

Multistate Tax Commission



EUGENE F. CORRIGAN, Executive Director

July 2, 1983

TO: Tax Administrators of all Member and
Associate Member States

FROM: Gene Corrigan

RE: Agenda of July 11 Meeting of Executive Committee

You have previously been notified that all of you will be welcome to attend this meeting, which will begin at 1:30 P.M. The Agenda for the meeting will be:

1. Approval of Prior Minutes (enclosed)
2. Report of Finance Committee
3. Budget
4. Airline Regulation
5. Nebraska Litigation Matter
6. Dexter Status
7. State Consistency
8. Potential Litigation
9. Public Law 91-569 re Employees of Interstate Carriers
10. Possible Amendment to Pension Plan re Loans to
Participants
11. Miscellany

Please call me if you would like any other matter added to the Agenda.

Enclosed please find a updated Agenda for the Four-Day Annual Meeting.

AIRLINE REGULATIONS

July 12, 1983

TO: EXECUTIVE COMMITTEE
FROM: GENE CORRIGAN
RE: AIRLINE REGULATION

I submit to you herewith a Proposed Airline Regulation for your consideration.

The process of developing this regulation has been pursued off and on for some seven or eight years. On March 22, 1978, a hearing on a prior draft was conducted. At that time, in response to a request from William Hawkins, of the Air Transport Association (ATA), I volunteered to pursue further consideration of certain aspects of the proposal then being considered. That response was reflected in the Hearing Officer's report. I did so with the expectation that the airlines, who were then complaining that the regulation then under consideration improperly relied upon terminal statistics, would recommend a formula which was better suited to attributing their income among the states in which they do business.

The results of extensive additional consultation with the ATA over the past few years plus another public hearing on December 6, 1982 and a hearing before this Committee on March 8 of this year have been highly unsatisfactory. They have consisted of a small retreat, on February 11, 1981, by the airlines from their former insistence that so-called "line-haul" factors (i.e. revenue passenger miles or flight time) alone be the basis for apportionment to a position that airtime should constitute eighty percent of the basis and that ground facilities, as reflected through departures, should constitute the remaining twenty percent. They have hardly budged from that position in two years. Furthermore, their lack of candidness in refusing to acknowledge that the airtime approach defeats the full attribution purpose has been, to say the least, frustrating.

The airlines believe that the states have been equally intransigent in maintaining that all of their income should be attributable somewhere. Indeed, the airlines have attacked the validity of my contention that that is even the position of the states.

Throughout our conferences, the airlines have maintained that any formula which the states were considering would produce an unfair and unreasonable result. For my part, I have continually invited the airlines to suggest an alternative formula which would better accomplish a fair and reasonable attribution of their income

among the states in which they do business. They have refused to submit anything other than the 80-20 proposal referred to above, except for their original 100% airtime proposal. At the March 8 meeting of this Committee, the Chairman again invited them to submit such an alternative formula. They have not done so.

The problem with the airtime proposal is that the airlines want to include all of their airtime in the denominator of their factors but that they would exclude from the numerators of most states, even many of the states in which they admittedly do business, so-called flyover airtime. The result is that much of their income is not attributable to any state or other jurisdiction. We typically refer to such income as "nowhere income." For the purposes of this document, I refer to it as "extra-terrestrial" or "E.T." income.

Over the years, moreso in earlier years than in later ones, some states have, for lack of a better alternative, accepted the linehaul formula. Increasing sophistication on the part of state tax administration personnel has resulted in increased dissatisfaction with that formula. Yet, the states have had great difficulty in arriving at agreement on a formula which would be fair, reasonable and workable. Their efforts appear to have been consistently thwarted by the insistence of the airlines that any fully terrestrial formula, i.e. one which would all airline income to some jurisdiction, would be demonstrably unfair and unreasonable because it would attribute to governmental units on the ground income which was earned in the air.

I do not represent that the proposed regulation presents a perfect means of attributing income. I do submit that it produces a reasonably approximate attribution of airline income in general whereas the airlines' proposal does not.

The proposal before you is identical with the one which was before you at the 1982 annual meeting except for the Safe Harbor Lease wording which has been added to the definition of "Original Cost" on the first page. At the 1982 meeting, first the Uniformity Committee and then this Committee recommended, despite my expressed concern that we not act too hastily, that the full Commission adopt the regulation. At the subsequent General Session, I again raised my objection partly out of concern that the Safe Harbor Lease wording should be added and partly out of a desire to allow the airlines to have their long-requested opportunity to talk directly with the Executive Committee.

It must be noted that the current proposal is far different from the 1978 proposal. While hewing closely to the fully terrestrial philosophy, it utilizes a weighted departure formula rather than terminal statistics such as ground time and originating and terminating tons. While it is a somewhat simplistic formula, it appears to accomplish its purpose as well as any other formula which has been considered.

Throughout the course of communications with the airlines through the ATA, I have remained cognizant of the fact that it is difficult for the ATA to speak on behalf of all of its members, particularly in the area of making concessions. Dave West has been candid and cooperative in all of his dealings with me.

Attached is an explanation of how the airline proposals and the proposal recommended here for approval would work.

EXPLANATORY ATTACHMENT RE AIRLINE INCOME ATTRIBUTION

In the following discussion, "E.T. income" refers to extra-terrestrial, or nowhere, income which is not attributed to any taxing jurisdiction; "E.T. 1," "E.T. 2," "E.T. 3" and "E.T. 4" refer to formulas which have the effect of producing extra-terrestrial or nowhere income; "F.T. income" refers to income all of which is attributed to some taxing jurisdiction on earth; and "F.T. 1" and "F.T. 2" refer to formulas which have the effect of attributing all income to some taxing jurisdiction on earth.

ASSUMED FACTS

Airline X flies planes into, out of, and between New York, Chicago and San Francisco. On some trips, it flies directly between New York and Los Angeles, a one-leg trip. On others it stops in Chicago and then continues on in the second leg of a two-leg trip. The trip is 2,000 miles, regardless of whether the Chicago stop is made. In both types of trips, the plane flies 20 miles from the New York airport to the New Jersey border, 100 miles over or in Illinois, and 120 miles from the Nevada border to the San Francisco airport.

Airline X has total ground payroll of \$1,000,000 in New York, \$1,000,000 in Chicago, and \$1,000,000 in San Francisco. It has total payroll, including flight crews, of \$5,000,000. It has \$10,000,000 invested (at cost) in ground facilities (property) in each of the three cities, and total property, including flight equipment, of \$100,000,000. Its total revenues for the year are \$50,000,000 and its net income is \$5,000,000.

E.T. 1

This is the original so-called "linehaul" formula favored by the airlines. Under it, all of an airlines revenue passenger miles (RPM's) are included in the denominator of a one-factor formula, but the only RPM's which are included in the numerator of a state's formula are those which are flown in a state by a place which lands there.

Under this approach, in the case of a two-leg trip, the attribution percentage calculation would be:

New York	Illinois	California	Total
20	100	120	
----- = 1%	----- = 5%	----- = 6%	12%
2,000	2,000	2,000	

But, in the case of a one-leg trip, the miles flown over Illinois would not be attributed to Illinois. Consequently, the total percentage of income attributed to all states would be only 7% for the one-leg trip and only 12% for the two-leg trip. The remaining income, 93% in the case of the one-leg trip and 88% in the case of the two-leg trip, would escape all state taxation.

E.T. 2

This formula illustrates the result of the first of three concessions which the airlines maintain that they have, after much disputation among themselves, made in an effort to take a middle position aimed at partially accommodating the states. It attributes flyover mileage to a state in which the airline actually operates, e.g. Illinois in the example. Under this approach, the airline in the example would attribute 5% of its income to Illinois on one-leg trips as well as on two-leg trips.

E.T. 3

This formula illustrates the result of the second of the concessions which the airlines claim to have made. It takes into account ground (i.e. airport) property and personnel in a three-factor formula in which property, payroll and revenue factors would be included but in which RPM's would determine the amount of flight equipment, of flight personnel, and of total revenue which would be included in the numerator of those factors. The airlines did not like this, but it was a concession.

Under this approach, the attribution percentage calculation would be:

	New York	Illinois	California	
Property:	$\frac{10,000,000}{100,000,000}$	$+$ $\frac{10,000,000}{100,000,000}$	$+$ $\frac{10,000,000}{100,000,000}$	= 33.3%
Payroll:	$\frac{1,000,000}{5,000,000}$	$+$ $\frac{1,000,000}{5,000,000}$	$+$ $\frac{1,000,000}{5,000,000}$	= 66.7%
Revenue:	1%	5%	6%	= <u>12.0%</u>
			$\frac{112}{3}$	= 37.3%

E.T. 4.

This formula illustrates the result of the third concession which the airlines have made in their final proposal. It treats ground equipment and personnel in the same manner as does E.T. 3, but it also takes a 20% portion of those items into account in a sub-formula to determine the revenue factor. The attribution percentage calculation would be:

Property:.....		.333
Payroll:667
Revenue: .20 x .333 (Prop.) + .20 x .667 (payroll)		
-----	+	
	2	
.80 x .12 (rev.) =		
		<u>.196</u>
		1.196

		3 + 39.7%

F.T. 1

Under this approach, which the MTC considered after the 1978 hearing, all of Airline X's income would be attributed among the three states which have taxing jurisdiction over the airline on the basis of total mileage flown in those three states, namely 240 miles, as follows:

New York	Illinois	California	Total
20	100	140	
--- = 8.33%	--- + 41.67%	--- = 50.00%	100.00%
240	240	240	

F.T. 2

The airlines objected strenuously to F.T. 1, maintaining that it resulted in unacceptable distortions. Subsequent liaison work with the ATA caused the MTC to seek an alternative approach in which the amount of required information would be reduced to a minimum. In doing so, it also sought to require only information that would be readily available and easily obtained. Toward that end, it considered alternatives which took into account not only RPM's but revenue ton miles, specific flight crew sizes and payrolls, landings and departures. Since all of these possibilities received consideration only within the context of the F.T. Concept, the airlines were always reluctant to participate in the effort; individual representatives of the airlines and of the ATA were concerned that they not become vulnerable to criticism from their cohorts for having contributed to the development or adoption of any F.T. approach.

The Executive Director gradually came to the conclusion that, within the F.T. concept, a weighted arrival and departure approach was adequate to produce a reasonable approximation of income attributable to each state. This conclusion was supported anonymously by some airline personnel. While other items could, of course, be taken into account, it appears that they would produce only insignificant variation in income distribution and would do so at the expense of a substantial complication of the calculation process and of a great increase in the effort required to make the income distribution determination; all of which amounted to an unjustified increase in the burdens placed upon both taxpayers and tax administrators.

Since each arrival is matched by a departure, the approach was further refined by taking into account only departures. Obviously, however, a small plane's departure should not have the same significance in the formula as does a large one's. Therefore, the formula now being proposed, F.T. 2, weights the departures by the cost of the particular type of plane.

The F.T. 2 approach assumes that payroll and revenue production will vary in roughly the same proportion as the cost of the plane.⁸ Obviously, this will not always be the case in specific instances. Nevertheless, the overall effect for a typical airline's total operations over the course of a year should be that F.T. 2 will accomplish the rough approximation required by Due Process. (One of the alleged infirmities of this formula is that it does not take into account revenue freight miles. Freight is an increasingly important item on passenger lines; yet the distortion, if any, appears not to be of great significance in distributing income of typical passenger lines among the states, and the airlines have refused to suggest anything which would be any more accurate within the fully terrestrial concept. In the case of specialty airlines and exclusively freight airlines, however, it may well be that additional formulas should be considered. This appears to be especially likely in the case of Federal Express because of the unique manner in which it operates: it flies all of its freight items to a central location at the Memphis airport from which it then re-ships them to their various destinations, and it does so all in the same day every day.)

The manner in which F.T. 2 is utilized is indicated in the Attachment to the Proposed Airline Regulation, which Attachment is entitled AIRLINE REGULATION EXAMPLES.

PROPOSED AIRLINE REGULATION

July 12, 1983

Reg. IV. 18.(e) Special Rules: Airlines. The following special rules are established with respect to airlines:

(1) In General. Where an airline has income from sources both within and without this state, the amount of business income from sources within this state shall be determined pursuant to IV. of the Multistate Tax Commission except as modified by this regulation.

(2) Apportionment of Business Income.

(i) General Definitions. The following definitions are applicable to the terms used in the apportionment factor descriptions.

A. "Value" of owned real and tangible personal property shall mean its original cost. (See Article IV.11. and Regulation IV.11(a).)

B. "Cost of aircraft by type" means the average original cost or value of aircraft by type which are ready for flight.

C. "Original cost" means the initial federal tax basis of the property plus the value of capital improvements to such property, except that, for this purpose, it shall be assumed that Safe Harbor Leases are not true leases and do not affect the original initial federal tax basis of the property. (See Regulation IV.11(a).)

D. "Average value" of property means the amount determined by averaging the values at the beginning and ending of the income year, but the (insert here the appropriate title of the administrative agency) may require the averaging of monthly values during the income year if such averaging is necessary to reflect properly the average value of the airline's property. (See Article IV.12. and Regulation IV.12.)

E. The "value" of rented real and tangible personal property means the product of eight (8) times the net annual rental rate. (See Article IV.11. and Regulation IV.11(b).)

F. "Net annual rental rate" means the annual rental rate paid by the taxpayer.

G. "Property used during the income year" includes property which is available for use in the taxpayer's trade or business during the income year.

H. "Aircraft ready for flight" means aircraft owned or acquired through rental or lease (but not interchange) which are in the possession of the taxpayer and are available for service on the taxpayer routes.

I. "Revenue service" means the use of aircraft ready for flight for the production of revenue.

J. "Transportation revenue" means revenue earned by transporting passengers, freight and mail as well as revenue earned from liquor sales, pet crate rentals, etc.

K. "Departures" means for purposes of these regulations all takeoffs, whether they be regularly scheduled or charter flights, that occur during revenue service.

(ii) Property Factor

A. Property valuation. Owned aircraft shall be valued at its original cost and rented aircraft shall be valued at eight (8) times the net annual rental rate in accordance with Article IV.11. and Regulation IV.11. The use of the taxpayer's owned or rented aircraft in an interchange program with another air carrier will not constitute a rental of such aircraft by the airline to the other participating airline. Such aircraft shall be accounted for in the property factor of the owner. Parts and other expendables, including parts for use in contract overhaul work, will be valued at cost.

B. The denominator and numerator of the property factor. The denominator of the property factor shall be the average value of all of the taxpayer's real and tangible personal property owned or rented and used during the income year. The numerator of the property factor shall be the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the income year.

In determining the numerator of the property factor, all property except aircraft ready for flight shall be included in the numerator of the property factor in accordance with Article IV.10.-.12, inclusive. Aircraft ready for flight shall be included in the numerator of the property factor in the ratio calculated as follows:

Departures of aircraft from locations in this state weighted as to the cost and value of aircraft by type compared to total departures similarly weighted.

(iii) The Payroll Factor.

The denominator of the payroll factor is the total compensation paid everywhere by the taxpayer during the income year. (See Article IV.13.-.14) The numerator of the payroll factor is the total amount paid in this state during the income year by the taxpayer for compensation. With respect to non-flight personnel, compensation paid to such employees shall be included in the numerator as provided in Article IV.13-.14. With respect to flight personnel (the air crew aboard an aircraft assisting in the operations of the aircraft or the welfare of passengers while in the air), compensation paid to such employees shall be included in the ratio that departures of aircraft from locations in this state, weighted as to the cost and value of aircraft by type compared to total departures similarly weighted, multiplied by the total flight personnel compensation.

(iv) Sales (Transportation Revenue) Factor.

The transportation revenue derived from transactions and activities in the regular course of the trade or business of the taxpayer and miscellaneous sales of merchandise, etc., are included in the denominator of the revenue factor. (See Article IV.1. and Regulation IV.1) Passive income items such as interest, rental income, dividends, etc., will not be included in the denominator nor will the proceeds or net gains or losses from the sale of aircraft be included. The numerator of the revenue factor is the total revenue of the taxpayer in this state during the income year. The total revenue of the taxpayer in this state during the income year is the result of the following calculation:

The ratio of departures of aircraft in this state weighted as to the cost and value of aircraft by type, as compared to total departures similarly weighted multiplied by the total transportation revenue. The product of this calculation is to be added to any non-flight revenues directly attributable to this state.

(3) Records. The taxpayer must maintain the records necessary to arrive at departures by type of aircraft as used in these regulations. Such records are to be subject to review by the respective state taxing authorities or their agents.

AIRLINE REGULATION EXAMPLES

Example #1: Assume the following facts for an airline for the tax year:

1. It has ten 747's ready for flight and in revenue service at an average per unit cost of \$40,000,000 for nine (9) of the aircraft. It rents the remaining 747 from another airline for \$9,000,000 per year. At eight times rents, the latter is valued at \$72,000,000 for apportionment purposes. Total 747 valuation is, therefore, \$432,000,000 for property factor denominator purposes.
2. It has twenty 727s ready for flight and in revenue service at an average per unit cost of \$20,000,000. Total 727 valuation is, therefore, \$400,000,000 for property factor denominator purposes.
3. It has nonflight tangible property (n.t.p.) valued at original cost of \$200,000,000.
4. It has the following annual payroll:

flight personnel	\$60,000,000
non flight personnel	40,000,000
Total	\$100,000,000
5. From its operations, it has total receipts of \$50,000,000, business net income of \$1,000,000 and no nonbusiness income.
6. It has the following within State X:
 - a. 10% of its 747 flight departures (\$43,200,000);
 - b. 20% of its 727 flight departures (\$80,000,000);
 - c. 5% of its nonflight tangible property (n.t.p.) (\$10,000,000); and
 - d. 15% of its nonflight personnel payroll (\$6,000,000).
7. State X has a corporate tax rate of 10%.

The airline's tax liability to State X would be determined as follows:

Property Factor:

$$\frac{43,200,000 \text{ (747s)} + 80,000,000 \text{ (727s)} + 10,000,000 \text{ (n.t.p.)}}{432,000,000 \text{ (747s)} + 400,000,000 \text{ (727s)} + 200,000,000}$$
$$= \frac{133,200,000}{1,032,000,000} = 12.9\%$$

Sales Factor

$$\frac{43,200,000 \text{ (747s)} + 80,000,000 \text{ (727s)}}{432,000,000 \text{ (747s)} + 400,000,000 \text{ (727s)}} = \frac{123,200,000}{832,000,000} = 14.8\%$$

Payroll Factor:

$$\frac{6,000,000 \text{ (nonflight)} + 8,880,000 \text{ (.148 x 60,000,000) (flight)}}{100,000,000} = \frac{14,880,000}{100,000,000} = 14.88\%$$

Average ratio - (Property, payroll and sales factors) =

$$\frac{.129 + .148 + .1488}{3} = \frac{42.156}{3} = 14.219$$

Taxable Income in State X: $.14219 \times \$1,000,000 = \$142,190$

Tax Liability to State X: $.10 \times \$142,190 = \$14,219.00$

Example #2: Same facts except that paragraphs 6 and 7 are changed to read:

6. It has the following within State Y:
 - a. 6% of its 747 flight departures (\$25,920,000)
 - b. 31% of its 727 flight departures (\$124,000,000)
 - c. 3% of its nonflight tangible property (\$6,000,000)
 - d. 7% of its nonflight personnel payroll (\$4,200,000)
7. State Y has a corporate tax rate of 6½%.

The airline's tax liability to State Y would be determined as follows:

Property Factor

$$\frac{25,920,000 \text{ (747's)} + 124,000,000 \text{ (727's)} + 6,000,000 \text{ (n.t.p.)}}{432,000,000 + 400,000,000 + 200,000,000} = \frac{155,920,000}{1,032,000,000} = 15.108\%$$

Sales Factor

$$\frac{25,920,000 \text{ (747's)} + 124,000,000 \text{ (727's)}}{432,000,000 + 400,000,000} = \frac{149,920,000}{832,000,000} = 18.019\%$$

Payroll Factor

$$\frac{4,200,000 \text{ (nonflight)} + 10,811,400 \text{ (i.e. } .18019 \times 60,000,000 \text{)(flight)}}{40,000,000 + 60,000,000} = \frac{15,011,400}{100,000,000} = 15.0114\%$$

Average Ratio

$$\frac{15.108 + 18.019 + 15.0114}{3} = \frac{48.1384}{3} = 16.046\%$$

Taxable Income in State Y: $.16046 \times \$1,000,000 = \$160,460$

Tax Liability to State Y: $.065 \times \$160,460 = \$10,430$