Survey of Member States Regarding Possible Changes to MTC Equitable Apportionment Regulation IV.18.(a).

1. Does your state currently have Model Regulation IV.18.(a) in force and effect?

Alabama: yes
California (FTB): yes
Connecticut: no
Kansas: yes
Michigan: no
New Mexico: yes
North Carolina: no
North Dakota: yes
Oregon: no
South Carolina: no
Tennessee: yes
Texas: no
Washington: no

California's comments:
California Supreme Court in *Microsoft Corp. v. Franchise Tax Board* refused to limit the application of this section.

Michigan's comments:
Michigan has a new tax for 2008, the Michigan Business Tax, which apportions tax bases using a single sales factor, and sources sales of services where the benefit of the service is received. Nevertheless, the MBT retains a provision comparable to Article IV.18, providing for alternative methods of apportionment. MCL 208.1309.

North Dakota's comments:
However, North Dakota has not adopted the two paragraphs following the four bulleted items

Oregon's comments:
Oregon adopted the model regulation at the time it was adopted by the MTC. The regulation was repealed following a statute change in 1999 because it did not add anything beneficial to the statute. The statute was changed to remove language that required there be a "violation of the taxpayers rights under the state or U.S. Constitution" in order to use an alternate apportionment under Section 18.

Tennessee's comments:
TCA Section 67-4-2014 and 67-4-2112

Texas' comment:
These provisions do not apply to the Texas Franchise Tax. Texas has no recommendations on possible amendments to the regulation.

Washington State's comments: Washington does not have a state income tax. Under Washington, apportionment is allowed by either separate accounting (the preferred method or cost apportionment. RCW 82.04.460(1). Washington's rule (WAC 458-20-194) specifies certain separate accounting methods as well as a method of allocating costs if cost apportionment is used. When using cost apportionment, the Rule uses many of the principles of UDITPA to allocate costs. Washington requires taxpayers and the Department to prove by clear and convincing evidence that the apportionment method in our rule does not fairly represent the activities of the taxpayer before an alternative method may be used. (do we need to say specifically what methods we allow?) or what are language is?

2. Should the regulation's current restriction of Section 18 adjustment provisions to cases with "unusual" factual situations be clarified or eliminated?

Alabama: yes
California (FTB): yes
Connecticut: yes
Kansas: yes
New Mexico: no
North Carolina: yes
North Dakota: yes
Oregon: yes
South Carolina: yes
Tennessee: yes

California's comments:
Even after *Microsoft*, this still seems to create some confusion.

Michigan's comments:
Not applicable to Michigan under the MBT. Since Michigan now has a market-based apportionment formula that is different than that set forth in UDITPA, Michigan favors permitting alternative apportionment methods only under very narrow and well-defined circumstances. Even under Michigan's previous Single Business Tax, however, alternative apportionment methods were rarely, if ever, permitted.

North Dakota's comment:
Eliminated.

Oregon's comments:
The change should be made with caution to ensure that taxpayers are being treated equally. For example, give express guidance on how a taxpayer will be "allowed or permitted" to use alternate apportionment. There may be difficulties in defining what distortion is, an option may be to characterize the types of results that are acceptable. The *Twentieth Century Fox*[1] case gives some guidance regarding why the standard formula may not work for traditional non-mercantile or non-manufacturing types of

businesses. The case also lists criteria for determining when alternate apportionment should be used, to reflect the economic reality, to fairly represent business activity in the state and when it does not encourage lack of uniformity among UDITPA states. The *Pacific Coca-Cola*[2] case brings out another criterion to use and that is to look at exactly what is the business activity taking place in the state.

Tennessee's comments:
Perhaps apply it only on the INCONGROUS RESULTS concept

3. Should the regulation's provisions be amended to clarify that adjustment on a case-by-case basis may be made even where the factual situation giving rise to the distortion is common to an entire business sector or common activity, e.g., factoring accounts receivables or sales of short-term investments?
Alabama: yes
California (FTB): yes
Connecticut: no
Kansas: no
New Mexico: no
North Carolina: yes
North Dakota: no
Oregon: yes
South Carolina: yes
Tennessee: yes
Washington: yes

Michigan's comments:
Not applicable to Michigan under the MBT. Even under the previous SBT, however, alternative apportionment methods were rarely, if ever, permitted.

New Mexico's comment:
I think that the States need to take a uniform and consistent approach according to the industry.

Oregon's comments:
The regulation should not restrict a state's ability to make case-by-case determinations. Whenever possible, regulations should be adopted to address entire business sectors or common activities, but a state should not be precluded from making such an adjustment just because it affects many taxpayers. Specifically, rules for service based businesses should be considered because UDITPA was adopted with a focus on manufacturing types of business.

Tennessee's comments:

Yes – if the standard appt gives INCONGROUS results, that should be enough. Perhaps 3-5 good normal examples should be used to explain that boundary.

4. Should the regulation be amended to specify that case- by-case adjustment may be made only in the case of *gross* distortions of business activity?

Alabama: no
California (FTB): no
Connecticut: yes
Kansas: yes
Michigan: yes
New Mexico: no
North Carolina: yes
North Dakota: no
Oregon: no
South Carolina: no
Tennessee: yes
Washington: yes

California's comments:
See below. Gross distortion is the constitutional standard for finding an apportionment method unconstitutional. The *Microsoft* Court held the statute is not limited to constitutional infirmities.

Michigan's comments:
The MBT provides that the act's apportionment provisions are rebuttably presumed to fairly represent the taxpayer's business activity in this state, unless the taxpayer can demonstrate that its attributed business activity is "out of all appropriate proportion to the actual business activity transacted in this state and leads to a grossly distorted result . . . ." MCL 208.1309(3). The previous SBT contained a substantially similar provision.

New Mexico's comment:
I think that there can be other situations which requires modification of the factors. Distortion is only one situation**.**

North Dakota's comment:
With respect to items (4.) and (5.), the use of the terms gross or moderate does not eliminate the subjective interpretations of those two terms. In other words, the amendment would not eliminate the arguments, it just shifts the arguments.

Oregon's comments:
There is still an overarching constitutional standard that must be adhered to. Again, we feel that a state's ability to make adjustments under the statute should not be constrained by a regulation. With the ever changing business landscape, states need this provision to be as flexible as possible. If this were to be done, the term "gross" would need to be defined which could be problematic.

South Carolina's comments:
Comment to 4 and 5 – Adjustment should be allowed where the distortion is not unconstitutional. Saying "gross" or "moderate" just adds another issue about the meaning of those terms without adding any certainty or direction. Judges would likely define gross or moderate depending on their opinion of "fairness."

Tennessee's comments:
Certainly a case-by-case application should be made.

5. Should the regulation be amended to specify that case-by-case adjustment may be made even where the distortion of business activity is only moderate?
Alabama: yes
California (FTB): yes
Connecticut: no
Kansas: no
Michigan: no
New Mexico: no
North Carolina: yes
North Dakota: no
Oregon: no
South Carolina: no
Tennessee: no
Washington: no

California's comments:
If meant to reflect an analysis based on a percentage change in the apportionment factor, this would be improper because under California case law, the application of this provision is a qualitative determination rather than a purely quantitative one and any distinction between gross vs. moderate percentages of change is not determinative**.**

Michigan's comments:
See above; Michigan's current statute is more narrow, as was the similar provision under the SBT.

North Carolina's comments:
"gross distortion" would present a problem if not defined as does our "true net income in North Carolina"

Oregon's comments:
Same as #4, except that "moderate" would need to be defined.

South Carolina's comments:

Comment to 4 and 5 – Adjustment should be allowed where the distortion is not unconstitutional. Saying "gross" or "moderate" just adds another issue about the meaning of those terms without adding any certainty or direction. Judges would likely define gross or moderate depending on their opinion of "fairness."

Tennessee's comments:
Well, at that point, it seems the regulation becomes a standard appt provision – if 'churning' for example is the target, shouldn't a requirement be placed in the sales factor to never allow 'return of principal' as sales.

Washington State's comments:
Washington believes that deviations from the specified method of apportionment should be very rare.

6. Is there a need to broaden the regulation to better enable Section 18's use in countering tax planning techniques?
Alabama: yes
California (FTB): no
Connecticut: no
Kansas: no
New Mexico: yes
North Dakota: no
Oregon: yes
Tennessee: yes
Washington: yes

California's comments:
Section 18 is designed to address apportionment issues, not the calculation of income. If the tax planning opportunity would result in odd apportionment results, the provision already applies.

Michigan's comments:
Not applicable to Michigan. Under the MBT, Michigan follows unitary principles and has mandatory combined reporting for unitary business groups, both of which are intended to curtail the use of tax planning techniques. Under the SBT, Michigan rarely, if ever, permitted alternative apportionment methods.

New Mexico's comment:
Probably yes, but I can't think of improved wording. We have a problem with using separate corporate entity filing methods and not picking up our fair share of tax at times.

North Carolina's comments:
Wouldn't making the changes in 1-5 do that anyway?

North Dakota's comments:

Any amendment would have to clearly define what "tax planning" techniques would be unavailable.

South Carolina's comments:
Possibly. It can now be used to counter some tax planning techniques. If it can be improved in that way without destroying its benefit to taxpayers who deserve relief, then it's a good idea.

Oregon's comments:
Taxpayers are constantly changing the way they do business and have many opportunities for tax planning. This regulation should not stop a state from making a fair adjustment just because it is a normal occurrence in an industry. Oregon has not had the limits of the MTC model regulation for many years; we are cautious in our application of Section 18 (ORS 314.670 in our law) and do not think it is being abused by industry either. We do receive requests for alternate apportionment; we approve some and reject others based on the specific facts and circumstances presented and whether the change "fairly represents" the taxpayer's business activity in Oregon. Criterion or desired outcomes that can provide guidance for the term "fairly represents" may be beneficial.

Washington State's comments:
To the extent that tax planning lacks economic substance.

7. Should the regulation be amended to specifically address possible distortion from sales throw-out and sales throw-back situations?
Alabama: no
Kansas: no
California (FTB): yes
New Mexico: no
North Carolina: no
North Dakota: no
Oregon: yes
South Carolina: no
Tennessee: yes

California's comments
Purpose of throw-out and throw-back is to address nowhere income. This is also an inherent aspect of fair representation and should be carved out from adjustment under section 18.

Connecticut's comment: N/A

Oregon's comments:
We think that this ability is within the realm of the statute so more guidance would be helpful. How does it work if an alternative apportionment does the opposite of another statute? For example, under UDITPA all sales made to the U.S. government that originate

in a state are sourced to that state unless specifically included in another state's apportionment. Do states have the authority to change that on a case by case basis if such sourcing of sales does not fairly represent the business activity in a state?

Tennessee's comments:
But - not applicable in our state. Tenn. did not adopt throw-back, but we have never made any adjustment for it in any regard or circumstance.

8. Should the regulation be amended to specify that the party seeking relief has the burden of proof to show that current formula does not fairly reflect business activity and that an alternative formula is better?
Alabama: yes
California (FTB): no
Connecticut: yes
Kansas: no
Michigan: yes
New Mexico: yes
North Carolina: yes
North Dakota: yes
Oregon: no
South Carolina: no
Tennessee: yes
Washington: yes

California's comments
The standard rule in tax cases is that the taxpayer always bears the burden of proof because it holds all the evidence. Under *Microsoft*, however, the Court held that (1) the party seeking relief has the burden of proof to show the formula does not fairly represent business activity, and (2) that the alternative method chosen is reasonable. However, in application, the Court deferred to the alternative chosen by the Franchise Tax Board rather than applying a burden of proof to this issue. Therefore, it appears that the alternative method used by the tax agency may be presumed reasonable and that the method chosen is disturbable on review only for an abuse of discretion. Therefore imposing the burden in two pieces, as proposed, may be inconsistent with California law following *Microsoft*.

Michigan's comments:
Michigan's current statute has a provision similar to this statement, as did the previous SBT; see answer to Question 4, above.

New Mexico's comment: Yes, as this can be the taxpayer or the Department.

Oregon's comments:
Burden of proof may be an inappropriate concept since it contemplates a third party, typically a court, rendering a decision rather than the department (one of the two parties).

If litigated, each state's own statutes will govern how the burden is dealt with. For purposes of the rule and the initial determination, the state or taxpayer should bear the burden of demonstrating the need for an alternate apportionment method. The regulation should require a rationale, reason or explanation and enough information to support the claim of distortion. The party seeking relief should also be required to demonstrate that the alternative more "fairly represents" their business activity.

Again, the *Twentieth Century Fox* case gives guidance on who bears the burden of proof (the party seeking to use the alternate apportionment), at least in Oregon.

Tennessee's comments:
It wouldn't be bad to have some type of objective computational measure. Whether a certain % value triggers the application or not, is hard to say. But we know, subjective applications are difficult.

Washington State's comments: As explained above this is the position that Washington has taken in its apportionment rule (WAC 458-20-194).

9. Should the regulation continue to impose restrictions on when and how Section 18 may be invoked?
California (FTB): yes
Connecticut: yes
Kansas: yes
Michigan: yes
Tennessee: yes
New Mexico: yes
North Carolina: no
North Dakota: yes
Oregon: no
Washington: yes

Alabama's comments:
Don't understand the question. The purpose of the regulation is to provide guidance as to the appropriate use of Section 18.

California's comments:
If referring to procedure, taxpayers should be required to put the tax agency on notice that an alternative methodology is being requested, whether by petitioning for relief or otherwise.

Michigan's comments:
Under the former SBT, Michigan favored a consistent approach to apportionment. Alternative apportionment methods were rarely, if ever, permitted, and the burden for proving entitlement to an alternative method was statutorily set very high.

North Carolina's comments:
Not beyond distortion of income earned in the state

Oregon's comments:
Oregon currently has no restrictions and it has not been a problem to date. Guidelines on the process to request or impose alternative apportionment and appeal rights could help provide boundaries for use of Section 18 without restrictions.

South Carolina's comments: Amend them if they are maintained.

Tennessee's comments:
Yes – and clearly there are times when the state could enact it to collect more tax, and doesn't, but that is not the sole measure.

10. Are there additional amendments that you believe should be made to clarify or change the current model regulation?
Alabama: no
California (FTB): yes
Kansas: no
Michigan: no
New Mexico: no
North Carolina: no
Oregon: no
Tennessee: no
Washington: no

Alabama's comments: Not at this time

California's comments: Clarify that section 18 relief is available only for apportionment questions rather than calculation of income.

Michigan's comments:
The underlying concern seems to be that the UDITPA apportionment methodology often fails to reflect how income is generated in our current service-based economy. Using Article IV.18 more expansively (and thus, broadening Regulation 18a) to help remedy that problem is, at best, a stop-gap measure. The focus should continue to be on more comprehensive changes to the underlying apportionment methodology.

Tennessee's comments:
It seems to have enough leeway, but is subjective and is always a difficult situation.

Additional comments:

From Kansas:

We want to continue to minimize the use of Section 18 and make it available only when the distortion produced by the standard apportionment methodology rises to the level that constitutional protections would mandate relief.

From North Carolina:
NC has different statutory guidelines for the State and for taxpayers. If the Secretary finds that a return doesn't reflect true earnings in NC, we can make adjustments, such as force combination of separate entities. If a taxpayer believes that the statutory apportionment formula operates or will operate so as to subject it to taxation on a greater portion of its income than is reasonably attributable to business or earnings within the State, it may file a petition with the Secretary of Revenue for permission to use an alternative method. We have extensive rules for this process, some of which were taken from section 18. (see our Administrative Code at http://reports.oah.state.nc.us/ncac/title%2017%20-%20revenue/chapter%2005%20-%20corporate%20franchise,%20income,%20and%20insurance%20taxes/subchapter%20d/17%20ncac%2005d%20.0114.html)

From North Dakota:
North Dakota strictly audits and assesses using what we like to call "the gold standard" – the equally weighted three factor formula. The only instance in North Dakota has applied Section 18 in the past is when countering taxpayers' refund claims based on the cost of performance rules.

From Oregon:
Oregon, in a way, has been able to experiment with a relaxed the Section 18 regulation – we've operated without it since 1999, yet we have kept and used the broader provisions of Section 18 from the compact in our statutes, with almost no notable concerns. Granted we haven't pushed the boundary too hard, but we haven't seen taxpayers substantially abuse the broader ability to request alternative apportionment either.
Several states are hearing from taxpayers that want to use the three factor formula (in the Multistate Compact) over the single sales factor (or other super weighted sales factor) despite a statute that requires otherwise (see ORS 314.606). Though this issue has not been raised under Section 18 (that we're aware of), and is based on interpretation of original compact and state's ability to deviate from the compact, it is an issue involving a dispute about apportionment, and taxpayers wanting another apportionment factor. Any changes to our regulation for Section 18 should be cognizant of this growing issue, and whether our changes impact it in any way.

From Tennessee:
Our state has as much or more problems with sourcing Intangible Income – ie Investment Income, such as Interest and the gain/loss on sales of investments and sale of p'ship interests etc. The Cost of Performance method doesn't really lend itself to these income items, and on a all or nothing basis leads to some very inequitable results.

From Wisconsin:

Wisconsin has not adopted this MTC model regulation, so I don't feel it appropriate for me to complete the survey form. However, for your information, we have s. 71.25(11), Wis. Stats. (2005-2006) that provides us with similar authority.