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## MEMORANDUM

To: Executive Committee, Multistate Tax Commission

From: Bruce Fort, Counsel, Multistate Tax Commission

Date: November 23, 2009

Subject: Proposed Amendment to Model Regulation IV.18.(a); Use of Equitable Apportionment Formulas

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On July 27, 2009, the Income Tax and Uniformity Subcommittee and the Uniformity Subcommittee both voted unanimously to recommend to the Executive Committee that a proposed amendment to the current regulation governing the use of Article IV, Section 18 be set for a public hearing.

The proposed amendment would replace a portion of the current model regulation on the use of equitable apportionment authority with new language which would arguably allow a broader field of operation for Art. IV, Section 18. The current model regulation limits the use of equitable apportionment to "...unusual fact situations (which ordinarily will be unique and non-recurring)... ." The amendment would remove that language but retain the requirement that Art. IV, Section 18 is to be invoked "only in limited and specific cases" where the application of the standard apportionment formula produces "incongruous results."

### A. Proposed Amendment:

Reg. IV.18.(a). Special Rules: In General. Article IV.18. provides that if the allocation and apportionment provisions of Article IV do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (1) separate accounting;
- (2) the exclusion of any one or more of the factors;
- (3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
- (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

[Article IV.18. permits a departure from the allocation and apportionment provisions of Article IV only in limited and specific cases. ~~Article IV.18. may be invoked only in specific cases where unusual fact situations (which ordinarily will be unique and non-recurring) produce incongruous results under where~~ the apportionment and allocation provisions contained in Article IV produce incongruous results.]

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

B. Purpose of the Proposed Amendment:

The proposed amendment would allow states (and taxpayers) more flexibility in invoking the equitable apportionment provisions of Article IV, Section 18 in situations where common business practices or particular business activities result in unfair reflection of business presence with a state under the standard apportionment formula. Fourteen states have a version of the current model regulation in effect (Nebraska has adopted the regulation's standard as a statute).

The Income and Franchise Tax Uniformity Subcommittee expressed general agreement that the current regulation may unduly impede the states from applying Section 18 in some circumstances where the state has not adopted a prior regulation covering specific factual circumstances or practices.

The regulation has been cited in several court cases in which taxpayers have attempted (so far unsuccessfully) to prevent the application of Section 18, by arguing that their factual circumstances or practices were not "unusual" or "unique and non-recurring." See *Microsoft Corporation v. California Franchise Tax Board*, 39 Cal. 4<sup>th</sup>. 750, 139 P.3d 1169 (2006)(upholding use of Section 18 authority despite taxpayer's position that treasury activities are not "unusual", "unique" or "non-recurring."); *Union Pacific Corp. v. Idaho*, 83 P.3d 116 (2004); See also, *In re Wal-Mart Stores, Inc.*, New Mexico Taxation and Revenue Department, Ad. Dec. & Order No. 06-07, [http://www.tax.state.nm.us/d&o/dno2006\\_07.pdf](http://www.tax.state.nm.us/d&o/dno2006_07.pdf).

The most recent case to consider the impact of the regulation is *Bellsouth Advertising & Publishing Co. v. Chumley*, Tenn. Ct. App., (8/26/09), in which the state of Tennessee applied Section 18 to assign receipts from Tennessee phone book advertising to the state, despite the fact that the phone books were printed elsewhere. <http://www.tsc.state.tn.us/OPINIONS/TCA/PDF/093/Bellsouth%20Advt%20Corp%20v%20Loren%20Chumley%20Opn.pdf>. (The taxpayer is expected to seek review in

the Tennessee Supreme Court.) In each case, the courts allowed the state to invoke its Section 18 authority to prevent distortion of the taxpayer's business presence in the state despite the restrictive language in the current regulation. The Subcommittee is concerned, however, that the regulation is not clear and the states cannot count on a favorable construction in every meritorious case.

#### D. Procedural History of the Project:

The idea of amending the current regulation was first presented to the Income and Franchise Tax Uniformity Subcommittee in March of 2007. The Subcommittee voted to consider the project proposal at its subsequent meeting.

In July of 2007, the Subcommittee voted to go forward with a study of the feasibility of amending the regulation. In November of 2007, the subcommittee voted to form a drafting/study group consisting of Wood Miller of Missouri, Leonore Heavey of Louisiana, Richard Cram of Kansas and Ted Spangler of Idaho.

In March of 2008, the Subcommittee discussed the project again and directed the drafting/study committee to prepare a policy and procedural checklist. That checklist was presented to the subcommittee in July of 2008. The Subcommittee then asked staff to prepare a survey of practices and preferences among the member states. The survey, issued in September of 2008, asked the states to detail their current practices concerning the use of equitable apportionment, asked whether the states would support an amendment, and asked for recommendations on what should be included in a proposed amendment.

The responses to that survey were received in October of 2008. Sixteen states responded, including the Compact states of Alabama, California, Kansas, New Mexico, Oregon and Utah. Seven states reported that they had the current model language in their regulations. All responding states agreed that the current model regulation could be construed as too restrictive on the use of Art. IV, Section 18 in some circumstances. There was no agreement, however, on the degree to which the regulation should be amended for clarity or for a greater use of "Section 18" authority, and there was no agreement on the best means for achieving that goal. The survey also revealed that the states had somewhat varying practices with regard to use of Section 18 authority, both on audit and via petition. The results of the survey were considered in a telephonic meeting of the Subcommittee held on October 22, 2008. The drafting/study group was instructed to prepare options for a proposed amendment to the model.

The Subcommittee considered five options for amendment to the current regulation put forth by the drafting/study group in November of 2008. The Subcommittee narrowed the choices to three and also requested that language be drafted incorporating procedural rules for petitioning for relief and a burden of proof.

The 3 remaining options were reviewed in the subcommittee in March of 2009. One proposal would have slightly relaxed the restrictions in the current regulation by removing the reference to “unique and non-recurring” factual circumstances. An intermediate proposal would have lifted the current regulation’s “limited and specific cases” restrictions, and the third proposal would have essentially eliminated any restriction on application of Section 18 authority beyond that found in the statute itself. The three new proposals did not contain any provisions related to procedural rules or burdens of proof because the drafting/study committee sought to simplify the options in order to gain a consensus, and the procedural rules did not seem critical for obtaining substantive uniformity in application of Article IV, Section 18. The Subcommittee divided its votes evenly between the most restrictive and least restrictive proposals. Some Subcommittee members explained they would like a “middle ground” but that the language of the intermediate proposal was unsatisfactory. Hence, they split evenly on their choice for second best. The Subcommittee asked staff to re-draft an intermediate proposal.

Two new proposals were considered by the Subcommittee in a telephonic conference held June 3, 2009. The teleconference produced spirited debate and discussion but no votes were taken. The Subcommittee chair asked that all states be prepared to vote for one of the two proposals at its next meeting scheduled for July of 2009. At the July meeting, the Subcommittee voted unanimously in favor of the proposal set forth above.<sup>1</sup>

#### E. Concluding Comments.

The proposal now before the Executive Committee retains the general standards in the current regulation in order to continue the states’ flexibility in applying Section 18 according to their prevailing practices. The language was also intended to signal the states’ agreement with the results in the previously-cited judicial decisions which have applied Section 18 appropriately to prevent distortion in a wide variety of circumstances notwithstanding the current regulation’s reference to “unusual factual circumstances.”

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The proposal which was rejected by the Subcommittee on July 27, 2009 provided: “Article IV.18 permits a departure from the allocation and apportionment provisions of Article IV only where unusual factual situations produce incongruous results under the apportionment and allocation provisions contained in Article IV.”