MULTISTATE TAX COMMISSION
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To: Robynn Wilson, Chair
Members of MTC Income & Franchise Tax Uniformity Subcommittee

From: Shirley Sicilian, General Counsel

Date: July 15, 2011

Subject: Model Compact Art. IV.9 Amendments

I. Background

At its July, 2009 meeting, the Executive Committee directed that "revisions to Article IV of the Compact - specifically, the five areas suggested as the focus for ULC's revision project - be referred to the Uniformity Committee and that [the Uniformity Committee] come back to the Executive Committee if the Uniformity Committee recommends the scope of issues be changed." The five areas are:

1. Sales factor numerator sourcing for transactions other than sales of tangible personal property – Art.IV.17
2. Definition of Sales – Art.IV.1(g)
3. Definition of Business Income – Art.IV.1(a)
4. Factor Weighting – Art. IV.9
5. Distortion Relief Provision - Art.IV.18

The Uniformity Subcommittee started with revisions for item 1, sales factor numerator sourcing for receipts from all transactions other than sales of tangible personal property under §17. This includes receipts from lease of TPP, sale/lease of real property, sale of services, and sale/license of intangibles. The Subcommittee recognized there is overlap between efforts to revise the definition of "sales" under §1(g) and to revise the sourcing for those sales under §17. If the sales are not included in the new definition, then they don't need to be sourced. So, before finalizing its work on §17, the Subcommittee turned its attention to §1(g). In the course of reviewing the definition of "sales" the Subcommittee also recognized overlapping issues with factor weighting.

This memorandum describes the current factor weightings used by the states (Part II), discusses considerations for possible revisions to the model weighting, including legal considerations (Part III.A.), policy considerations (Part III.B.) and then lists some possible options for amended factor weighting (Part IV).

II. Current Factor Weighting

The Compact, Art. IV.9, calls for an equal-weighting of the property, payroll and sales factors:

> All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

But as of January, 2011, only nine jurisdictions exclusively require the equal-weighted formula: Alabama, Alaska, Delaware, Hawaii, Montana, North Dakota, Oklahoma, Rhode Island, and District of Columbia. Six of those nine are Multistate Tax Compact members. Although states are moving away from the three-factor equal-weighting, they are at least moving away in the same direction – toward more heavily weighting the sales factor. Thirty-eight states now at least double weight the sales factor. And thirteen of those thirty-eight states apportion based on the sales factor only: Colorado, Georgia, Illinois, Indiana, Iowa, Louisiana, Maine, Michigan, Nebraska, New York, Oregon, Texas, and Wisconsin. Four of these thirteen are Multistate Tax Compact members. (See Table, Attachment A.)

III. Possible Revisions

With less than 25% of states adhering to the equal-weighted formula, the Commission suggested this provision is worthy of study and an attempt to find a workable rule that states can adopt.

A. Legal Considerations

No apportionment formula is going to reflect all of a taxpayer's activities in the various states in which it is doing business. The idea behind the three-factor equal-weighted formula is that it reflects three significant activities – property investment, labor, customers – in equal parts. In 1983, the United States Supreme Court noted that this equal-weighted formula not only meets with the Court's approval, but has become "something of a benchmark against which other apportionment formulas are judged."[1] So, what are the criteria by which formulas are judged?

1. Due Process Clause

The U.S. Supreme Court has interpreted the due process clause of the U.S. Constitution to require that an apportionment formula be "fair," and for a formula to be "fair" it must be internally and externally consistent.[2]

Internal consistency means that "if applied by every jurisdiction, [the formula]… would result in no more than all of the unitary business' income being taxed."[3] Any formula that uses

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[1] *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 170, 183, 103 S.Ct. 2933, 77 L.Ed.2d 545 (1983). *See also, Butler Brothers v. McColgan*, 315 U.S. 501, 62 S.Ct. 701, 86 L.Ed. 991 (1942).

[2] *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 160.

[3] *Id.*

one or more of the three factors, regardless of the weightings, would clearly meet the internal consistency test. For example, if all jurisdictions used a single factor formula, all business income would be taxed and no more.

External consistency requires "that the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated."[4] Undoubtedly, all activities of a unitary business contribute something to the realization of its income.[5] Of course no apportionment formula could, or even attempts to, include all factors reflecting all activity. And a legal requirement to do so would certainly defeat the usefulness of formulary apportionment as a "rough approximation."[6] Even the UDITPA three-factor formula includes only three types of taxpayer activity: property, payroll and sales. These three factors do not exhaust the entire set of factors arguably relevant to the production of income. And none of these three factors is included in its entirety.[7] Yet, the Supreme Court has acknowledged that the "[t]he standard three-factor formula can be justified as a rough, practical approximation of the distribution of either a corporation's sources of income or the social costs which it generates."[8]

The Supreme Court also recognized that "[s]ome methods of formula apportionment are particularly problematic because they focus on only a small part of the spectrum of activities by which value is generated."[9] Nonetheless, even a single factor formula provides a reasonable "rough approximation" of income attributable to a state, and the Supreme Court has "generally upheld the use of such formulas…"[10] Most state's apportionment formulas fall somewhere on a continuum between the relatively robust spectrum of activity included in a three-factor formula and the more circumspect spectrum of activity included in a single factor formula.

Any formula, whether a single sales formula or the "benchmark" UDITPA three-factor formula, will occasionally over-reflect or under-reflect income attributable to a state for a particular taxpayer. To be sure, the more narrow the spectrum of activity included in an apportionment formula, the more likely the formula will fail to reflect particular taxpayers' activity in the taxing state. But the Supreme Court held in *Hans Rees'* that "when the [jurisdiction] has adopted a method *not intrinsically arbitrary*, it will be sustained until proof is offered of an unreasonably and arbitrary application *in particular cases*."[11] Indeed, the Court has "on occasion found the distortive effect of focusing on only one factor so outrageous *in a particular case* as to require reversal."[12] As long as the formula is not "intrinsically arbitrary", it

[4] *Id.*
[5] See, e.g., *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123, 133 (1931)
[6] *Id.* at 271. *See also,*
[7] The property factor excludes intangible property; the payroll factor may exclude independent contractors; and the sales factor reassigns sales made to the U.S. government on the basis of origination rather than destination.
[8] *General Motors Corp. v. District of Columbia*, 380 U.S. 553, 561 (1983).
[9] *Container Corporation* at 170.
[10] *Id.*, *citing to Moorman Mfg. Co. v. Bair, supra* (upholding a single sales factor formula and its application to a specific taxpayer); *Underwood Typewriter Co.* v. *Chamberlain*, supra (upholding a single property factor formula, which did not include intangible property, and its application to a specific taxpayer). *See also, Hans Rees' Sons, Inc.* v. *North Carolina, supra* at 134 (holding a single tangible property factor to be "fair on its face," but rejecting its application to a specific taxpayer in a particular case as distortive.)
[11] *Id.* at 133 (emphasis added)
[12] *Container Corporation, supra at* 182-183; *referring to Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell, supra*.

will be applied unless, with respect to a particular taxpayer, it is "out of all appropriate proportion to the business transacted by the [taxpayer] in that State." [13]

In *Container*, the Court also addressed the weighting of various factors. It recognized that, with the three-factor equal-weighted formula, the relationship between the activity reflected by a particular factor and the income that activity generates is assumed to be roughly the same for the included factors: "The three-factor formula … is based in part on the very rough economic assumption that rates of return on property and payroll – as such rates of return would be measured by an ideal accounting method that took all transfers of value into account – are roughly the same in different taxing jurisdictions."[14] But a state may also – constitutionally – reach a policy conclusion that including of property, payroll, and sales in equal proportion would not be the best reflection of relative rates of return attributable to the various factors and the state.

2. Dormant Commerce Clause

The dormant commerce clause prohibits taxation that results in "discrimination against interstate or foreign commerce."[15] And the Supreme Court has long-identified the potential for multiple taxation as the essence of discrimination and burden on interstate commerce.[16] The dormant commerce clause might have been construed to impose a requirement on the states that the combination of different state apportionment formulas never result in a tax burden higher than what the taxpayer would have incurred if its business were limited to any one of the jurisdictions in which it operates. But in *Container*, the Supreme Court acknowledged that "at least in the interstate commerce context … the antidiscrimination principle has not in practice required much in addition to the requirement of fair apportionment." [17]

B. Policy Considerations

As uniform apportionment developed, the policy issue of the day was whether the model formula should include property, payroll, and sales, or just property and payroll. Of course, ultimately, the model formula included all three factors. In 1957, William J. Pierce, who was one of the original UDITPA drafters, noted that "[t]he uniform act appears to be equitable in that it represents a compromise between the positions of consumer and manufacturing states."[18] But in 1964, the Special Subcommittee on State Taxation of Interstate Commerce of the house Committee on the Judiciary (the "Willis Committee ") disagreed and "evoked a storm of virtually unanimous protest" from the states when it recommended federal legislation imposing only a two-factor equal-weighted formula that included property and payroll, but no sales.[19] Professor John Swain explains that "[t]he Willis Committee's recommendation to abandon the

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[13] *Hans Rees' Sons v. North Carolina ex rel. Maxwell,* 283 U. S. at 135.
[14] *Id.* at fn. 20.
[15] *Container Corporation, supra at 170, citing Mobil Oil Corp., supra,* at 444.
[16] *Japan Line, Ltd.* v. *County of Los Angeles,* 441 U.S. 434, 444 - 448 (1979).
[17] *Container Corporation, supra at* 170-171. See also *Japan Lines.*
[18] William J. Pierce, *The Uniform Division of Income for State Tax Purposes*, Taxes, the Tax Magazine (October, 1957; Vol. 35, No.10)
[19] John Warren, *UDITPA – A Historical Perspective,* 38 State Tax Notes 133 (2005).

sales factor was based largely on considerations of administrative convenience and costs of compliance."[20]

> Several economists testified before the committee that market states do not have a legitimate claim to tax the income of businesses merely selling, but not producing products within their borders. The opposing point of view, which also has been expressed by public finance experts, is that demand is as necessary as supply in the creation of income, and that governments in market states are entitled to extract a tax from sellers in the marketplace that they foster.

Id. at 12.

And Professor Swain cites to Peggy Musgrave, who concludes that, from an economic perspective, there is no definitive answer as to whether sales should be included in an apportionment factor.

> Either of two approaches can be taken … The first is a supply approach which says that income has its source where the factor services which generate that income operate, a concept of value added at origin. The second is a supply-demand approach which holds that market value is created through interplay of supply and demand, by both blades of the Marshallian scissors… There seems to be no straightforward economic basis for choosing between the two or for assigning respective weights under the supply-demand approach.

Id. at 12-13*; citing to* Peggy B. Musgrave, *Principles for Dividing the State Corporate Tax Base*, in THE STATE CORPORATE INCOME TAX 234 (Charles E. McLure, Jr., ed. 1984)

Over the years, the debate has shifted from whether sales should be included to the weight it should be given. As shown above, the states have been moving toward more heavily weighted sales. The impetus for this trend is two-fold. First, there is a desire to at least equalize the recognition given to market vs. production states. An equal-weighted formula assigns greater value to the contributions of the production state relative to the market state because two of the three factors – property and payroll, are intended to reflect the factors of production. When a state double weights the sales factor, it is giving equal weight to the contributions of the production and market states. Second, some states have chosen to emphasize the sales factor, and de-emphasizes the property and payroll factors, to encourage taxpayers to move property and payroll (i.e., investment and jobs) to their state. Of course, if all states employed the same single-sales weighting, the comparative advantage for any particular state would disappear.

As the movement intensifies, despite acceptance by the U.S. Supreme Court, some authors have criticized the single sales factor formula that results when the trend is taken to its extreme:

[20] John A. Swain, *Reforming the State Corporate Income Tax: A Market State Approach to the Sourcing of Service Receipts* (April 25, 2008). Arizona Legal Studies Discussion Paper No. 08-02; Tulane Law Review, 2008. Available at SSRN: http://ssrn.com/abstract=1108087, Available at: http://works.bepress.com/john_swain/1 (2008)

> The three-factor formula based on payroll, property, and sales probably does fairly well at reflecting where income is earned, whether or not sales are double-weighted. By comparison, it is obvious that sales-only apportionment generally does not reflect where income is earned; it would be an unusual economic activity in which neither payroll nor property played a significant role in the creation of income. Indeed, I believe that any weight on sales greater than 50 percent is likely to be too great.

Charles McLure; *A Comprehensive and Sensible UDITPA*; State Tax Notes (Sept. 26, 2005)

John Warren, who represented California during the original drafting of UDITPA, recently wrote that:

> [T]he biggest setback to what UDITPA has accomplished is the growing tendency of states to seek a competitive edge in the business location market by changing the apportionment to overweight the sales factor or even make it a single factor. To me, there is a right way and a wrong way to apportion income. You should do it the right way; if you want to adjust the tax burden, you can do it by adjusting the tax rates. That's the only way you can attain fairness between local businesses and multistate businesses.

John S. Warren, *UDITPA—A Historical Perspective*, 38 State Tax Notes 133 (2005).

IV. Options

A. Re-commit to the current factor weighting

Art.IV.9 All business income shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

B. Double weight the sales factor

Art.IV.9 All business income shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus two times the sales factor, and the denominator of which is ~~three~~ four.

C. Single sales factor

Art.IV.9 All business income shall be apportioned to this State by multiplying the income by a ~~fraction, the numerator of which is the property factor plus the payroll factor plus the~~ sales factor~~, and the denominator of which is three~~.

D. Model alternative factors

Some have suggested the model list optional alternative weightings as an acknowledgement of states' differing tax policy philosophies on factor weighting.

Attachment A

STATE APPORTIONMENT OF CORPORATE INCOME

(Formulas for tax year 2011 -- as of January 1, 2011)

ALABAMA *	3 Factor	NEBRASKA	Sales
ALASKA*	3 Factor	NEVADA	No State Income Tax
ARIZONA *	Double wtd Sales/80% Sales, 10% Property & 10% Payroll	NEW HAMPSHIRE	Double wtd Sales
		NEW JERSEY	Double wtd Sales
ARKANSAS *	Double wtd Sales	NEW MEXICO *	3 Factor/Double wtd. Sales
CALIFORNIA *	Sales/Double wtd Sales (1)	NEW YORK	Sales
COLORADO *	Sales	NORTH CAROLINA *	Double wtd Sales
CONNECTICUT	Double wtd Sales/Sales	NORTH DAKOTA *	3 Factor
DELAWARE	3 Factor	OHIO	Triple Weighted Sales (4)
FLORIDA	Double wtd Sales	OKLAHOMA	3 Factor
GEORGIA	Sales	OREGON	Sales
HAWAII *	3 Factor	PENNSYLVANIA	90% Sales, 5% Property & 5% Payroll
IDAHO *	Double wtd Sales		
ILLINOIS *	Sales	RHODE ISLAND	3 Factor
INDIANA	Sales	SOUTH CAROLINA	Double wtd Sales/Sales (5)
IOWA	Sales	SOUTH DAKOTA	No State Income Tax
KANSAS *	3 Factor/Sales	TENNESSEE	Double wtd Sales
KENTUCKY *	Double wtd Sales	TEXAS	Sales
LOUISIANA	Sales	UTAH	3 Factor/Double wtd Sales
MAINE *	Sales	VERMONT	Double wtd Sales
MARYLAND	Sales/Double wtd Sales	VIRGINIA	Double wtd Sales
MASSACHUSETTS	Double wtd Sales	WASHINGTON	No State Income Tax
MICHIGAN	Sales	WEST VIRGINIA *	Double wtd Sales
MINNESOTA	90% Sales, 5% Property, & 5% Payroll (2)	WISCONSIN *	Sales
		WYOMING	No State Income Tax
MISSISSIPPI	Sales/Other (3)	DIST. OF COLUMBIA	3 Factor
MISSOURI *	3 Factor/Sales		
MONTANA *	3 Factor		

Source: Compiled by FTA from state sources.

Notes:
The formulas listed are for general manufacturing businesses. Some industries have a special formula different from the one shown.
* State has adopted substantial portions of the UDITPA (Uniform Division of Income Tax Purposes Act).
Slash (/) separating two formulas indicates taxpayer option or specified by state rules.
3 Factor = sales, property, and payroll equally weighted.
Double wtd Sales = 3 factors with sales double-weighted
Sales = single sales factor

(1) Beginning with the 2011 tax year, California taxpayers may elect to use a single sales factor.
(2) Minnesota is phasing in a single sales factor which will reach 100% in 2014.
(3) Mississippi provides different apportionment formulas based on specific type of business. A single sales factor formula is required if no specific business formula is specified.
(4) Formula for franchise tax shown. Department publishes specific rules for situs of receipts under the CAT tax.
(5) Taxpayers are allowed only 80% of the reduced taxes from a single sales factor.

FEDERATION OF TAX ADMINISTRATORS -- MARCH 2011