



## RESPONSE OF THE MULTISTATE TAX COMMISSION ON UDITPA ISSUES TO CONSIDER FOR REVISION

### I. Summary Remarks

Thank you for the opportunity to comment on the Drafting Committee's list of UDITPA issues. Our comments reflect the direction of the Commission's Executive Committee, based on the results of a membership survey.<sup>1</sup> Forty-seven states and the District of Columbia are members of the Commission.<sup>2</sup> Each member state is represented at the Commission by the head of the state's tax agency or that person's designee. The Multistate Tax Compact, adopted by the Commission's compact member states, includes UDITPA nearly word for word.

We recommend the Drafting Committee focus on the following provisions:

- Sales factor numerator sourcing for services and intangibles (UDITPA §17)
- Factor Weighting (UDITPA §9)
- Definition of Business Income (UDITPA §1(a))
- Definition of Gross Receipts (UDITPA §1(g)), and
- Distortion Relief Provision (UDITPA §18)

For the most part, UDITPA has held up well. The States have largely adhered to its provisions. And the provisions that have undergone judicial review have been upheld as constitutional.<sup>3</sup> But a few, those listed above, are in critical need of modernization. We believe states will be able to enact reasonable amendments targeted to these critical provisions. Venturing beyond clearly needed changes to tweak reasonably workable rules, even in the interest of conceptual superiority, could jeopardize timely completion of the project and result in less uniformity rather than more as some states opt for the improvement while others retain the existing workable rule.

We also recommend against risking progress on these critical provisions by attempting to address issues beyond the scope of apportionment and the current UDITPA. Maintaining UDITPA's focus on the critical apportionment issues enables broader adoption of the uniform rule among states that may have made different policy choices on issues of tax base, nexus, combination or procedural processes.

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<sup>1</sup> Comments were prepared at our Executive Committee's direction by the Committee's staff: Executive Director, Joe Huddleston, and General Counsel, Shirley Sicilian.

<sup>2</sup> For a map of our member states, please see <http://www.mtc.gov/AboutStateMap.aspx>. Compact Members: Alabama, Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Michigan, Minnesota, Missouri, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah and Washington. Sovereignty Members: Georgia, Kentucky, Louisiana, Maryland, New Jersey, West Virginia and Wyoming. Associate Members: Arizona, Connecticut, Florida, Illinois, Iowa, Indiana, Maine, Massachusetts, Mississippi, Nebraska, New Hampshire, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Vermont and Wisconsin.

<sup>3</sup> See e.g., *Allied Signal v. Dir. Div. of Taxation*, 504 U.S. 765 (1992); *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159 (1983)

## **II. Specific Recommendations**

Our response is focused on the provisions we recommend for amendment. If the committee chooses an expanded scope, we request an opportunity to respond in more detail on the additional provisions.

### **SECTIONS OF THE EXISTING UDITPA**

#### **Section 1.**

##### **Section 1(a)**

We recommend this provision for review and amendment. Several alternative options should be considered, including apportionment of income to the extent permitted by the U.S. Constitution. If the current framework is maintained, the existence of both a functional and a transactional test, the treatment of gain at liquidation, and other aspects of the current rule should be clarified. The NCCUSL policy criteria should be used to weigh the relative benefits of all alternative options.

##### **Section 1(b)**

Issues associated with this provision do not rise to the level of importance or difficulty that would warrant review as part of this project. The potential improvements would not justify the additional time and complexity, or the diminished ability to get critical amendments enacted.

##### **Section 1(c)**

Issues associated with this provision do not rise to the level of importance or difficulty that would warrant review as part of this project. The potential improvements would not justify the additional time and complexity, or the diminished ability to get critical amendments enacted.

##### **Section 1(d)**

These issues should be dealt with in the context of section 17.

##### **Section 1(e)**

Re-definition should focus on business income. Non-business income definition should stay as-is to avoid inadvertent gaps or overlaps.

##### **Section 1(f)**

These issues should be dealt with in the context of section 17.

### **Section 1(g)**

We recommend this provision for review and amendment. The current definition of sales should be clarified. “Sales” is defined as “all gross receipts of the taxpayer...” But the term “gross receipts” is not defined. Many states have confronted the question of whether “gross receipts” includes return of investment principal in the case of the repayment of a loan or a short-term investment of working capital.

### **Section 1(h)**

Issues associated with this provision do not rise to the level of importance or difficulty that would warrant review as part of this project. The potential improvements would not justify the additional time and complexity, or the diminished ability to get critical amendments enacted.

### **Section 2**

These issues should be dealt with in the context of section 17.

### **Section 3 – 8**

Issues associated with these provisions do not rise to the level of importance or difficulty that would warrant review as part of this project. The potential improvements would not justify the additional time and complexity, or the diminished ability to get critical amendments enacted.

### **Section 9.**

We recommend this provision for review and amendment. As of January 1, 2007, only eight states exclusively require an equal-weighted formula. Seven of those eight are Compact member states. Although States are moving away from the three-factor equal-weighted formula, they are at least moving away in the same direction – toward the sales factor. Thirty-four states now at least double weight the sales factor, and six of those apportion based on the sales factor only.<sup>4</sup>

The impetus for this trend appears to be two-fold. First, an equally-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 - tend to be concentrated where production occurs. When a State double weights the sales factor, it is giving equal weight to contributions of the production and market states.

Second, some states may have chosen to emphasize the sales factor, and de-emphasize the property and payroll factors accordingly, in hopes of encouraging taxpayers to move

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<sup>4</sup> *State Apportionment of Corporate Income*; Federation of Tax Administrators  
[http://www.taxadmin.org/fta/rate/corp\\_app.html](http://www.taxadmin.org/fta/rate/corp_app.html)

property and payroll (i.e., investment and jobs) to their state. Of course, this incentive exists only in relation to other states' less heavily weighted sales factor apportionment rules. The comparative incentive disappears if all states uniformly employed a similarly-weighted formula – whether it's an equally-weighted three factor formula, a single sales factor formula, or something in between.

Several alternative options should be considered. The NCCUSL policy criteria should be used to weigh the relative benefits of all alternative options.

### **Section 10 - 12**

Issues associated with the property factor provisions do not rise to the level that would warrant the additional time and complexity, or the diminished ability to get critical amendments enacted. Conceptual questions regarding current rule's exclusion of intangible property are well known, as are the intractable administrative difficulties any alternative would face. The current rule on this point is nearly uniformly followed. Attempting to revisit these issues could hold up progress and ultimately compromise ability to enact critical amendments.

### **Section 13 - 14**

Although states are facing questions arising from use of “leased” employees, issues associated with the payroll factor provisions do not generally rise to the level that would warrant the additional time and complexity, or the diminished ability to get critical amendments enacted.

### **Section 15**

These issues should be dealt with in the context of section 1(g).

### **Section 16**

These provisions are appropriate and administratively workable. The provisions have not been uniformly interpreted with respect to dock sales, but that issue does not rise to a level of importance or difficulty that would warrant review as part of this project. The potential improvements would not justify the additional time and complexity, or the diminished ability to get critical amendments enacted.

### **Section 17.**

We believe this provision has the highest priority for review and amendment. The provision is outmoded, major service industries are excluded from its application and subject instead to special rules, and states have begun to unilaterally implement non-uniform alternative sourcing. Problems with the cost of performance approach include:

- Weaknesses which were recognized, but acceptable, 50 years ago are no longer tolerable in light of service sector growth and the trend toward overweighting the sales factor.
- It fails to reflect the contributions of the market state, which should be the purpose of the sales factor.
- It is very difficult to determine cost of performance and thus to administer the rule.
- Increasing use of section 18 to deal with these problems is leading to non-uniformity.

Cost of performance should not be retained. Ideally, the rules for services and intangibles should be coordinated with the rule for tangibles and should reflect market sourcing. The current MTC special rules generally use a market sourcing approach. There are several options for amendment that should be considered. NCCUSL's proposed policy criteria should be used to weigh the various options.

### **Section 18.**

We recommend this provision for review and amendment. The current provision should more clearly allow for adoption of industry-wide and issue-wide special apportionment rules. Modernizing Section 17 and clarifying the statutory definitions discussed above will hopefully minimize the need to use section 18 in crafting special rules, and presumably relieve much of the pressure currently brought to bear on the Act's equitable apportionment provisions. Nonetheless, the economy will certainly continue to change. There will always be a need to fill statutory gaps in taxation and policy. Ideally, these gaps should be filled uniformly across taxpayers, and not merely on an ad-hoc basis. Authority to do so should be made clearer.

### **ISSUES NOT COVERED BY EXISTING UDITPA**

We recommend the Drafting Committee's charge for review should not be expanded beyond critical UDITPA provisions, and certainly not beyond UDITPA.

UDITPA has been well accepted over the years, in part because it provides a reasonable way to apportion a tax base regardless of how a state defines that base or determines its jurisdiction to tax an apportioned share. This flexibility is important for maintaining uniformity in the area that requires it the most. Uniformity with respect to tax base, treatment of credits, nexus, or procedure, is desirable from an administrative standpoint, but is not critical to avoiding duplicative taxation. Maintaining UDITPA's focus on the critical issue of apportionment enables broader adoption of that uniform rule among states that may have made different policy choices on other issues where uniformity is less critical.

As mentioned above, the controversies surrounding these external issues would impede development of a model and enactment of state statutes on badly needed revisions to the apportionment provisions. The risk of derailing needed changes would be particularly acute if the scope were expanded to include the notoriously controversial subject of nexus. States and taxpayer groups have litigated this issue intensively since the U.S.

Supreme Court's decision in *Quill*.<sup>5</sup> For the last eight years, States have fought back efforts in the U.S. Congress to impose a "physical presence" nexus rule for business activity taxes.<sup>6</sup> It could be very detrimental to bring that controversy into this forum.

Combined reporting carries similar risks. Although some courts have found combined reporting to be implicit in UDITPA, others have not.<sup>7</sup> Recent state legislative efforts to make combined reporting explicit have met determined opposition.<sup>8</sup> Inserting the combined reporting controversy into this forum could be unnecessarily divisive.

There is little to be gained by expanding UDITPA to cover these topics. Nothing in UDITPA prevents combination, and model uniform rules already exist for nexus, combined reporting and treatment of pass-through entities.<sup>9</sup> The Commission suggested

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<sup>5</sup> See, e.g., *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 114 S.Ct. 550 (1993); *Comptroller of the Treasury v. SYL, Inc.*, and *Comptroller of the Treasury v. Crown Cork & Seal Co. (Delaware), Inc.*, 825 A.2d 399 (Md. 2003), *cert. denied*, 124 S.Ct. 961 (2003); *A&F Trademark, et al. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *review denied* (N.C., 2005), *cert. denied*, 126 S.Ct. 353 (2005); *General Motors Corp. v. City of Seattle*, 25 P.3d 1022 (Wash. Ct. App. 2001), *cert. denied*, 122 S.Ct. 1915 (2002); *Kmart Properties, Inc. v. Taxation and Revenue Dept.*, No. 21,140 (N.M. Ct. App. 2001), *cert. quashed* (N.M., 12/29/05); *Lanco, Inc. v. Director, Division of Taxation*, 908 A.2d 176 (N.J. 2006), *cert. denied*, 127 S.Ct. 2974 (U.S., 6/18/07); *Geoffrey, Inc. v. Oklahoma Tax Commission*, 132 P.3d 632 (Okla. Ct. Civ. App., 12/23/05), *review denied* (Okla., 3/20/06); *Borden Chemicals and Plastics, L.P. v. Zehnder*, 726 N.E.2d 73 (Ill. App. Ct. 2000), *appeal denied*, 731 N.E.2d 762 (Ill. 2000); *Commissioner v. MBNA America Bank, N.A.*, 640 S.E.2d 226 (W.V. 2006), *cert. denied*, *FIA Card Services, N.A. v. Tax Commissioner of West Virginia*, 127 S.Ct. 2997 (U.S., 6/18/07)

<sup>6</sup> See, e.g., H.R. 5267, the Business Activity Tax Simplification Act of 2008.

<sup>7</sup> See, e.g., *Wal-Mart Stores East, Inc. a/k/a Wal-Mart Stores East I, Inc. v. Hinton*, No. 06-CV-3928, 12/31/07. Courts in other UDITPA states have held that UDITPA does not provide authority for combined reporting. See, e.g., *Polaroid Corp. v. Comm. of Rev.* (Mass., 1984) 472 N.E.2d 259). See, Peters, *State Income Tax Problems of Interstate Business*, 33<sup>rd</sup> Annual 1975 N.Y.U. Inst. on Fed. Tax. (1975) pp. 899, 939 ("There is nothing in the documented history of the Uniform Act to suggest that the Commissioners envisioned the Act to encompass combined reporting....").

<sup>8</sup> See e.g., legislative testimony by the Counsel on State Taxation (COST) in opposition to combined reporting proposals in Connecticut, Massachusetts, Florida and Maryland.  
<http://www.statetax.org/StateTaxLibrary.aspx?id=17546>

<sup>9</sup> See MTC model Factor Presence Nexus Standards:  
[http://www.mtc.gov/uploadedFiles/Multistate\\_Tax\\_Commission/Uniformity/Uniformity\\_Projects/A\\_-\\_Z/FactorPresenceNexusStandardBusinessActTaxes.pdf](http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/FactorPresenceNexusStandardBusinessActTaxes.pdf)

MTC model rule for pass-through entities:

[http://www.mtc.gov/uploadedFiles/Multistate\\_Tax\\_Commission/Uniformity/Uniformity\\_Projects/A\\_-\\_Z/ProposedStatLanguageReportingOptions.pdf](http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/ProposedStatLanguageReportingOptions.pdf)

MTC model Combined Reporting Statute:

[http://www.mtc.gov/uploadedFiles/Multistate\\_Tax\\_Commission/Uniformity/Uniformity\\_Projects/A\\_-\\_Z/Combined%20Reporting%20-%20FINAL%20version.pdf](http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Combined%20Reporting%20-%20FINAL%20version.pdf)

Since the model was developed only West Virginia has newly enacted combined reporting for corporate income tax and it adopted the model virtually word for word. This year, the MTC model provisions have been included in proposed combined reporting legislation introduced in Florida HB 1237; Kentucky HB 302; Massachusetts HB 4645; Tennessee SB 3158.

that because uniform model rules on these topics already exist, and because the controversies surrounding any duplicative effort may delay or impede acceptance of badly needed revisions to the UDITPA apportionment provisions, there is little to be gained and possibly something to be lost by taking on these issues in this forum.