes that the formula will not work for all taxpayers. In those cases, all states provide that an alternative apportionment methodology or allocation may be used. Many of the states that have adopted UDITPA and most of the other states have patterned their statutes after UDITPA. UDITPA has a specific provision, Section 18, which allows for variations from the standard provisions of the act. Even those states that have not adopted or patterned their statutes after UDITPA have a provision similar to Section 18 of UDITPA. The discussion is this chapter uses Section 18 as the focal point. Included in this discussion with be regulations that have been adopted by the Multistate Tax Commission to implement Section 18. The adoption of these regulations may be limited to states that are members of the Multistate Tax Compact.

The use of alternative apportionment methodologies may be provided for by statute or regulation or may be obtained through *ad hoc* variances. This chapter discusses

1. the general principles that apply in determining whether and when an alternative apportionment formula is appropriate,
2. the facts that should be considered in making that determination, and
3. the relief that will be allowed.

Footnotes

1 Uniform Division of Income for Tax Purposes Act drafted by the National Conference of Commissioners on Uniform State Laws, Adopted 1957.

CCH Expert Treatise Library: State Taxation of Income and Other Business Taxes, ¶9.02, Authority to Adjust

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¶9.02[A] Federal Arms' Length Adjustments

The Commissioner of Internal Revenue is authorized by statute to distribute, apportion or allocate[2] gross income, deductions, credits or allowances between or among commonly-controlled taxpayers if it is determined that it is necessary in order to prevent the evasion of taxes or clearly to reflect the income of the commonly-controlled entities.[3] There are lengthy federal regulations[4] that provide rules for the implementation of this method. This is almost always established by the use of separate accounting with the goal of adjusting transactions to conform to the way they would have been entered into by unrelated parties using arm's-length accounting.

The methods of establishing arm's-length accounting transactions are frequently costly and require the services of accountants, engineers, and others. The best evidence of an appropriate adjustment is generally thought to involve obtaining evidence of comparable transactions entered into between or among unrelated parties. Such evidence frequently does not exist or is required to be adjusted by subjective judgments to reflect differences between the "comparable" transaction and the one to be adjusted. There usually is no single answer to the questions involved. The best that can be expected is the establishment of a range of prices at which transactions would be undertaken.

¶9.02[B] States Adjustment of Apportionment Formulas and Allocations

¶9.02[B][1] Arm's-length Adjustments

All states grant the tax administrator authority similar to that provided to the Commissioner of Internal Revenue.[5] This authority may be provided directly by statute or by incorporation of the Internal Revenue Code. This authority does not speak directly to the division of income among states; instead it is directed to the assignment of income, deductions, credits, and allowances among entities. The grant of authority is so broad, however, that it could be used for purposes of making the geographic assignment of income. States, however, have not used this authority, because of the difficulties inherent in establishing arm's-length prices within a common market place, the administrative difficulties in making such adjustments, the costs involved in performing audits, and the uncertainty that is involved. The United States Supreme Court has set forth the reasons why the states have not resorted to arm's-length accounting and why it has not required them to do so.[6]

The problem with the arm's-length accounting method is that formal accounting is subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise.[7]

¶9.02[B][2] Adjustments to Allocation and Apportionment

The states are required under federal constitutional authorities to limit their taxation of income to that which can be attributed to activities within their boundaries.[8] This assignment of income is accomplished through the use of allocation and apportionment methods. All states have statutes that describe their methods of allocation and apportionment. The statutes are written in general terms for application to corporate businesses as a whole. General statutes necessarily cannot address all situations, so every state provides a statute that authorizes the use of alternative methods to the statutory methods of allocation or apportionment. These statutes are separate and distinct from the statutes that authorize the arm's-length adjustment of income and other items between or among commonly-controlled taxpayers.

¶9.02[C] Comparison of Federal and State Authority

In general, the federal government taxes all of the income earned by a corporation organized in the United States, including that earned by foreign branches. The federal government is not as concerned as the states with determining the geographic source of income, because it is not subject to the constraints of the Due Process Clause of the Fourteenth Amendment. The federal government is only concerned with determining the geographic source of a United States corporation for purposes of allowing foreign tax credits. With respect to foreign-organized entities, the federal government has statutory provisions that determine the geographic source of income.

To the extent the federal government in concerned with the geographic sourcing of income, it polices these transactions under arm's-length accounting principles. The authority for the use of arm's-length accounting is found in Internal Revenue Code Section 482. This section gives the Commissioner the authority to "distribute, apportion or allocate gross income, deductions, credits or allowances" between or among entities owned or controlled directly or indirectly by the same interests in order to prevent the evasion of taxes or clearly to reflect income. While Section 482 uses the words "apportion" and "allocate," the regulations under this section[8] do not apply those terms in the manner contemplated for state tax purposes.

State statutes that authorize the use of arm's-length accounting are patterned after the federal statute. As a consequence there are no material differences between the federal and state practices. States have made minimal use of the arm's-length adjustment authority because of its expense and uncertainty. Those states that have used it are generally those states that do not utilize combined reporting.[9] The success of states with the use of arm's-length accounting authority has been mixed.[9] Its most frequent use has been in the area of intangible holding companies. The difficulties involved have led some states, such as Alabama, to adopt add-back statutes which have their own set of problems.[10]

Meaningful differences do exist between the federal statute authorizing arm's-length accounting and state statutes that authorize adjustment under the state's allocation and apportionment provisions. Those differences are discussed below.

¶9.02[C][1] Who Can Invoke

The authority to make arm's-length adjustments resides with the tax administrator. A taxpayer cannot require an adjustment under the authority of the statute. This should not be surprising, because it is the taxpayer who sets up the original transaction and determines the price at which it will be consummated.

The statutes authorizing adjustment to allocation and apportionment rules generally provide the taxpayer with a right to request an adjustment and the tax administrator with the right to require an adjustment. It is a two-way street. The logic underlying this is the fact that the allocation and apportionment rules are general and therefore cannot necessarily address every individual situation.

¶9.02[C][2] Standard for Invoking

Use of the authority to adjust to an arm's-length standard is conditioned upon a showing that it is necessary in order to prevent evasion of tax or clearly to reflect income.

Variances from the standard rules of allocation and apportionment are typically conditioned upon the standard rules resulting in an unfair reflection of the taxpayer's activities in the state. They do not require a showing of evasion of tax or an unclear reflection of income. Again, the difference in standard is logically based. If a single entity is being reviewed, there will be no question as to what its income is; the question is how and where that income should be assigned.

¶9.02[C][3] Issues Addressed

Under the arm's-length standard, the issues addressed are evasion of tax and the inappropriate assignment of items among entities. It largely involves questions of determining net income and attributing it to a particular entity.

Under allocation and apportionment, the issues addressed are whether the activities of the taxpayer in the state are fairly reflected. It is a question of activities, not a question of income.

Footnotes

2 Even though the federal statute uses the terms "apportion" and "allocate" they are used in a different sense than they are used for State purposes. For federal purposes they relate mainly to entity assignment while for state purposes they relate to geographic assignment. For federal purposes all the income of an entity is generally taxable, regardless of its geographic source.

3 Section 482, Internal Revenue Code.

4 Reg. §1.482-0 et seq.

5 Sec. 482, Internal Revenue Code.

6 Container Corp. of America v. Franchise Tax Board., 463 U.S. 159 (1983).

7 *Id.*

8 See Chapter 4, Unitary Business Principle.

8 Reg. §1.482-0 et seq.

9 see ¶7.01 and following for a discussion of Combined Reporting.

9 E.g. The Sherwin-Williams Company v. Commissioner of Revenue, 438 Mass. 71, 778 N.E. 2d 504 (2002) and Syms Corporation v. Commissioner of Revenue, 436 Mass. 505, 765 N.E. 2d 758 (2002).

10 Surtees v. VFJ Ventures, Inc., 8 So.3d 950 (2008), a lengthy opinion discussing the issues involved in addback statutes and overturning the lower court's determination that the add-back statute was unconstitutional...

CCH Expert Treatise Library: State Taxation of Income and Other Business Taxes, ¶9.03, Section 18 of UDITPA

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UDITPA Section 18 provides:

> [I]f the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for, or the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> 4. Separate accounting;
> 5. The exclusion of any one or more factors;
> 6. The inclusion of one or more additional factors which would fairly represent the taxpayer's business activities in this state; or
> 7. The employment of any other method to effectuate an equitable apportionment of the taxpayer's income.

For discussion purposes, it will be assumed that all state provisions for variations in the apportionment and allocation rules apply the principles applicable to Section 18. To the extent there are material variations in the wording of an individual state's statute, the discussion herein should allow for a determination of the consequences arising from those differences.

¶9.03[A] Purpose of Section 18

Section 18 is based upon recognition of the fact that one size does not necessarily fit all. Businesses do not operate in a uniform manner and therefore their activities may not be identical even though directed to the same final result. Section 18 also recognizes that the economy and business forms evolve. A statute is necessarily written at a point in time and addresses current conditions and practices or those that are expected to exist in the future. A particular statute for the geographic assignment of income may reach acceptable results in most cases, but the result may be unfair in a particular circumstance. The unfairness may rise to the level of constitutional unfairness.

One of the drafters of UDITPA explained the purpose of this provision as follows:

> Section 18 is a general section which permits the tax administrator to require, or the taxpayer to petition, for some other method of allocating and apportioning the income where unreasonable results ensue from the operation of the other provisions of the act. This section necessarily must be used when the statute reaches arbitrary or unreasonable results so that its application could be attacked successfully on constitutional grounds. Furthermore, it gives both the tax collection agency and the taxpayer some latitude for showing that for the particular business activity, some more equitable method of allocation and apportionment could be achieved. Of course, departures from the basic formula should be avoided except where reasonableness requires. Nonetheless, some alternative must be available to handle the constitutional problem as well as the unusual cases, because no statutory pattern could ever resolve satisfactorily the problems for the multitude of taxpayers with individual business characteristics.[11]

¶9.03[B] Grounds for Relief

Section 18 specifically states that the reason for granting relief is "[I]f the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state." The test is not phrased in terms of whether the amount of income has been correctly or fairly assigned; instead, the focus is on activities and whether the standard rules fairly reflect those activities[12]

The question of unfair reflection is addressed to a taxpayer, not taxpayers generally. Consequently section 18 can be invoked solely with respect to a single taxpayer; it does not have to deal with industry or widespread situations. In the case of a separate entity state, "taxpayer" probably is entity specific. However, in the case of a combined reporting state, "taxpayer" can be read to encompass the entities conducting a unitary business.

¶9.03[B][1] Apportionment Rules

Apportionment refers to the assignment of income by formula. The income to be apportioned is what is defined as "business income" under UDITPA. The UDITPA apportionment formula is an equally-weighted three-factor formula of tangible property, payroll and sales. Variances in the apportionment rules could countenance the use of some other factor, the disregard of a particular factor, valuation of the elements of a factor, and numerator assignments of the factor elements. Section 18 has most frequently been used in questions of apportionment.

¶9.03[B][2] Allocation Rules

UDITPA provides a series of rules for the allocation of what it refers to as "nonbusiness income.[13] These rules generally assign nonbusiness income to a single state. Variations from these rules could encompass the division of the income among several states or assignment of the income to a different state than that provided by the statute. Section 18 has rarely, if ever been used in the case of nonbusiness income.

¶9.03[C] Issues Not Entitled to Relief under Section 18

¶9.03[C][1] Determination of Income

UDITPA addresses how income is to be geographically assigned, it does not address how income is determined. As such, whether income has been properly determined is not an issue that should be the subject of relief under Section 18.

In a California case involving a combined report for a unitary business with a Mexican parent company, the taxpayer sought relief under California's enactment of section 18 to redetermine the income of the unitary business because of the inflation of the Mexican peso with respect to the United States dollar. The Board of Equalization sustained the Franchise Tax Board's rejection of the taxpayer's request stating, "At the outset, we note that section 25137 is a part of UDITPA, which deals only with the allocation and apportionment of income, and not the determination of income itself. ... Accordingly, this Board has held that relief under section 25137 is not available to correct alleged distortion in the amount of income to be apportioned."[14]

¶9.03[C][2] Business\Nonbusiness Classification

It is not clear whether the question of classifying income as business income or nonbusiness income is a subject that can be considered under Section 18. The better view is that the classification of an item income as business or nonbusiness income is definitional in nature and therefore is not appropriately the subject of a petition. The issue presented with respect to classification is not one of assignment or reflection of activities, it is a question of classification and, thereafter, application of the rules of the statute.

¶9.03[C][3] Components of a Unitary Business

There is a split of authority on whether Section 18 allows for consideration of whether a combined report should be used and, if it is used, who should be included in the combined report. The majority of states would probably consider this question as appropriately raised under Section 18.

UDITPA does not define who the taxpayer is; rather, it provides the rules for the geographic assignment of the income of the taxpayer. UDITPA is silent with respect to the issue of combined reporting. As such, the better view is it should not be used to determine which entities are members of the unitary business. The question of which entities constitute a unitary business does not constitute a rule of allocation or apportionment.

There are a number of states, however, that have found UDITPA inferentially contemplates combined reporting.[15] California, which is the birth place of combined reporting,[16] adopted UDITPA through the statutory provision[17] that was used to authorize combined reporting as a means of perpetuating its unitary business authorities without raising questions of whether UDITPA supplanted those authorities.[18]

¶9.03[D] Requests for Relief

Section 18 by its terms provides that a taxpayer may request by petition a variance from the standard provisions of UDITPA. The language appears to contemplate some type of formal request being made by the taxpayer and either a grant or denial of the petition by the taxpayer. Very few, if any, states have set up a formal mechanism for filing a petition.

¶9.03[D][1] To Whom Addressed

By the terms of the statute, it is necessary to approach the tax administrator with a petition prior to submitting the issue to a third party adjudicator. If the tax administrator is supposed to rule upon the petition, it is inappropriate to deny that right or ability. A petition should not be presented for the first time before an adjudicatory body, because to do so denies the tax administrator the right to consider the petition.

¶9.03[D][2] Timing of Request

From an administrative perspective, it can be argued that the petition should be filed prior to taking a filing position on the return. This is necessary to prevent taxpayers from playing "audit roulette."[19] Audit roulette prevents a tax administrator from ensuring that uniformity of treatment is provided to all similar taxpayers. California has announced that position, and a taxpayer may be subject to penalty if it files in some manner other than what is provided by the standard provisions. Exceptions are provided by California if certain conditions are met. These conditions generally revolve around prior acceptance and consistency of filing position.[20]

There appears to be no reason why a petition cannot be filed in conjunction with protesting a proposed assessment by the tax agency or as a claim for refund. The tax administrator will have the opportunity to consider the petition. All of this assumes the statute of limitations is open. Attempting to raise a question of fair reflection after the statute has closed should be, and has been, rejected by some states.[21]

First raising a question of fair apportionment before an adjudicatory body should lead to its rejection for failure to exhaust administrative remedies. Arguably, the tax administrator has been divested of authority to consider the request, an authority that is vested in the administrator by the statute.

¶9.03[D][3] Contents of Request

A petition should set forth the reasons and present evidence or arguments why the standard provisions of the state's act do not fairly represent the activities of the taxpayer in the state. In addition, taxpayers normally set forth the relief they are requesting and why that relief would be reasonable. But it should be kept in mind that the relief to be given is in the discretion of the tax administrator.

¶9.03[E] Requirement of Relief

¶9.03[E][1] Timing

The tax administrator's requirement for alternative means of allocation and apportionment will typically arise after the fact of filing a return. It will only be after the initial filing of a return that the tax administrator will be in a position to make a judgment whether an alternative filing method should be required.

¶9.03[E][2] Determination

The tax administrator's determination is subject to review, and some burden must be overcome to show the need for an alternative method and that the result proposed is reasonable. All of this indicates that the tax administrator should be required to collect facts, hold a hearing of some type, and make findings of fact in support of the conclusion that an alternative is required.

¶9.03[F] Establishing Need for Relief

¶9.03[F][1] Constitutional

If an allocation or apportionment result is unconstitutional, then the result is invalid. As pointed out by Professor Pierce, the reporter[22] for the Uniform Law Commissioners for UDITPA, Section 18 was included in the act to allow for the use of alternative methods whenever an unconstitutional result is reached.[23] At least one state has at times taken the position that an unconstitutional result is required before Section 18 can be invoked.[24] This position is extreme and is counter to the language of the section 18. This position was supported by legislative enactment that subsequently was rescinded [25]

What constitutes an unconstitutional result is difficult to determine. It probably needs to be a result that shocks the conscience. There are two United States Supreme Court cases, one involving income tax and one involving property tax, that found a state's apportionment unconstitutional.

The income tax case is from the 1930's and involved an apportionment that involved the use of a single apportionment factor, property.[26] The court found that the single factor apportionment formula applied to a multistate business "operated unreasonably and arbitrarily, in attributing to North Carolina a percentage of income out of all appropriate proportion to the business transacted by the appellant in that state." The case is cited for the proposition that an apportionment that was more than 250% greater is unconstitutional. In this case, the 250% was calculated by reference to the taxpayer's offer of separate accounting evidence. To what results should be compared is unclear, but generally it is the difference between what a taxpayer wants and a tax commissioner wants.

In the property tax case, the Court was faced with a situation where one railroad had been acquired by another.[27] In the year prior to acquisition, the railroad property had been assessed at one value and in the year after acquisition the assessed value was increased by over 100% even though there were no assets added to the railroad. Under another metric, it could be argued that the distortion was roughly 260%. In any event the Court found that the result was grossly distortive.

In contrast there are several cases where the Court has examined apportionment results in the income tax area and found them not to be unconstitutional. In one case the Court considered the results of a state tax based upon a single-factor formula of sales and allowed the state tax to stand in spite of evidence presented by the taxpayer of the amount of income assigned to the other state.[28] In another case involving the constitutionality of world-wide combined reporting the Court found that an increase in the amount of income apportioned to the state of 14% was not unconstitutional.[29]

Not infrequently, efforts will be made to compare the results achieved under various methods of allocating income in an attempt to argue that the difference in the results meets a quantitative standard that establishes an unconstitutional result. The argument is that 250% was unconstitutional in *Hans Rees'* and 14% was not in *Container,* so obviously somewhere in between is a level of unconstitutional distortion. The problem with the approach is that it presupposes that there is some amount that is appropriate for determining whether there is an unconstitutional result.

It is clear that, from the Supreme Court's perspective, there is no such standard. Separate accounting cannot be used as the standard. The Court has repeatedly held that separate accounting results cannot be used to impeach a formula result.[30] In the alternative consider the situation where a taxpayer reports a loss in one state under separate accounting but has an overall profit. When the overall profit is apportioned, it results in income being assigned to the state even though there is a separate accounting loss.[31] The percentage change in that case is infinite but that does not make it unconstitutional.

¶9.03[F][2] Fair Reflection of Income

The standard in Section 18 is the unfair reflection of activity, not the unfair reflection of income.[32] In addition, separate accounting cannot be used to impeach the results reached under formula apportionment, so it cannot be used to show an unfair reflection of income. Comparing the results of different apportionment methods or separate accounting to an apportioned result should not be accepted as an offer of proof justifying the use of an alternative method.

Application of Section 18 is not justified simply because a proponent contends that its method is "better" than the standard formula. What must be shown is sufficient distortion that the taxpayer's business activity in the state is not clearly reflected. Mere allegations that the standard formula is not precise do not justify the use of Section 18.

¶9.03[F][3] Unfair Reflection of Activity

Section 18 focuses upon activity and whether the taxpayer's activities have been fairly reflected by the standard methods. By the statute, this must be the relevant evidence to consider. If the taxpayer does not have a particular factor anywhere, then it is unfair to consider that activity in the apportionment formula. Many states have specifically adopted this as a standard for eliminating the consideration of a factor. In the case of apportioning the income of financial corporations, most states construct an apportionment formula that takes into account loans, deposits, or some other type of intangible even though intangible property is not included in the standard UDITPA formula.[33]

¶9.03[F][4] Burden of Proof

Because Section 18 allows a variance to be either requested by the taxpayer or required by the tax administrator, there is a question of what is the burden of proof that must be met in order to qualify for a variance In the case of the taxpayer, the request for relief is made to the tax administrator, and the burden of proof question arises when the administrator denies the request and the taxpayer challenges that denial. In the case of the tax administrator requiring the use of an alternative method, the burden of proof question arises when the taxpayer questions the administrator's requirement.

There is general acceptance of the fact that the burden of proof lies on the party seeking the variance.[34]

¶9.03[F][5] Who Reviews

In most states, review of action on a petition or request for a variance will be made by the adjudicatory body for tax disputes. In California, the Franchise Tax Board had adopted a regulation that provides for a hearing before the Board itself if the taxpayer and the department's staff do not agree on the disposition of a petition or objection to a requirement for a variance. The taxpayer receives a hearing before the three-member Board. Hearings are in open session, and therefore are subject to the requirement of the waiver of confidentiality. The materials presented to the Board and transcripts of the Board meeting are available. These items are not viewed as providing precedential authority.

¶9.03[F][6] Standard of Review

There is a lack of agreement as to what the standard of review might be. In a California Supreme Court case, it was held that the standard was "clear and convincing proof."[35] Other states have not imposed a clear-and-convincing standard. The standard most frequently used is "clear and cogent."[36]

Most states take the position that the burden is equivalent regardless of who is seeking the variance. However, at least one state appears to have phrased the burden of proof differently for the taxpayer and the tax administrator, with the administrator having a lesser burden.[37]

¶9.03[G] Determination of Relief to be Granted

¶9.03[G][1] Who Determines

The California courts in pre-UDITPA cases held that the "[D]iscretion as to the factors to be used was placed in the commissioner and his successor, the Franchise Tax Board."[38] UDITPA did not change this rule. Section 18 provides that a taxpayer may petition the administrator or the administrator may require the use of an alternative method. By the plain terms of the statute, the tax administrator is the party making the initial determination as to whether there is an unfair reflection. That determination is subject to review, and the party seeking the change bears the burden of showing that there is an unfair reflection.

¶9.03[G][2] Method of Relief

¶9.03[G][2][a] Statutory Provisions

UDITPA by its terms sets forth four types of relief:

(1) separate accounting;

(2) the exclusion of any one or more factors;

(3) the inclusion of one or more additional factors that would fairly represent the taxpayer's business activities in the state; and

(4) the employment of any other method to effectuate an equitable apportionment of the taxpayer's income.

The fourth method in particular is all inclusive.

¶9.03[G][2][b] Limitations on Statutory Provisions

The first alternative listed is separate accounting. Clearly separate accounting can apply in the case of allocation, which under UDITPA is only used statutorily in the context of nonbusiness income.

Whether separate accounting can apply to situations involving apportionment in less certain. States that do not allow combined reporting already are committed to separate entity accounting but not necessarily to geographic separate accounting. Therefore separate accounting could apply even though a separate entity is conducting a unitary business within and without the state. By the same reasoning, separate accounting could be applied in combined reporting states, at least to make a geographic separation of income, if not also an entity separation of income. However, for states such as California that have adopted combined reporting as the result of court decisions, it is unlikely that separate accounting could be used for a unitary business. In both California and Illinois, taxpayers successfully brought actions that required the state to use combined reporting for their unitary business.[39] The taxpayers' position was not founded on Section 18, however. Rather it was founded on what might be characterized as an "equal protection" argument. Combined reporting filing was required by the tax administrator when a unitary business exists so a taxpayer should equally be able to require it. The administrator's requirement was not based upon a showing of failure to clearly reflect income or fair apportionment but rather on the existence of certain factual relationships. Taxpayers should be able to rely on the same factual circumstances to justify a combined report.

The second and third alternatives, exclusion of a factor or inclusion of a factor, are by their terms limited to questions of apportionment. They do not apply to nonbusiness income situations. The fact that these two alternatives can not apply to issues of allocation may lend some support to limiting separate accounting to issues of allocation.

The fourth alternative is any other method, a description without limitations, other than those included in the language “to effectuate an equitable allocation and apportionment of income."

¶9.03[G][2][c] Nature of Relief

By the terms of the statute, the relief needs to be reasonable. There is no requirement that it be the best possible relief or that it must be the relief sought by a taxpayer petitioning for relief.[40]

One state court has held that an alternative method is "reasonable" only if the division of income under that system:

(1) fairly represents business activity and would, if applied uniformly in all states, tax 100 percent of the taxpayer's income;

(2) does not create or foster lack of uniformity among UDITPA jurisdictions; and

(3) reflects the economic reality of the business activity engaged in by the taxpayer in the state.[41]

¶9.03[G][2][d] Burden of Proof

It is the tax administrator that has the power to make the determination of the relief to be granted; therefore, it is the taxpayer that bears the burden of showing that the relief granted or required is unreasonable.

¶9.03[G][2][e] Who Reviews

The reviewing body will be the administrative or judicial tribunal that has that right of review on tax matters pursuant to the statutes of the state.

¶9.03[G][2][f] Standard of Review

The statute provides that the variance must be "reasonable." This means that there is no requirement that the best relief be granted or used. Nor is there a requirement that the relief the taxpayer requests should be used. Because the requirement of the statute is that the variance must be reasonable, the standard of review is whether there is an abuse of discretion by the administrator.

The relief given obviously is reviewed by a third party, but it is reviewed on the basis of whether it is reasonable. "[D]iscretion as to the factors to be used was placed in the commissioner and his successor, the Franchise Tax Board."[42] The choice of the tax administrator should be accepted as long as it is reasonable.[43]

The California Supreme Court appears to have given conflicting statements in as to the nature of review of the alternative. In *Microsoft*, the court first held that what was reasonable was subject to review under the clear and convincing evidence standard but later stated, “If the Board's proposal is reasonable, we are not empowered to substitute our own formula."[44] The first statement was made with respect to both the initial question of unfair reflection and reasonableness. The second statement was made only with respect to reasonableness and is the correct standard that should be applied to that question.

Footnotes

11 Pierce, “The Uniform Division of Income for State Tax Purposes,” Taxes, Oct. 1957, 747, 781.

12 Amoco Production Company, Formerly Pan American Petroleum Corporation v. Armold, 213 Kan. 636, 518 P.2d 453 (1974).

13 Sections 5-8, UDITPA

14 Appeal of Crisa Corporation, California State Board of Equalization, 2002-SBE-004, June 20, 2002; rehearing denied, Appeal of Crisa Corporation, California State Board of Equalization, 2002-SBE-004-A, December 19, 2002.

15 E.g. Media General, Inc. v. South Carolina Department of Revenue, 388 S.C. 138, 694 S.E. 2d 525 (2010); Collins v. American Telephone & Telegraph Co., 219 Ga. App. 196 (1995); Donovan Construction Company v. Michigan Department of Treasury, 126 Mich. App. 11, 337 N.W. 2d 297 (1983).

16 Keesling, "A Current Look at the Combined Report and Uniformity in Allocation Practices," J. Tax'n, Feb. 1975, p. 106.

17 Edison California Stores v. McColgan, 30 Cal 2d 472 at 480, 183 P.2d 16 (1947).

18 Cal. Rev. & Tax Code Section 25101.

19 "Audit Roulette" refers to taking a chance that the tax administrator will not have the resources to audit the return. With large taxpayers the chance of this happening is slight.

20 FTB Notice 2004-5, California Franchise Tax Board, August 6, 2004.

21 Montauk Improvement. Inc. v. Procaccion, 50 A.D. 2d 449, 377 N.Y.S. 759 (1976).

22 The reporter is typically an academic who is retained by the Uniform Law Commissioners to do the actual drafting of Uniform Acts and frequently provides supplemental material which explicates the provisions of the Act, the alternatives considered and the reason for the choices made.

23 *See* footnote 1 *supra*.

24 OAR 150-314.280-(M) (1987) provided, in part:

> "If the allocation and apportionment provisions of OAR 150-314.280-(A) to 150-314.280-(L) do not fairly represent the extent of the taxpayer's business activity in this state and result in the violation of the taxpayer's rights under the Constitution of this state or of the United States, the taxpayer may petition for and the department may permit, or the department may require, an alternative method of apportionment and the department may approve that method of apportioning all or any part of the net income from the taxpayer's business activity within Oregon." The regulation was subsequently amended to remove the italicized language.

25 ORS 314.670(1) Oregon Stats 1999 c. 143 Section 9

26 Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell 283 U.S. 123 (1931).

27 Norfolk & Western R. Co. v. State Tax Comm'n, 390 U.S. 317 (1968).

28 Moorman Manufacturing Co. v. Bair, 98 Sup. Ct. 2340 (1978).

29 Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983).

30 Butler Bros v. McColgan, 315 U.S. 501 (1942); Exxon Corp v. Wisconsin Dep't of Revenue, 447 U.S. 207 (1980); and Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983).

31 *E.g.*, Edison California Stores v. McColgan, 183 P.2d 16 (Cal. 1947).

32 Amoco Production Company, Formerly Pan American Petroleum Corporation v. Armold, 213 Kan. 636, 518 P.2d 453 (1974).

33 It should also be noted that UDITPA as adopted by the Commissioners on Uniform State Laws specifically exclude financials from the apportionment process.

34 Colgate-Palmolive Co. v. Franchise Tax Board, 10 Cal. App. 4th 1768(1992).

35 Microsoft Corporation v. Franchise Tax Board 39 Cal.4th 750 at 765 (2006).

36 Union Pacific Corporation v. Idaho State Tax Commission 83 P.3d 116, 119-120 (2004); Kmart Properties, Inc. v. Taxation and Revenue Department (2001) 139 N.M. 177, 131 P.3d 27, 41; R.H.Macy & Co. v. Lindley 495 N.E.2d 948, 950 (1986); and American Telephone and Telegraph Company v. Tennessee 880 S.W.2d 682, 691-92 (1994).

37 In Tennessee, the courts have held that "a taxpayer seeking to deviate from the standard apportionment formula bears the burden by clear and cogent evidence." Peterson Mfg. Co. v. State, (1989) 779 S.W.2d 784, 787, but that the question to be answered when the Commissioner invokes the relief provision is whether it "amounts to an abuse of discretion." Sherwin-Williams Co. v. Johnson, (1998) 989 S.W. 2d 710, 715.

38 McDonnell Douglas Corp. v. Franchise Tax Board, 69 Cal 2nd 506, 68 Cal Rptr. 494 (1968).

39 Superior Oil Company v. Franchise Tax Bd. 60 Cal. 2d 406 (1963), Honolulu Oil Corp. v. Franchise Tax Bd. 60 Cal. 2d 417 (1963), and Caterpillar Tractor Co. v. Lenckos, 417 N.E. 2d 1343 (1981).

40 Microsoft Corporation v. Franchise Tax Board, San Francisco Superior Court, Docket CGC 08-471260, February 17, 2011.

41 Twentieth Century-Fox Film Corporation v. Department of Revenue, 299 Or. 220, 700 P.2d 1035 (1985).

42 Chase Brass & Copper Co. v. Franchise Tax Board, (1977) 70 Cal.App.3d 457, at 468, citing Montgomery Ward & Co. v. Franchise Tax Board, 6 Cal.App.3d 149, at 155. RKO Teleradio Pictures, Inc. v. Franchise Tax Board, 246 Cal.App.2d 812.

43 Microsoft Corporation v. Franchise Tax Board 39 Cal.4th 750 (2006).

44 *Id.* at 765 and then at 771.

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One issue that frequently arises in petitions under section 18 is the question of what evidence can be used to establish that the standard result is unfair. Reference is made to case law for the proposition that separate accounting cannot be used to impeach formulary results.[45]

In determining the type of evidence that can be presented to justify the use of an alternative apportionment method or a different allocation, courts have suggested that it may be helpful to break evidence into two types: qualitative and quantitative. The term "qualitative" suggests evidence that is subjective in nature. The term "quantitative" suggests that the evidence can be reduced to mathematical numbers, which assumes that comparisons can be made that are measurable. Qualitative evidence obviously is comparative in nature, but also, it is evidence that simply cannot be broken down to a mathematical preciseness.

¶9.04[A] Separate Accounting

The standard in Section 18 is the unfair reflection of activity, not the unfair reflection of income.[46] In addition, separate accounting cannot be used to impeach the results reached under formula apportionment, so it cannot be used to show an unfair reflection of income. Comparing the results of different apportionment methods or separate accounting to an apportioned result should not be acceptable as an offer of proof justifying the use of an alternative method. It will, however, be presented in every case because it will show the difference in the results.

¶9.04[B] Qualitative and Quantitative

In a California case[47] involving the short-term investment of liquid assets, the California Supreme Court looked at various types of relationships to determine whether the sales of the securities should be included in the apportionment formula. It categorized the various items it looked as either qualitative or quantitative. As a result of that decision, the California courts have adopted those terms in evaluating requests for relief from the standard apportionment formula.

In *Microsoft,* the court referred to its comparisons as being both qualitative and quantitative. In a subsequent case, the court interpreted this as mean there are two separate tests that must be satisfied.[48]

¶9.04[B][1] Qualitative

Qualitative evidence looks to the nature of the activities involved. The significance of a particular activity to any individual business will vary.

One of the issues that illustrate qualitative differences has been litigated in many states. Almost all large businesses have a significant amount of working capital that is used to pay day-to-day bills. If the business is on sound footing, it typically will have money available to pay bills prior to the time it is needed. The amounts can be significant, in the billions of dollars. To allow the money to sit idle in a bank account paying no interest makes no sense. As a consequence, the corporate treasury department will either manage such funds directly or will hire an outside party to manage the funds. The funds are invested in highly liquid, low-risk securities so funds can be immediately available to pay bills. The investment of working capital is not the business of the taxpayer, so the activity is not qualitatively significant to the business but nonetheless it makes no sense to let the assets lay fallow. However, if the business of the taxpayer is to buy and sell securities, then such trading activity is qualitatively significant to the business, it is what the business is about.[49] For corporations not involved in the securities business, the sales of securities should not be reflected in the apportionment formula; they are not qualitatively significant. For a corporation that is in the business of selling securities, such sales should be reflected in the apportionment formula because such sales are qualitatively significant to that business.

Another case illustrating a qualitative difference arose in Idaho.[50] The taxpayer in that case had receivables generated from its business. The receivables were typically payable in 30 to 60 days. The taxpayer sold the receivable to a third party. The taxpayer included the sales from its principal business operations in the sales factor and also sought to include the receipts from the sale of its receivables in the sales factor. In effect, the taxpayer was seeking to have the same sales included in the denominator of the sales factor twice. It assigned the sales arising from its business of providing transportation services under the rules of UDITPA and then attempted to assign the sales of the receivables from the transportation activity to its state of commercial domicile, thereby reducing the sales factor in Idaho by roughly one-half. The court's analysis did not refer to the evidence of double counting the same sale as qualitative, but that is how the California court would have characterized what the taxpayer was attempting.

¶9.04[B][2] Quantitative

Quantitative comparisons involve mathematical comparisons. A variety of comparisons can be made, depending on the circumstances and activity involved in requesting the variance. Consideration of requests for relief by the tax administrator in cases involving whether gross receipts from investing and trading working capital in short-term securities include:

8. the number of employees engaged in the activity as compared to the number of employees in the general business;
9. the percentage of the taxpayer's business activity that would be attributed to the particular item; and
10. the rate of return on a particular activity as compared to the general rate of return on the other activity reflected in the factor.[51]

In *Pacific Telephone,* the number of employees was a few (34) compared to many (millions). The amount of income apportioned by the treasury activity in *Pacific Telephone* was about 11.33%; in *Microsoft* it was approximately 28%; and in *The Limited* it was assumed by the court to be 9.25%.[52] The rates of return were more extreme. In *Microsoft* the rate of return on the Treasury activity was 0.2% as compared to rate of return of 31% on the sale of software and operating systems.

¶9.04[B][3] Evaluation of Qualitative and Quantitative

The better view is that the quantitative comparisons made by the *Microsoft* court were illustrative of the qualitative differences in the activities involved. As the court itself said, “Rather the analysis [comparison of income and receipts from short-term investments to general business] simply underscores the qualitative recognition that the different nature of short-term investments means that mixing short-term gross receipts with gross receipts from other types of business activity involves an apples-to-oranges comparison that may require correction."[53]

The California State Board of Equalization has provided appropriate insight into the role of qualitative and quantitative comparisons.[54]

> "We acknowledge that, in some cases ..., quantitative comparisons based upon separate geographical accounting were discussed in the context of attempting to impeach the standard apportionment formula. Unfortunately, a discussion of percentage comparisons in distortion cases is often wrongly interpreted as having a greater significance than it actually had and acts as a distraction from the primary task of determining whether the standard apportionment formula fairly represents the extent of the taxpayer's business activity in California."
>
> ***
>
> "The central question under section 25137 is not whether some quantitative comparison has produced a large-enough "distortive" figure. Rather, the question is whether there is an unusual fact situation that leads to an unfair reflection of business activity under the standard apportionment formula. [Citation omitted.] The answer to this question lies in an analysis of the relationship between the structure and function of the standard apportionment formula and the circumstances of a particular taxpayer. If the analysis reveals some manner in which the standard formula does not adequately deal with the taxpayer's circumstances, then Section 25137 may apply. Section 25137 must be analyzed on a case-by-case basis; there is no bright line rule that determines when the standard formula does not adequately deal with a particular situation."

¶9.04[B][4] Amount of Difference Between Alternatives

The apportionment of income is only expected to roughly approximate where income is earned. Because rough approximation is the standard, precision is unnecessary[55] and in any event, impossible.[56] This allows arguments to be made that no adjustment should be made unless it is significant. This may be an appropriate rule where the variation has been made as an *ad hoc* variation, but it should have no application when the variation from the standard formula is provided for by statute or regulation. Variation from a method of apportionment required by a statute or regulation should require a showing that the result obtained pursuant to the statute or regulation results in an unfair reflection of the taxpayer's activities in the state.

There are no cases that have articulated a standard for what is or is not sufficient. The California State Board of Equalization held in a letter decision that no variation should be made where the change in apportionment percentage was roughly three percent, even though the tax assessment at issue was approximately $1 million.[57]

Footnotes

45 *E.g.,* Butler Brothers v. McColgan (1941) 17 Cal.2d 664, 678, 111 P.2d 334, 341, aff'd, 315 U.S. 501 (1942); Container Corporation of America v. Franchise Tax Board 463 U.S. 159 (1983).

46 Amoco Production Company, Formerly Pan American Petroleum Corporation v. Armold, 213 Kan. 636, 518 P.2d 453 (1974).

47 Microsoft Corporation v. Franchise Tax Board 39 Cal.4th 750 (2006).

48 The Limited Stores, Inc. v. Franchise Tax Board, 152 Cal App 4th 1491, 62 Cal Rptr. 3d 191 (2007).

49 See Appeal of Merrill, Lynch, Pierce, Fenner & Smith, California State Board of Equalization, 89-SBE-017, June 2, 1989, for recognition of this distinction between a securities dealer and the investments of a corporate treasury department.

50 Union Pacific Corporation v. State Tax Commission, 83 P.3d 116 (2004 Idaho).

51 Appeals of Pacific Telephone and Telegraph Company, California State Board of Equalization, 78-SBE-028, May 4, 1978; Microsoft Corporation v. Franchise Tax Board, 39 Cal.4th 750 (2006); and, The Limited v. Franchise Tax Board, 152 Cal App 4th 1491 (2007).

52 An issue not reached by the court was what amounts should be treated as sales. The court assumed that the smallest amount should be sales so the percentage involved was the smallest.

53 Microsoft Corporation v. Franchise Tax Board, 39 Cal.4th 750 at 769 (2006).

54 Appeal of Crisa Corporation, California State Board of Equalization, 2002-SBE-004, June 20, 2002.

55 International Harvester Co. v. Evatt, 329 U.S. 416 (1947).

56 Container Corporation of America v. Franchise Tax Board, 463 U.S. 159 (1983).

57 Letter Decision, Appeal of Home Depot, Inc., California State Board of Equalization, No. 298693, December 18, 2008. This decision is not precedential.

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Each petition or requirement to use something other than the standard provisions for the allocation and apportionment of income is to a large extent unique. If it were commonplace, it should be expected that the standard formula would work appropriately. There are a variety of items that should be considered in determining whether a variation from the standard rules of allocation and apportionment should be allowed.

¶9.05[A] UDITPA and the Environment It Reflects

One thing that should be kept in mind is that UDITPA was written over 50 years ago. Businesses function in a different manner and in ways that were not contemplated in the 1950's. What was common now may not have been common in the 1950's. In addition, in should be kept in mind that UDITPA broke new ground in several areas. First, it endorsed the use of a sales factor, which was intended both to reflect the market and to balance the traditional economic view that income was solely the product of invested capital and labor. Second, it embraced California authorities that made significant amounts of income, dividends, interest, capital gains, royalties, etc., apportionable where they previously had been treated by most states as allocable to a single location, typically the commercial domicile of the taxpayer. Because of this, the rules applicable to the assignment of these items to a location were not fully developed and had not had the benefit of the test of time. The regulations promulgated by the Multistate Tax Commission have not addressed the geographic allocation of these receipts to the sales factor except for the exclusion of amounts which have no income producing activity related to them.

¶9.05[B] Taxpayer's Activities

One of the first things to consider in determining whether there is an unfair reflection of the activities of the taxpayer is to determine what the principal activities of the taxpayer are4. Those activities that are necessary probably should be included in the apportionment formula in some manner. If the activity is ancillary or supportive to the business, it may well be included in the apportionment factors but it should not be a dominant element in the apportionment process.

¶9.05[C] Significance of Activities

In determining whether a particular activity has been properly reflected in the apportionment formula, there is a need to evaluate that activity in terms of the business of the taxpayer.

The cases involving investing\trading in short-term securities are a text book illustration of this principle. A company has a main line of business. Microsoft is a provider of software of computer operating systems; Merrill Lynch is a stock broker. In the case of Microsoft, it is unreasonable to attribute through apportionment over 25% of its income to the trading of securities. In the case of Merrill Lynch, it is perfectly reasonable to attribute approximately 33% of its income to the trading of securities.[58] In the case of Microsoft, its "business" is not trading securities, and in the case of Merrill Lynch, it is.[59]

Where that line is to be drawn depends on the unique facts of each case. There can be circumstances in which the income from investing working capital generates the only net income for a taxpayer. In that circumstance, it may be difficult to justify removing the receipts from such activity from the sales factor for that particular year. But it is better to view this from a broader perspective. A taxpayer that is making income only from investing working capital is unlikely to survive.

¶9.05[D] Role of the Apportionment Factors

In determining whether there has been a fair reflection of income, consideration should be given to the role of the individual apportionment factors. The property factor and the payroll factor reflect elements of production, but the sales factor reflects the market. The sales factor is intended to balance the other two elements. In considering the need to modify any individual factor, it is necessary to consider what that factor is intended to reflect. In considering the overall result of an apportionment, consideration should be given to whether the balance inherent in the formula factors is being achieved.

¶9.05[E] Activities Otherwise Reflected in the Factors

In some circumstances, it may appear that an important element of the business is not represented in the factors and that, therefore, an adjustment is necessary. It may be, however, that the activity is fairly reflected in the other apportionment factors.

An example of this is intangible property. The UDITPA formula does not include intangible property in the property factor or have a separate apportionment factor for it. In the case of companies whose principal asset is their intangibles, an argument can be made that the failure to include the principal asset of the company in the apportionment formula does not fairly reflect the company's activities.

Upon reflection, however, this may not be the case, because the intangibles are otherwise reflected in the factors. What creates intangibles? Typically it is the labor of the employees of the company. That activity is already reflected in the payroll factor. It can be argued that payroll is temporally limited to a single year, while property is capitalized and continues on in the factor at its original cost, and therefore the payroll factor does not give adequate recognition to the continuing value of the intangibles. But a company that is doing research and development typically continues to do so, and that activity is localized in specific geographic areas that do not change quickly. As a result, the payroll factor devoted to developing and maintaining intangibles will normally not change dramatically year to year.

In addition, under UDITPA, property is assigned to the place where it is used. Where are intangibles used? If the intangible is a patent or something of that nature, it will be used where it is employed by the taxpayer, typically this will be where a plant is located. If the intangible is licensed to a third party or it is an intangible that adheres to a product wherever that product is used, then these values may be reflected in a property factor based upon where the receipts arise from the use of the intangible. It should be noted that the UDITPA rules for the assignment of sales of other than tangible property assign the sales based upon where the greatest portion of the income producing activity occurs. Under UDITPA the rules for the assignment for property factor purposes, however, is different than the rule for the assignment of sales therefore there is no reason the sales factor assignment rules should control for the assignment of property.

¶9.05[F] Treatment by Other States

Two of the fundamental principles of UDITPA are that (1) no income should be assigned to more than one state and (2) no income should escape taxation. The first principal is the goal of uniformity. If every state applied the same rules, no state would include in the numerator of an apportionment factor an item that was included in the numerator of that factor by another state. The second principal is shown by the creation of the throwback rule[60] and the inclusion of rules for determining taxability in a state.[61] It should be noted that the UDITPA rule of taxability is not premised upon actual taxation, but upon the ability to assert a tax.

These are principles that should be considered in determining the appropriateness of giving relief from the standard methods of allocation and apportionment.

¶9.05[F][1] Home State of Industry

There are some industries that are principally conducted in, or at least historically associated with, a particular state. As such, there is a reasonable presumption that that state has peculiar knowledge of the industry and how it should be taxed. Therefore, other states can look to the treatment of the "home" state to determine what formula would fairly reflect the activities of members of that industry. Conforming to the "home" state's treatment will promote uniformity and full accountability and avoid double taxation.

For example, California was the principal state in which the motion picture industry first did business. California developed a special formula for apportioning the income of the motion picture industry in the 1950's. It is now reflected in a regulation[62] Oregon successfully applied the California formula to apportion the income of a member of the industry.[63]

Similarly, New York is the location of Wall Street and historically where most securities trading occurred. The special formula used by New York should be a model for other states and is, at the very least, evidence that the standard UDITPA provisions do not work in every case.

¶9.05[F][2] Multiple Taxation

Because one of the goals of UDITPA is to avoid multiple taxation, it can be relevant to look at how the taxpayer is apportioning income to other states. Initially, it must be recognized that states can, and frequently do, have different rules for the apportionment of income. In such cases, multiple taxation may be a possibility that may not need adjustment. Who would determine which state's approach is correct or better? But in many circumstances the statutes and interpretations are the same. In that circumstance, the fact that multiple taxation is actually occurring suggests the need for examination.[64]

If there is actual multiple taxation, this may be evidence of a need for variance. Conversely, the absence of multiple taxation may suggest the standard method is working appropriately.

¶9.05[F][3] No taxation

A rule, whether it is the standard rule or a variance, should be looked at to determine whether application of the rule would allow some portion of the income of the taxpayer to escape any state's tax in the sense that it would be assigned someplace that does not have jurisdiction to tax the income. A standard rule or a request for an alternative method of apportionment that would result in the income being assigned to someplace where it could not be taxed is unlikely to reach a fair result, at least in the context of one of the guiding principles of UDITPA..

¶9.05[G] Historic Treatment

A fact to be considered is how the taxpayer or the state has treated the question in the past. Requests for relief or a requirement for use of an alternative method are frequently made after returns are filed. It can be argued that the method of filing, or acceptance of that method, provides some support for the assertion that the filing method did not reach an unreasonable result. It can even be argued that this is an admission against interest. This should not be treated as determinative, but it is an item worth considering. Factors that should be weighted in evaluating this are

11. how significant it was for the taxpayer and
12. whether something has occurred, such as a new decision or change in statute or regulation, that has caused light to be cast upon the issue.

¶9.05[H] Analogous Situations

Sometimes there will be a prior consideration of an issue, similar to that raised in a request for a variance that has already been addressed. To the extent the two situations can be analogized, it may provide guidance as to how to deal with the current situation.

In a suit brought by Microsoft, it sought inclusion of its intangible property in the apportionment formula.[65] One of the questions that existed was, if the intangible property were to be included, where would it be assigned? The tax administrator argued that the formula it had adopted for the motion picture industry[66] provided an appropriate model. Motion pictures are similar to computer programs, in that the original, or master, of the film resides in one place. In the case of films, the copies are shown in theaters. In the case of computer software, the copies are sent to other locations to be copied and installed on individual computers. Title is retained by the developer, but the licensee is free to copy. Under the California motion picture regulation, the value of the film is assigned proportionally to a location based upon the receipts generated by exhibition of the film. If the trial court had determined that it was necessary to include Microsoft's intangible property in the apportionment formula, it indicated that it would make an assignment of value based upon the receipts generated by the intangible.

Footnotes

58 Both cases assume the use of an equally weighted three-factor formula with sales as one of the components.

59 For a discussion of this issue see McLure, Charles "How Should the UDITPA Sales Factor Treat Receipts From Transactions Involving Financial Instruments?, Part 1," 51 State Tax Notes 491 (Feb 16, 2009) and "How Should the UDITPA Sales Factor Treat Receipts From Transactions Involving Financial Instruments?, Part 2," 51 State Tax Notes 571 (Feb 23, 2009).

60 Section 16(a) UDITPA. A "throwback rule" provides that if the taxpayer is not taxable in the state where a sale would be assigned under the destination rule it will be thrown back to the state the goods were shipped from.

61 Section 3 UDITPA.

62 Cal. Admin. Code, tit. 18 Section 25137-8.

63 Twentieth Century-Fox Film Corporation v. Department of Revenue, 299 Or. 220, 700 P.2d 1035 (1985).

64 It is worth noting that the Multistate Tax Commission has an Alternative Dispute Resolution program that allows a taxpayer to request that the states mediate the dispute to eliminate the multiple taxation.

65 Microsoft Corporation v. Franchise Tax Board, San Francisco Superior Court, Docket CGC 08-471260, February 17, 2011. This is a new lawsuit from one considered by the California Supreme Court discussed earlier.

66 Cal. Admin. Code, tit. 18 Section 25137-8.

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Relief from the standard UDITPA provisions can be accomplished in three different circumstances, as follows:

- the Legislator can enact a formula which is applicable to only a specific industry or specific circumstances;
- the tax administrator may enact regulations which described the circumstance where a variation from the standard provisions will generally be appropriate; or
- the variation can arise as the result of a taxpayer request or by the requirement of the tax administrator.
- Each of these situations exists and each is subject to different types and levels of review.

¶9.06[A] Statutory

When a variation arises as the result of legislative action it is entitled to the same level of deference as UDITPA itself. It is the expression of the state legislature as to what is the fair method for assigning the income in the particular situation addressed. Typically such legislation would not have an equivalent of Section 18. If the legislation is enacted as part and parcel of the standard apportionment rules, then it should be subject to petitions or requirements for the use of different methods. If it is enacted outside of the standard rules, then it will be more difficult to adopt an alternative. It will be the method used unless the result is so extreme as to be unconstitutional.

¶9.06[B] Regulatory

Many states have adopted regulations dealing with either particular circumstances or with specific industries. Because the regulations have been subject to the formal ruling making process in the state, they have gone through a hearing process with the opportunity for public comment. The rule making files typically will have findings of facts setting forth the circumstances that support adopting the regulation. Based upon these files there is at least a presumption that need for the variance has been established. The burden of proof to justify the variance has been met and the approach adopted is reasonable.

In at least one state the ability of the tax administrator to implement a variation from the standard rules may need to be accomplished by regulation. This restriction may be limited to those circumstances where the administrator is attempting to change prior practice.[67]

If a state had adopted a rule by regulation Due Process arguments strongly support a change in position being applied prospectively only.

¶9.06[B][1] Particular Circumstances

The Multistate Tax Commission has adopted a series of regulations under Section 18 that identify specific circumstances where the standard rules do not fairly reflect activities.[68]

¶9.06[B][1][a] Property Factor

The Multistate Tax Commission's section 18 regulations have two provisions dealing with the treatment of property. These rules have been adopted by many states.

Rented property is included in the standard property factor capitalized at eight times the rental rent. A taxpayer may rent more property than it needs and subrent the property to a third party. The subrent should be deducted from the rent the taxpayer pays to arrive at the value that should be capitalized in the property factor. There is a regulation[69] that provides,

If the subrents taken into account in determining the net annual rental rate under Regulation IV.11.(b) produce a negative or clearly inaccurate value for any item of property, another method which will properly reflect the value of rented property may be required by the [tax administrator] or requested by the taxpayer.

In no case, however, shall the value be less than an amount which bears the same ratio to the annual rental rate paid by the taxpayer for the property as the fair market value of that portion of the property used by the taxpayer bears to the total fair market value of the rented property.

Example

The taxpayer rents a 10-story building at an annual rental rate of $1,000,000. Taxpayer occupies two stories and sublets eight stories for $1,000,000 a year. The net annual rental rate of the taxpayer must not be less than two-tenths of the taxpayer's annual rental rate for the entire year, or $200,000.

In some circumstances a taxpayer may use property for which it pays no or nominal rent. This may occur when a taxpayer is operating a government owned plant[70] or has a natural resource concession. In that circumstance the regulation provides that a reasonable market rental rate shall be used.[71]

California has adopted a rule for the valuation of natural resources leases in the property factor that values them at eight times the royalty paid to the owner of the property.[72]

¶9.06[B][1][b] Sales Factor

The Multistate Tax Commission has four special rules applicable to the sales factor. Many states have adopted these rules.

The first rule provides that receipts from sales of fixed assets outside the ordinary course of business that still constitute business income are excluded from the sales factor. For example, a taxpayer sells a plant that it no longer needs. The sale is out of the ordinary course of the business but constitutes business income. The regulation provides that the receipts from that sale shall be excluded from the sales factor.[73] California has adopted this regulation but has amended it by inserting the words "or other property" and by setting forth a standard for exclusion, five percent or greater decrease in the sales factor percentage.[74]

The second special rule in the Multistate Tax Commission regulations provides for the exclusion of insubstantial amounts of gross receipts from the sales factor for incidental or occasional sales unless their exclusion would materially affect the amount of income apportioned to the state.[75]

The third special rule included in the Multistate Tax Commission regulations provides that, if the income producing activity can be readily identified, it will be included in the sales factor.[76] The example given is receiving interest income on deferred payments.

The second paragraph of this regulation provides for the exclusion of such receipts if the income producing cannot be readily identified. Examples in the regulation are receiving dividends on stock, interest income, or royalties arising from the mere holding of the underlying assets.[77] The regulation does not define what constitutes mere holding but it seems likely that this would probably constitute the bookkeeping function of entering receipt of the payments on the companies books. Having individuals charged with monitoring, managing and protecting the assets generating the receipts would probably constitute more than "mere holding."

The fourth special rule in the Multistate Tax Commission regulations deals with treasury activity. The paragraphs of this portion of the regulation reflected the results that have been obtained in many states in litigation. The regulation provides that the overall net gains shall be included.[78] A noted economist that has frequently written about state taxes has suggested that even the gain and interest should be excluded from the sales factor.[79] California has adopted a regulation that is consistent with the approach recommended by the economist.[80]

¶9.06[B][2] Industries

The Multistate Tax Commission's regulations provide:

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

The regulations adopted by the Multistate Tax Commission are discussed in ¶9.07 herein.

¶9.06[B][3] Relief From Regulatory Rules

If the taxpayer falls within the class described in a regulation, then the rules of the regulation become in effect the standard rules for the situation. In a California case, the State Board of Equalization held that regulations adopted by the Franchise Tax Board pursuant to section 25137, in effect, become the standard rules of allocation and apportionment and that a party seeking to vary from the rules has the burden of establishing that the rules provided by the regulations do not fairly reflect its activities within the state in the circumstances of that case.[81] This is the correct interpretation.

¶9.06[C] *Ad Hoc* Special Formulas

Section 18 of UDITPA provides for taxpayer petitions to the Commissioner to allow, or Commissioner power to require, deviations from the standard apportionment and allocation provisions when the standard provisions do not fairly reflect a taxpayer's activities in the State.

As originally adopted by the Multistate Tax Commission its regulation under Section 18 provided:

Section 18 may only be invoked in specific cases where unusual fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results under the apportionment and allocation provisions contained in these regulations.

The purpose of the regulation was to indicate that relief from the standard provisions would be difficult to achieve. However, as evidenced by the treasury function cases, there are activities engaged in regularly by many, if not most, businesses that can result in an unfair reflection of a taxpayer's activities in the state.

Taxpayers frequently have pointed to the language of this regulation in support of the proposition that relief should only be granted if the situation presents "unique and non-recurring situations" to defeat variances proposed by tax administrators. For example, most corporations engage in Treasury activities, the short-term investment of idle cash. This activity is therefore neither unique nor non-recurring. This argument was rejected in a California case with the court stating "Systematic oversights and undersights are equally a matter of legislative concern." The Court went on to note that failure to address this particular issue could give rise to a significant loophole that could be exploited by subtle changes in investment strategy." Furthermore, the court held that the regulation should not be read as limiting the statute because the phrase "unique and nonrecurring" is modified by the word "ordinarily." Ordinarily means there are other circumstances, which are not unique and nonrecurring that can give rise to a need for modification of the standard formula.[82]

As a result the Multistate Tax Commission amended this portion of it regulation which now provides:

Article IV.18. permits a departure from the allocation and apportionment provisions of Article IV only in limited and specific cases where the apportionment and allocation provisions contained in Article IV produce incongruous results.

In order to promote uniformity that will avoid duplicative taxation and non-taxable income, states should not make decisions whether to invoke section 18 either as a matter of routine or in a vacuum.

Footnotes

67 CBS Inc .v Comptroller of Treasury, 319 Md 697 (1990). The method of assignment proposed by the tax administrator, viewership was certainly reasonable and fairly reflective. The opinion does not comment on the appropriateness of the variations sought only on the manner in which it was attempted to be accomplished.

68 MTC Reg IV.18.

69 MTC Reg IV.18.(b).

70 A pre-UDITPA example of this occurred during World Was II when the federal government built facilities for the manufacture of military aircraft for Douglas Aircraft in Kansas so it would be safe from attack from enemies. See McDonnell Douglas Corp. v. Franchise Tax Board, 69 Cal 2nd 506.

71 MTC Reg IV.18(b).

72 Cal. Admin. Code, tit. Reg. Section 25137(b)(1)(C).

73 MTC Reg IV.18.(c)(1).

74 Cal. Admin. Code, tit. 18 Section 25137(c)(1)(A).

75 MTC Reg IV.18.(c)(2).

76 MTC Reg IV.18.(c)(3).

77 MTC Reg IV.18.(c)(3).

78 MTC Reg IV.18.(c)(4).

79 McLure, Charles "How Should the UDITPA Sales Factor Treat Receipts From Transactions Involving Financial Instruments?, Part 1," 51 State Tax Notes 491 (Feb 16, 2009) and "How Should the UDITPA Sales Factor Treat Receipts From Transactions Involving Financial Instruments?, Part 2," 51 State Tax Notes 571 (Feb 23, 2009).

80 Cal. Admin. Code, tit., 18 Section 25137(c)(1)(D).

81 The Appeal of Fluor Corporation, California State Board of Equalization, 95-SBE-016, December 12, 1995.

82 Microsoft Corporation v. Franchise Tax Board 39 Cal.4th 750(2006).

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Whether these results are accomplished by statute, regulation, or *ad hoc* determinations lies within the province of each state and, therefore, results will vary from state to state. The fact that a particular variation is discussed in a particular example section below is not determinative of how it will be treated by every state.

¶9.07[A] Statutory

¶9.07[A][1] Multistate Tax Commission

The Multistate Tax Commission has promulgated a Model Statute for apportioning the income of financial institutions. This statute was adopted because UDITPA by its terms has no application to financials.[83]

¶9.07[A][2] Sample of State Statutes

Several states have adopted by statute special apportionment formulas for specific industries. For example, how oil and gas revenues are apportioned in Alaska depends on the nature of activities, and the apportionment formula for that industry contains a special factor for extraction.[84]

Arizona has statutory special rules for motor vehicle transportation, telecommunications, sports, financials and airlines.[85] California has special formulas that apply to sea transportation,[86] airlines,[87] and professional sports teams.[88] The telecommunications,[89] broadcasting[90] , insurance,[91] financials,[92] and transportation[93] industries have statutory special formulas in Illinois. Louisiana has adopted special formulas for the insurance[94] and broadcasting[95]

¶9.07[B] Regulatory – Industries

¶9.07[B][1] Multistate Tax Commission

Pursuant to this regulation the Multistate Tax Commission has adopted special formula regulations for a number of industries.

¶9.07[B][1][a] Construction Contractors[96]

Multistate construction contractors are frequently involved in projects that overlap a contractor's year-end or that take several years to complete. Because projects may not be completed within a single year, special rules need to be adopted to match the activities involved in the project to the apportionment factors and to handle the reporting of income. The method for accounting for multi-year projects may be based on either the percentage of completion or the completed contract method. Specific rules, with examples, are provided for assigning property and sales and for reporting of income under the accounting method chosen.

¶9.07[B][1][b] Airlines[97]

The airline industry presents special problems for apportionment because members of the industry have a variety of types of aircraft that operate in a multistate environment. A detailed set of definitions specific to the airline industry are provided. Each type of aircraft will have its own unique cost and load capacity. Types of aircraft are assigned to a state based upon the ratio of departures in the state to departures everywhere. Flight personnel are assigned to a state based upon departures weighted by the cost and type of aircraft. Flight revenue is also assigned by a departures factor weighted by type and cost of aircraft. Specific types of receipts are excluded from the sales factor including receipts from the sale of aircraft.

¶9.07[B][1][c] Railroads[98]

There are special rules for railroads for the assignment of property used in interstate travel, train crews operating in interstate travel, and revenue from interstate transportation. It is common in the railroad industry for rail cars to be used on the systems of competitors. In general, the use of others' cars tends to balance out. The regulation specifically excludes any *per diem* charges for the use of such cars as rent for purposes of the property factor and provides that a railroad will not reduce its owned property for any of its cars for which it receives *per diem* charges. Property that travels interstate is assigned to a state based upon "car miles" or "locomotive miles" within the state to such miles everywhere. Engineers and trainmen that operate interstate are assigned where their income is reported for state purposes. Revenues from moving goods are allocated to a state based upon the ratio of the miles traveled by the goods in state to the total miles traveled by the goods. Passenger revenue is assigned to a state based upon the ratio of revenue passenger miles within the state to revenue passenger miles everywhere. Revenue from *per diem* and mileage charges are excluded. All property, payroll and sales arising from intrastate activity are assigned to the state where the activity occurs.

¶9.07[B][1][d] Trucking Companies[99]

The regulation provides that property, payroll and sales that relate to intrastate activities are assigned to the state where the activities occur. Property, payroll and sales involving interstate movements are assigned on the basis of mobile property miles. The calculation of mobile property miles is made on an overall basis. The regulation provides a *de minimis* exception based upon the lack of ownership of non-mobile property, the lack of pick-ups or deliveries in the state, and traveling less than 25,000 mobile miles or 12 trips in the state.

¶9.07[B][1][e] Television and Radio Broadcasters[100]

The regulation for television and radio broadcasters excludes outer jurisdictional and film and radio program property from the property factor. For purposes of the sales factor receipts, advertising revenues are included and are assigned to a state based upon the "audience factor" for a station within a state to its total audience factor everywhere. The "audience factor" is determined by either the books and records of the taxpayer or industry statistics.

¶9.07[B][1][f] Publishers[101]

For publishers outer-jurisdictional property is included in the property factor and is assigned to a state on the basis of half-links (uplinks and downlinks) in the state to half-links everywhere. If data for half-links is not available then assignment is made on a time basis. To the extent receipts are derived from the sale of tangible personal property, they are assigned to a state under normal rules. Receipts from advertising revenue and subscriber lists are assigned by a circulation factor determined for each publication based upon purchasers and subscribers within a state to purchasers and subscribers everywhere.

¶9.07[B][1][g] Telecommunications[102]

The rule for this industry has not yet been adopted by the Commission. It contains an extensive list of definitions. Its apportionment rules are limited to the exclusion of outer-jurisdictional property and the assignment of receipts. Receipts are generally assigned by reference to the address or place of use by the customer.

¶9.07[B][2] California

California has adopted rules for other situations as well as the rules of the Multistate Tax Commission. California's rules that are in addition to those of the Multistate Tax Commission are set forth here because they are the most extensive of any state.

¶9.07[B][2][a] Partnership Income[103]

Partnerships present complex issues because the activities of the partnership "flow through"[104] to the partners. The flow through means that there is no unity of ownership requirement and that the partner is attributed only a portion of the activities and income of the partnership based upon its distributive share.

The first determination that must be made is whether the activities of the partnership are unitary with those of the partner. The activities of the partnership generally generate business income for the partnership, which will make it business income for the partner but it may be business income of unitary business separate from the unitary business or businesses conducted by the partner. A partnership can also have nonbusiness income which will then be nonbusiness income of the partner.

If the partnership is unitary with the partner, then the partner's proportion share of the partnerships property, payroll and sales shall be included in the apportionment factors of the partner. The sales factor presents special problems if the partnership is selling to the partner as rules of intercompany elimination should apply. The sales are to be eliminated to the extent of (1) sales by the taxpayer to the partnership and (2) sales by the partnership to the taxpayer. To the extent the partnership has sales to non-partners, that will be included in the partner's sales factor.[105] The regulation provides that the standard apportionment rules will apply in apportioning the income of a partnership that is not part of the partner's unitary business.[106]

Additional provisions of the regulation pick-up the special rules applicable to long-term contracts.[107]

¶9.07[B][2][b] Franchisors[108]

The business of franchising is defined as including the granting of a license of a trademark, trade name, or service mark to market or use a product or service. A special rule is provided for assigning the payroll of traveling employees who regularly provide administrative or advisory services on the basis of the ratio of time spent. Various fees relating to the franchise are assigned to the location of the franchisee provided the franchisor is taxable in the state. If the franchisor is not taxable in the state the amounts are assigned to the commercial domicile of the franchisor.

¶9.07[B][2][c] Banks and Financials[109]

The California regulation is virtually identical to the Mulitstate Tax Commission's Recommended Formula for the Apportionment and Allocation of the Net Income of Financials.

The special rule provides for inclusion of intangible property in the property factor of the apportionment formula. Detailed rules are provided for the assignment of receipts. Receipts from loans secured by real property are assigned to the state where the real property is located.[110] Other loans are assigned to the state where the borrower is located.[111] Credit card receivables are assigned to the state of the billing address.[112] For property factor purposes, loans are assigned to the state with the preponderance of substantive contacts.[113] The items to be considered in determining the preponderance of substantive contacts are solicitation, investigation, negotiation, approval and administration.[114]

The Multistate Tax Commission is currently reviewing the provisions of its recommended formula.

¶9.07[B][2][d] Commercial Fishing[115]

The regulation limits commercial fishing to the taking of fish utilizing a ship or ships. Property, payroll and sales are assigned to a state on the basis of “port days” in the state to port days everywhere. A "port day" is any day when a ship is in operation within an area over which a government claims jurisdiction over fishing. This includes international territorial limits.

¶9.07[B][2][e] Motion Picture and Television Producers and Television Networks[116]

The motion picture and television industry presents unique problems because of the nature of the principal assets of the industry. These assets are theatrical properties which are presented in a tangible form but whose value arguably lies in their content. The regulation defines films as tangible property[117] and provides for the numerator assignment of the value of films based upon the receipts they generate.[118] The payroll factor has special rules because of the unique manner in which actors and others may be paid.[119] The sales factor has special rules for films in release to television, which uses a viewership factor.[120] The Franchise Tax Board is in the process of proposing amendments to this regulation.

¶9.07[B][2][f] Combination of General and Financial Corporations[121]

Special problems are involved when a unitary business has a financial subsidiary that facilitates its business operations. A classic example is provided by the automobile industry where all the major manufactures have, or have had, a financial subsidiary to fund both individual dealers and individual purchasers. The particular problem to be addressed is how to deal with the intangible assets of the financials. In reviewing this problem it was determined that the property of financial corporations was generally ten times as productive of income while the payroll and receipts were generally no more than twice as productive in producing income. The principal attributes of the formula provided for in the regulation were to include intangible assets in the property factor[122] and to value those intangible assets at 20% of their face value.[123]

¶9.07[B][2][g] Mutual Fund Service Providers and Asset Management Service Providers[124]

The Mutual Fund service industry has some unique attributes that arise from the regulatory provision that requires the separation of various activities. Typically a fund will provide administrative services, distribution services, and management services.[125] The regulation generally provides for the assignment of receipts based upon the number of shares of a mutual fund owned by shareholders with a billing address in the state to the total number of shareholders.[126] In recognition of the required organizational structure of the industry, the regulation provides that taxability will be determined by the presence of any member of the unitary business.

¶9.07[C] *Ad hoc*

¶9.07[C][1] Treasury Activity

A business, other than a dealer in securities, invests working capital and idle cash in short-term securities. The standard UDITPA formula would include the amounts received in redemption of the securities and sales prior to maturity in the receipts factor. If the principal business of the taxpayer is not dealing in securities it should not be able to include these transactions in the sales factor. Section 18 has been invoked to exclude such receipts in a number of states.[127] The rule in most states includes the interest received and net gains, but California has adopted a regulation to exclude all receipts from treasury activities.[128]

There have been cases where the change in the apportionment factor is small enough that the receipts have been included.[129] Another factor that has been considered is what portion of the net income of the taxpayer comes from this activity.[130] Because apportionment is only required to achieve a rough approximation, these decisions may need to be accepted. In those states that have dealt with this issue by regulation, exclusion of such receipts should be sustained.

¶9.07[C][2] Doing Business Without Factor Assignment

In several of the professional sports leagues the home team retains all of the gate receipts. As a consequence, even though visiting teams play games in the state, no factors are attributed to the state. Section 18 relief is appropriate to attribute a portion of the gate receipts to the visiting team. The team would not forgo a portion of the gate receipts but for the fact it is able to retain all of the receipts from its own home games.[131]

¶9.07[C][3] A Zero Factor

Where one or more of the apportionment factors of the corporation is not present or is insubstantial, the factor should be disregarded in the apportionment formula. If a standard three-factor formula was employed, the non-existent or insubstantial factor should be removed and the remaining factors should be averaged based on the number of the remaining factors.[132]

New Mexico has a unique instruction that states "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 without prior approval or the Department may require—if reasonable—the exclusion of any one or more of the factors (property, payroll or sales). This would include removal of one or more of the factors whose factor is insignificant. A factor is insignificant if the denominator (column 1) is from between 0% and 3% of net income. Use the number of significant factors included to compute the average."[133]

¶9.07[C][4] "Nowhere Income"

Circumstances may arise where taxpayers have property located in international waters or in outer-space. Under the standard apportionment rules the property would be included in the denominator of the apportionment formula but might not be assignable to any jurisdiction. Section 18 should be invoked, if necessary, so that the apportionment process would not result in having a factor where there would be no numerator assignment to a jurisdiction that would be able to tax the income.[134]

¶9.07[C][5] Income Attribution Prior to Commencing Business

In preparation for entering into business in a state, a taxpayer establishes an inventory of goods within the state but has no other presence and makes no sales in the state. The standard apportionment rules include the value of inventory in the property factor and would assign it to the state because it is located in the state. Section 18 can be invoked to disregard the inventory.[135]

¶9.07[C][6] Authority for Combined Report

Taxpayer petitions for the use of a combined report arguing that excluding commonly-controlled entities with which it has substantial intercompany transactions must be included. UDITPA does not deal with combined reporting. Section 18 only allows for variations of items covered by UDITPA. Combined reporting should not be an alternative under Section 18, though it may qualify as any other method. At least one state has allowed combined reporting under Section 18.[136]

¶9.07[C][7] Zero Basis Property

Taxpayer acquired a productive mine for $1 because of concerns involving toxic waste. The taxpayer was able to operate the mine and produce income. The mine should be valued at its fair market value once it goes into production.

¶9.07[C][8] Factor Relief for Dividends

Taxpayer receives dividends from entities not included in the combined report. Should some portion of the factors of the dividend payors be included in the apportionment formula of the recipient?

The State of Maine uses the "Augusta formula" to include a portion of the dividend payor's factors if it does not decrease the amount of tax that would be owed if the dividends and factors related to it were not included and limits the amount of tax to the amount of tax that would be paid if the dividend payor was fully included in a combined report.[137]

A number of other states have denied any factor relief.[138] The analysis in these cases is the better approach. Dividends are paid from post tax earnings and may involve earnings from more than one year.

¶9.07[C][9] Installment Sales

The taxpayer makes an installment sale of assets in state A. The gain, when it is reported, should be apportioned on the basis of the apportionment factors at the time of the sale. The full sale price should be included in the sales factor of the apportionment formula as of the date the sale is made. Nothing, except perhaps interest, would be included in the sales factor in the year of the receipt of payment. The sale could be excluded in the year it is made if it is distortive.[139]

¶9.07[C][10] Hedging

Taxpayer manufactures cereal and flour from grain. As it enters into contracts to sell product, it engages in futures transactions to hedge its positions. By doing so it locks in the margin and therefore profits on the contracts. In virtually all situations it closed the futures position prior to taking delivery or having to take delivery on the contract. The futures contracts are a form of insurance. Including the nominal value of the sale of the futures contract in the sales factor is distortive and the sales should be excluded from the sales factor.[140]

¶9.07[C][11] Intangible Property

Taxpayer sought to add a fourth factor to its apportionment formula to reflect patents and copyrights that were derived from foreign subsidiaries. Use of a fourth factor was denied. The three factor apportionment formula adequately reflected the contributions made to the earning of the royalty income. [141]

Taxpayer sells and licenses its copyrighted computer software and operating systems. The copyrighted systems are its primary asset and constitute intangible property. Taxpayer seeks to have the value of the intangible property included in the apportionment formula. The value of the computer software and the resources to protect it are reflected in the payroll factor. The intangible property should be assigned to where it is used, which is reflected in the sales factor. There is no need to modify the standard apportionment formula because the contribution of the intangible property is already reflected in the other apportionment factors.[142]

¶9.07[C][12] Advertising Revenue

Taxpayer distributed "yellow pages" in a state, deriving its revenue from the sale of advertising. All of the costs of producing the yellow pages were incurred out-of-state but all the revenue was derived from advertising products to customers in the state. The state was successful in arguing that a cost of production assignment of advertising receipts did not fairly reflect the activity occurring in the state.[143]

¶9.07[C][13] Cable Company

Taxpayer operated a cable company out-of-state but had subscribers in-state. Apportionment of income should be based upon ratio of subscribers in-state to those everywhere.[144]

¶9.07[C][14] Air Carrier

An air carrier is subject to tax in the state, which had adopted a special formula for airlines. One of the elements used in calculating the factors was miles flown over the state to miles everywhere. It was held that the formula could not include miles involved in flights that only flew over the state and did not land in the state. The court found there was no nexus with the overflights.[145]

This decision may not have been proper. There clearly was nexus with the state since there were landings in the state. The use of miles flown to make factor assignments with the exclusion of fly-over miles results in the creation of nowhere income.

Footnotes

83 UDITPA Section 2.

84 Alaska Statutes 43.20.072.

85 A.R.S. Section 43-1139(A) and B.

86 Cal Rev. & Tax Code Section 25101.

87 Cal. Rev. & Tax Code Section 25101.3.

88 Cal. Rev.. & Tax. Code Section 25141.

89 35 ILCS 5/304(a)(3)(B-5).

90 35 ILCS 5/304(a)(3)(B-7).

91 35 ILCS 5/304(b).

92 35 ILCS 5/304(c).

93 35 ILCS 5/304(d).

94 La. Rev. Stats. Section 47:221 and 227.

95 La. Rev. Stats. Section 47:287.95(K).

96 MTC Reg IV.18.(d).

97 MTC Reg IV.18.(e).

98 MTC Reg IV.18.(f).

99 MTC Reg IV.18.(g).

100 MTC Reg IV.18.(h).

101 MTC Reg IV.18.(j).

102 Multistate Tax Commission Special Rule June 20, 2008.

103 Calif. Admin. Code, tit. 18 Regulation Section 25137-1.

104 For a comprehensive discussion of business income tax treatment of pass-through entity income, see the discussion beginning at ¶33.01.

105 Calif. Admin. Code, tit. 18 Regulation Section 25137-1(f)(3)(A) and (B).

106 Calif. Admin. Code, tit. 18 Regulation Section 25137-1(g).

107 Calif. Admin. Code, tit. 18 Regulation Section 25137-1(h).

108 Calif. Admin. Code, tit. 18 Regulation Section 25137-3.

109 Calif. Admin. Code, tit. 18 Regulation Section 25137-4.2.

110 Calif. Admin. Code, tit. 18 Regulation Section 25137-4.2(c)(3)(C).

111 Calif. Admin. Code, tit. 18 Regulation Section 25137-4.2(c)(3)(D).

112 Calif. Admin. Code, tit. 18 Regulation Section 25137-4.2(c)(3)(F).

113 Calif. Admin. Code, tit. 18 Regulation Section 25137-4.2(d)(3)(B).

114 Calif. Admin. Code, tit. 18 Regulation Section 25137-4.2(d)(3)(C)2.

115 Calif. Admin. Code, tit. 18 Regulation Section 25137-5.

116 Calif. Admin. Code, tit. 18 Regulation Section 25137-8.

117 Calif. Admin. Code, tit. 18 Regulation Section 25137-8(b)(4).

118 Calif. Admin. Code, tit. 18 Regulation Section 25137-8(c)(1)(C)(ii).

119 Calif. Admin. Code, tit. 18 Regulation Section 25137-8(c)(2)(A)(ii).

120 Calif. Admin. Code, tit. 18 Regulation Section 25137-8(c)(3)(B) and (C).

121 Calif. Admin. Code, tit. 18 Regulation Section 25137-10.

122 Calif. Admin. Code, tit. 18 Regulation Section 25137-10(d)(1)(A)2. and 3.

123 Calif. Admin. Code, tit. 18 Regulation Section 25137-10(d)(1)(C).

124 Calif. Admin. Code, tit. 18 Regulation Section 25137-14.

125 See Calif. Admin. Code, tit. 18 Regulation Section 25137-14(a)(1) -(3).

126 Calif. Admin. Code, tit. 18 Regulation Section 25137-14(b)(1).

127 Sherwin-Williams Co. v., Johnson, 989 S.W. 2d 710 (TN, 1998); American Tel. & Tel. Co. v. State Tax Appeal Bd., 241 Mont. 440, 787 P. 2nd 754 (Mont. 1990); Sherwin-Williams Co. v. Dept. of State Revenue, 329 Ore. 599, 996 P 2nd 500 (Ore., 2000); United States Steel Corp. v. Wisconsin Dept. of Revenue, Wisconsin Tax Appeals Commission, Dkt. No. I-6578, May 9, 1985; Microsoft Corporation v. Franchise Tax Board 39 Cal.4th 750 (2006).

128 Calif. Admin. Code tit. 18 Section 25137(c)(1)(D).

129 Letter Decision, Appeal of Home Depot, Inc., California State Board of Equalization, No. 298693, December 18, 2008. This decision is not precedential.

130 Montgomery Ward LLC. v. Franchise Tax Board, San Diego Superior Court G/C 802767, January 15, 2008. Superior Court decision not citable as a precedent.

131 Appeal of Milwaukee Professional Sports and Services, Inc., California State Board of Equalization, 79-SBE-093, June 28-1979.

132 Appeal of Oscar Enterprises, LTD, California State Board of Equalization, 87-SBE-069, October 6, 1987.

133 2010 Instructions, Form CIT-1, New Mexico Corporate Income and Franchise Tax Return.

134 Communications Satellite Corp. v. Franchise Tax Board 156 Cal.App.3d 726 (1984).

135 Appeal of Hyundai Motor America, California State Board of Equalization, June 25, 1998. Memo decision not citable as precedent.

136 Media General, Inc. v. South Carolina Dep't of Revenue,388 S.C. 138, 694 S.E.2d (2010).

137 E.I. du Pont de Nemours & Co. v. State Tax Assessor, 675 A. 2d 82 (1996) and Tambrands, Inc. v. State Tax Assessor, 595 A 2d 1039 (1991).

138 Comptroller of the Treasury v. NCR Corporation, 313 Md. 118, 544 A. 2nd 764 (1988); NCR Corp. v. Commissioner of Revenue,438 N.W. 2d 86 (1988); NCR Corp. v. South Carolina Tax Commission, 402 S.E. 2d 666 (1993); NCR Corporation v. Taxation and Revenue Department, 115 N.M. 612, 856 P. 2d 982 (1993); and NCR Corporation v. Commissioner of Revenue, Massachusetts Appellate Tax Board, Docket Nos. 147997, 168150, 168151 and 168152 (1996).

139 Tenneco West, Inc. v. Franchise Tax Board, 234 Cal. App. 3d 1510, 286 Cal. Rptr. 354 (1991).

140 General Mills Inc. v. Franchise Tax Board, San Francisco Superior Court Docket CGC 05-439929, November 1, 2010.

141 Colgate-Palmolive Company, Inc. v. Bower, Circuit Court, Cook County Judicial Circuit (Illinois), No. 01 L 50195, October 15, 2002.

142 Microsoft Corporation v. Franchise Tax Board, San Francisco Superior Court, Docket CGC 08-471260, February 17, 2011.

143 Bellsouth Advertising & Publishing v. Chumley, 308 S.W.3d 350 (Tenn. App. 2009).

144 Indiana Letter of Findings No. 04-0398, Indiana Department of Revenue, September 1, 2006.

145 Northwest Airlines, Inc. v. State Tax Appeal Board, 221 Mont. 441, 720 P 2d 676 (1986).