MULTISTATE TAX COMMISSION

MEMORANDUM

To: Robynn Wilson, Chairperson,
Income and Franchise Tax Uniformity Subcommittee

From: Bruce Fort, MTC Counsel

Date: February 24, 2012

Re: Status of Project to Review Regulations Pertaining to Application of the "Taxable in Another State" Provisions in Multistate Tax Compact Article IV.3 and Model Allocation and Apportionment Regulations IV.3.(a), (b) and (c).

In March of 2011, the Uniformity Committee initiated a study to determine if changes to our current regulations governing the "taxable in another state" provisions of the Multistate Tax Compact, Article IV.3, are needed. The subcommittee has met on several occasions since that time to consider initiating a project.

In November of 2011, the subcommittee was asked to vote on a motion to remove the project from the list of on-going projects, but some committee members asked that the vote be postponed to this meeting to allow a final opportunity for the state representatives to ask their legal and audit staffs if the current regulations are proving adequate to ensure that taxpayers are consistently reporting their taxable status for purposes of the sales-throwback provisions of Article. IV, Section 16.

I have attached a copy of a July 14, 2011 memorandum to the subcommittee outlining the issues. As before, there are relatively few cases or administrative rulings addressing the issue. I would be happy to answer any questions you or the subcommittee may have on the topic or the course of this study project.

MULTISTATE TAX COMMISSION

MEMORANDUM

To: Robynn Wilson, Chairperson,
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From: Bruce Fort, MTC Counsel

Date: July 14, 2011

Re: Report on Application of the "Taxable in Another State" Provisions in Multistate Tax Compact Article IV.3 and Model Allocation and Apportionment Regulations IV.3.(a), (b) and (c).

In March of 2011, the Uniformity Committee discussed issues that have arisen regarding the "taxable in another state" provision of the Multistate Tax Compact, Article IV.3, and associated regulations. The Committee asked staff to produce an issue paper, so that it might consider in more depth whether those regulations should be amended or clarified. Article IV.3 provides in its entirety:

> For purposes of allocation and apportionment of income under this Article, a taxpayer is taxable in another State if (1) in that State he is ***subject to*** a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or (2) that State has ***jurisdiction*** to subject the taxpayer to a net income tax regardless of whether, in fact, the State does or does not do so.

Article IV.3 has application in two contexts. The first context arises under Article IV.2, which provides that if a taxpayer has "business activity which is taxable both within and without this state" it will be required to allocate and apportion its income. There are a number of cases addressing whether a taxpayer has a right to apportion its income among states. *See, e.g., Jay Wolfe Imports, Inc. v. Dept. of Revenue,* 282 S.W.2d 839 (Mo. 2009). The second application is the "throw-back" rule for sourcing receipts from sales of tangible personal property under Article IV.16.(b), which provides that receipts should be sourced to the state from which a shipment originated if "the taxpayer is not taxable in the State of the purchaser."

The Committee specifically raised two issues related to the second application of Article IV.3—throwback of sales--to consider for possible uniformity projects. The first issue is whether the regulations should further clarify the types of taxes that may

substitute for a net income tax in determining whether a taxpayer is "subject to tax" in the destination state. The second issue is whether a state should use its own nexus and PL 86-272 interpretation, or alternatively those of the destination state, in determining whether there is jurisdiction to subject the taxpayer to a net income tax in the destination state. This memorandum provides background on these two issues to assist the Committee in deciding whether or not to initiate a project.

A. Purpose of the Throwback Provision

One of the goals of the throwback provisions in Art. IV.16(b) is to ensure full apportionment of income where appropriate, so that taxpayers who operate in interstate commerce do not have a competitive advantage over intra-state taxpayers. Throw-back provisions further that goal by sourcing sales activity to the shipping state, rather than the destination state, if the taxpayer's activities in the destination state are insufficient to create taxing jurisdiction under the U.S. Constitution or to allow the exercise of that jurisdiction under federal law. As set forth below, the drafters of the Compact recognized that throw-back is not appropriate in every circumstance, however, and in particular where the taxpayer is subject to other business taxes in the destination state that operate as a substitute for net income-based taxation.

The "throw-back" provisions of the Compact can be expected to become a more important factor in determining a taxpayer's overall tax liability because many states now rely more heavily on the sales factor--to the diminution of the property and payroll factors--as the means of dividing the income tax base.[1] Currently, 26 states and the District of Columbia have a "throw-back" or "throw-out" provision in their apportionment statutes, although some states have amended their statutes to eliminate throw-back and throw-out requirements.[2]

At the Committee's March 2011 meeting, members expressed concern that taxpayers may be able to improperly diminish their total state tax liabilities by paying a minimal amount of franchise or similar taxes in sales destination states in which the taxpayers are otherwise immune from income tax liability under Public Law 86-272 (15 U.S.C. Sec. 351, *et seq*.), resulting in "nowhere" sales apportionment. The extent to which taxpayers are currently relying on payment of minimal franchise-type taxes to avoid "throw-back" is not clear, but the Committee questioned whether the

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[1] **Double-weighted Sales**: Alabama, Arkansas, Connecticut, D.C., Florida, Indiana, Kentucky, Maryland, Maine, New Jersey, North Carolina, South Carolina, Tennessee, Utah, Vermont, Virginia, West Virginia. **Sales Factor Only (or nearly so):** Arizona, California, Colorado, Georgia, Illinois, Indiana, Iowa, Michigan, Minnesota, Mississippi, Nebraska, New York, Pennsylvania, Oregon, Texas, Wisconsin.

[2] Alabama, Alaska, Arkansas, California, Colorado (limited), District of Columbia, Hawaii, Idaho, Illinois; Indiana; Kansas, Kentucky (for sales to U.S. gov't only), Maine, Massachusetts, Mississippi, Missouri (income tax is being phased out), Montana, New Jersey (throw-out only, repealed effective 2010), New Mexico, North Dakota, Oregon, Rhode Island, Tennessee (limited to sales to U.S. gov't), Utah, Vermont, West Virginia and Wisconsin.

Commission's regulations aimed at preventing such "tax planning" should be clarified to discourage such planning.

B. The MTC Model Regulations Defining "Taxable in Another State."

In 1973, the Commission promulgated a series of model regulations interpreting and expanding on Article IV.3. The regulations are appended to this report as Attachment A. Regulation IV.3.(a) amplifies the Compact language by providing that a taxpayer is taxable in another state "if it has income from business activity" in the state, that is, "transactions and activities in the regular course of a particular trade or business." The regulation further explains that the Compact has two tests. The first test is based on whether the taxpayer is "subject to": (a) a net income tax; (b) a franchise tax measured by net income; (c) a franchise tax "for the privilege of doing business" or (d) a corporate stock tax.

The second test for whether a taxpayer is taxable in another state is whether its activities related to the production of business income would be enough to subject the taxpayer to a net income tax liability, excluding activities related to a separate line of business or non-business income, regardless of whether the jurisdiction has in fact chosen to implement such a tax. The theory of this exception to the throw-back rule, according to one of the original drafters of UDITPA, Professor William Pierce, is that states without an income tax would likely have other "compensatory" taxes imposing a similar burden on business activity:

> In states not having income taxes or taxes measured by net income, other types of franchise taxes are usually imposed. Income is justifiably attributed to these states since these other taxes substitute for the income tax, and it must be recognized that these other states may change their tax structure at any time.

Pierce, *The Uniform Division of Income for Tax Purposes Act*, 35 Taxes 748, 749 (October 1957).

1. MTC Regulation Explaining "Subject to Tax" Provision.

Regulation IV.3.(b)(1) expands on the concept of when a corporation is "subject to" taxes in another state, the first of the two tests described above. A taxpayer is "subject to" a state's taxes when carries on business activities in that state and the state imposes one of the four identified taxes on that activity. Section (b)(1) of the regulation provides that a taxpayer must provide evidence to support the claim of taxability upon request, and that such request for proof can include tax returns and evidence of payment. Failure to provide returns or payment information "may be taken into account" in determining whether the taxpayer was "subject to tax." (Illinois has gone further and

provided that failure to provide returns is fatal to the claim of being subject to the destination state's tax.)[3]

Regulation IV.3.(b)(1) goes on to provide that voluntary payment of a tax or payment of "a minimal fee for qualification, organization or for the privilege of doing business" does not constitute being "subject to" tax where (a) the taxpayer either "does not actually engage in business activity in the state" or (b) the business activity is "not sufficient for [income tax] nexus and the minimum tax bears no relationship to the taxpayer's business activity in the state."

Regulation IV.3.(b)(2) provides that the four types of taxes enumerated in Article IV.3 (a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax) will qualify under the "subject to tax" provision of the Compact only if the taxes "may be considered basically revenue raising rather than regulatory measures."

Example (i) describes a state with a capital stock tax with a $50 minimum and a $500 maximum amount; failure to pay the tax precludes a corporation from using the state's courts. The state also has a separate income tax. Because the taxpayer carries on no business activity in the state, it is not "taxable" there.

Example (iv) describes a state with a franchise tax measured by net income with a minimum tax amount. A taxpayer whose liability was below the minimum amount would still be considered "taxable" in that state.

One could argue that Regulation IV.3.(b) and its examples provide insufficient guidance to the states and taxpayers in determining whether a taxpayer should be considered "taxable" in another state by virtue of payment of a small amount of franchise or capital stock taxes. In particular, the distinction between "basically regulatory" and "basically revenue raising" tax systems could be open to debate in many situations. The lack of clear guidance may invite taxpayers to either pay minimal franchise taxes to avoid throw-back or to take inconsistent filing positions.

2. MTC Regulation on "Jurisdiction to Subject Taxpayer to Net Income Tax."

Regulation IV.3.(c) provides that a taxpayer is not subject to a state's income tax jurisdiction if its activities would be insufficient to create nexus under the U.S. Constitution or if the taxpayer's activities are protected by federal statute, *i.e.*, P.L. 86-272. The determination of whether a taxpayer is taxable (as opposed to being "subject to" a state's tax) is accordingly made by reference to federal law only. Thus, state statutes or administrative regulations setting forth *de minimis* nexus standards or immunizing out-of-state taxpayers engaged in certain protected activity would be irrelevant in determining whether the taxpayer is "taxable" in that state. For instance, several states have adopted regulations providing that mere attendance at a trade show or

[3] *See Dover Corp. v. Dept. of Revenue*, 648 N.E.2d 1089 (Ill. 1995) (failure to file returns precludes argument that taxpayer subject to tax in destination state).

using in-state computer services will not subject an out-of-state business to nexus on that basis alone. If such activities would be enough to subject the taxpayer to nexus under constitutional standards (and P.L. 86-272 was not available as an immunity), the taxpayer would be "taxable" in those states under Article IV.3. By contrast, the taxpayer would not be "subject to" that state's income taxes if its only activities were exempted from taxation under state regulation.

There is not currently a split of authority among the states' highest courts as to how to apply constitutional income tax nexus standards, so it may not be necessary to consider whether a tax administrator would be bound by the legal interpretations of the sales origin state, the destination state, or both states in the event of a conflict as to whether a taxpayer's activities in the destination state are sufficient to create nexus. Also, nexus determinations tend to be heavily fact-dependent, suggesting that it would be a highly speculative exercise to determine how the highest court of another state would interpret and apply federal law to particular factual situations.

The regulation also provides that sales into foreign countries will be treated as if the foreign country was a "state" for purposes of applying constitutional nexus standards and P.L. 86-272. Thus, an Arizona corporation whose activities in Mexico were limited to having salesmen soliciting orders in the country for tangible property shipped from Arizona would be required to apportion those sales back to Arizona, unless the corporation could demonstrate that it paid sub-national taxes in Mexico on its income. On the other hand, if the Arizona-based taxpayer exceeded P.L. 86-272 protections but was immune from taxation in Mexico because of a federal tax treaty, the regulation provides that Mexico would still have "jurisdiction to tax" and no throw-back would be required.

C. Recent Litigation of Throw-Back Rules and "Subject to Tax."

The constitutionality of state throw-back rules has been upheld on several occasions. *Scott & Williams, Inc. v. Board of Taxation*, 372 A.2d 1305 (N.H. 1977); *Covington Fabrics Corp. v. South Carolina Tax Commission*, 212 S.E. 2d 574 (S.C. 1974). *But see, Homes Interiors and Gifts, Inc. v. Strayhorn*, 175 S.W.3d 856 (Tx. App. 2005)(Throw-back failed internal consistency test under former Texas taxing system which imposed lower of franchise tax and capital tax on taxpayers, where out-of-state taxpayers subject to franchise tax would pay more tax if their state imposed similar taxing scheme on sales into Texas.).

I was unable to locate any reported litigation in which it was alleged that a taxpayer had systematically or deliberately filed *de minimis* franchise or similar tax returns in destination jurisdictions in order to avoid the operation of state throw-back rules.

One case which illustrates the problem facing tax administrators is *Knauf Fiber Glass GMBH, Inc. v. Alabama Dept. of Revenue*, Corp. Docket No. 05-970, 2006 WL 3587185 Ala. Admin. Hrg. (11/30/05), http://216.226.178.107/aljrules/05-970-2.pdf., in which the state tried unsuccessfully to argue that sales should be thrown back to the state.

The taxpayer manufactured fiberglass insulation in Alabama and shipped the products nationwide. The administrative hearing officer first ruled that Michigan's single business tax was a franchise tax on the privilege of doing business in the state and accordingly did not require throw-back of those sales. With respect to sales into Mississippi and Tennessee, the taxpayer had failed to file and pay franchise taxes but the ALJ held that Alabama's regulation (identical to the MTC regulation set forth above) did not require proof that returns were filed in order to claim protection from throw-back. (The taxpayer was immune from income taxes in those states pursuant to 86-272.) Because the taxpayer was legally responsible for filing franchise tax returns in the destination states, the sales could not be thrown back into Alabama despite the failure to pay taxes in those states. Accordingly, the taxpayer was allowed to source $1.8 million of annual sales to "nowhere". The ALJ held that Washington's Business and Occupations ("B&O") tax was a franchise tax on the privilege of doing business in that state and did not require throw-back. On the other hand, the ALJ held that payment of a $300 minimum income tax to New Jersey (imposed on corporations who enjoyed P.L. 86-272 immunity) was a tax which "bore no relationship" to the level of activity conducted in the state and thus throw-back was appropriate.

Another case illustrating the administrative difficulties in determining a taxpayer's P.L. 86-272 immunity in the context of a refund claim is *Colgate Palmolive Company v. Commissioner of Revenue,* Mass. Appellate Tax Board No.C255116 (4/23/03), 2003 WL 1787975,http://www.mass.gov/?pageID=afsearchlanding&sid=Eoaf&q=colgate-palmolive&collectorName=EOANFxDECISIONSx. In that case, the taxpayer argued successfully that it was entitled to a refund based on sourcing its sales of medical products to destination states because its salesmen exceeded the protections of P.L. 86-272 in 33 states, although it did not file income tax returns in those states. *Accord, Goldberg v. State Tax Commission*, 618 S.W.2d 635, 642 (Mo. 1981)(failure to file return immaterial to issue of whether taxpayer subject to tax in destination state); *Indiana D.O.R. v. Continental Steel Corp.*, 399 N.E.2d 754, 758 (Ind. App. 1980)(same); *Compare, In re Appeal of Galvatech, Inc*., 2006 WL 29531 (Cal. SBE 2006)(failure to demonstrate that taxes were paid precluded claim that taxpayer was subject to tax in foreign jurisdictions).

With respect to what it means to be "subject to tax" in a particular jurisdiction in other contexts, a recent case from the Indiana Tax Court may provide some guidance. In *United Parcel Service, Inc. v. Indiana Dept. of Revenue,* 940 N.E.2d 870, 872 (Ind. Tax. Ct. 2010), the Department attempted to combine UPS's income with the incomes of two foreign reinsurance companies that re-insured UPS packages, arguing that such combination was allowed since neither re-insurer had filed returns in the state and were thus not "subject to" the state's premium tax. The tax court disagreed, suggesting that the entities were theoretically within the state's insurance taxing system even though both the insurers and their clients' contracting offices were out of state and were reinsurers entitled to deduct reinsurance premiums since the direct insurers were responsible for premium tax:

> Unless specifically defined, statutory words will be given their plain, ordinary and usual meaning, as presented in the dictionary [citations omitted]. Consequently, to be "subject to" the premiums tax under Indiana Code Sec. 6-3-2-2.8 (4) does not mean that one must "pay" the premiums tax; rather, it simply means that one is "placed under the authority, dominion, control, or influence" of the premiums tax under Section 27-1-18-2.

D. Considerations for Possible Amendment to Regulations IV.3.(a), (b) and (c).

The subcommittee may wish to consider if some practical alternatives exist to the current regulations establishing a distinction between "regulatory" franchise fees and "revenue-raising" franchise fees. In addition, the subcommittee may wish to consider whether the current legal standard for being "subject to tax" should be amended to require proof in all circumstances that appropriate tax returns have been filed and taxes paid in the destination state.

Regulatory clarification does not appear necessary as to which state's interpretation of federal constitutional and statutory laws should apply in determining whether a taxpayer's activities in the destination state are sufficient to make it liable for income taxes in that state, since there is not currently a clear split of authority on this issue.

Attachment A

MTC Regulations IV.3.(a), (b) and (c)

••• Reg. IV.3.(a). Taxable in Another State: In General. Under Article IV.2. the taxpayer is subject to the allocation and apportionment provisions of Article IV if it has income from business activity that is taxable both within and without this state. A taxpayer's income from business activity is taxable without this state if the taxpayer, by reason of such business activity (i.e., the transactions and activity occurring in the regular course of a particular trade or business), is taxable in another state within the meaning of Article IV.3.

(1)Applicable tests. A taxpayer is taxable within another state if it meets either one of two tests: (1) By reason of business activity in another state, the taxpayer is subject to one of the types of taxes specified in Article IV.3.(1), namely: A net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; or (2) By reason of such business activity, another state has jurisdiction to subject the taxpayer to a net income tax, regardless of whether or not the state imposes such a tax on the taxpayer.

(2)Producing nonbusiness income. A taxpayer is not taxable in another state with respect to a particular trade or business merely because the taxpayer conducts activities in that other state pertaining to the production of nonbusiness income or business activities relating to a separate trade or business.

••• Reg. IV.3.(b).Taxable in Another State: When a Corporation Is "Subject to" a Tax under Article IV.3.(1).

(1) A taxpayer is "subject to" one of the taxes specified in Article IV.3.(1) if it carries on business activities in a state and the state imposes such a tax thereon. Any taxpayer which asserts that it is subject to one of the taxes specified in Article IV.3.(1) in another state shall furnish to the [tax administrator] of this state upon his/her request evidence to support that assertion. The [tax administrator] of this state may request that such evidence include proof that the taxpayer has filed the requisite tax return in the other state and has paid any taxes imposed under the law of the other state; the taxpayer's failure to produce such proof may be taken into account in determining whether the taxpayer in fact is subject to one of the taxes specified in Article IV.3.(1) in the other state.

Voluntary tax payment. If the taxpayer voluntarily files and pays one or more of such taxes when not required to do so by the laws of that state or pays a minimal fee for qualification, organization or for the privilege of doing business in that state, but
(A) does not actually engage in business activity in that state, or
(B) does actually engage in some business activity not sufficient for nexus and the minimum tax bears no relationship to the taxpayer's business activity within such state, the taxpayer is not "subject to" one of the taxes specified within the meaning of Article

IV.3.(1).

Example: State A has a corporation franchise tax measured by net income for the privilege of doing business in that state. Corporation X files a return and pays the $50 minimum tax, although it carries on no business activity in State A. Corporation X is not taxable in State A.

(2) The concept of taxability in another state is based upon the premise that every state in which the taxpayer is engaged in business activity may impose an income tax even though every state does not do so. In states which do not, other types of taxes may be imposed as a substitute for an income tax. Therefore, only those taxes enumerated in Article IV.3.(1) which may be considered as basically revenue raising rather than regulatory measures shall be considered in determining whether the taxpayer is "subject to" one of the taxes specified in Article IV.3.(1) in another state.

Example (i): State A requires all nonresident corporations *Example (i):* State A requires all nonresident corporations which qualify or register in State A to pay to the Secretary of State an annual license fee or tax for the privilege of doing business in the state regardless of whether the privilege is in fact exercised. The amount paid is determined according to the total authorized capital stock of the corporation; the rates are progressively higher by bracketed amounts. The statute sets a minimum fee of $50 and a maximum fee of $500. Failure to pay the tax bars a corporation from utilizing the state courts for enforcement of its rights. State A also imposes a corporation income tax. Nonresident Corporation X is qualified in State A and pays the required fee to the Secretary of State but does not carry on any business activity in State A (although it may utilize the courts of State A). Corporation X is not "taxable" in State A.

Example (ii): Same facts as Example (i) except that Corporation X is subject to and pays the corporation income tax. Payment is prima facie evidence that Corporation X is "subject to" the net income tax of State A and is "taxable" in State A.

Example (iii): State B requires all nonresident corporations qualified or registered in State B to pay to the Secretary of State an annual permit fee or tax for doing business in the state. The base of the fee or tax is the sum of (1) outstanding capital stock, and (2) surplus and undivided profits. The fee or tax base attributable to State B is determined by a three factor apportionment formula. Nonresident Corporation X which operates a plant in State B, pays the required fee or tax to the Secretary of State. Corporation X is "taxable" in State B.

Example (iv): State A has a corporation franchise tax measured by net income for the privilege of doing business in that state. Corporation X files a return based upon its business activity in the state but the amount of computed liability is less than the minimum tax. Corporation X pays the minimum tax. Corporation X is subject to State A's corporation franchise tax.

••• Reg. IV.3.(c). Taxable in Another State: When a State Has Jurisdiction to Subject a Taxpayer to a Net Income Tax. The second test, that of Article IV.3.(2), applies if the taxpayer's business activity is sufficient to give the state jurisdiction to impose a net income tax by reason of such business activity under the Constitution and statutes of the United States. Jurisdiction to tax is not present where the state is prohibited from imposing the tax by reason of the provisions of Public Law 86-272, 15 U.S.C.A. §§ 381-385. In the case of any "state" as defined in Article IV.1.(h), other than a state of the United States or political subdivision thereof, the determination of whether the "state" has jurisdiction to subject the taxpayer to a net income tax shall be made as though the jurisdictional standards applicable to a state of the United States applied in that "state." If jurisdiction is otherwise present, that "state" is not considered as being without jurisdiction by reason of the provisions of a treaty between that "state" and the United States.

Example: Corporation X is actively engaged in manufacturing farm equipment in State A and in foreign country B. Both State A and foreign country B impose a net income tax but foreign country B exempts corporations engaged in manufacturing farm equipment. Corporation X is subject to the jurisdiction of State A and foreign country B.