



**MULTISTATE TAX COMMISSION**

*Maximizing the synergies of multi-state tax cooperation*

**To: Uniformity Committee**

**From: Sheldon H. Laskin, MTC Acting General Counsel**

**Date: March 12, 2014**

**Subject: Report of the Hearing Officer, Multistate Tax Compact Article IV Proposed Amendments**

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The purpose of this memo is to summarize the discussions that the Committee has had since the MTC meetings in New Orleans in December. I have listed the issues currently pending before the Committee, as those issues are stated on the agenda for the Committee teleconferences that have been conducted since December. In each case, the Committee is to decide whether to recommend to the Executive Committee that the Committee draft be adopted as is or whether instead the Executive Committee should adopt the Hearing Officer's recommendation.

I have treated the Section 18 procedural issues somewhat differently than I have the substantive Article IV UDITPA issues. This is because the Section 18 issues are not currently reflected in the Committee draft; the Hearing Officer's Section 18 proposals are *additions to*, rather than *amendments to*, the Draft. Because the Committee has essentially been considering these issues for the first time as a result of the Hearing Officer report, I have provided a summary of the Committee discussions on Section 18. This should not be construed as a summary of the Committee's position on the Section 18 issues, because the Committee has not yet taken a formal position. Since the Committee has taken a position on the substantive Article IV issues as reflected in the draft, I have summarized the draft language on those issues as well as the Hearing Officer's recommended amendments.

Attached are the results of the February 25<sup>th</sup> straw poll and Wood's chart comparing the draft Article IV proposals with the Hearing Officer recommendations.

1. Should Section 18 contain an explicit provision stating that the party invoking alternative apportionment should have the burden of proof that the statutory conditions for alternative

apportionment have been satisfied? Should the burden of proof be the same for either the taxpayer or the tax administrator? Hearing Officer Report (“Report”), p. 27.

Current draft position: None.

Suggested reasons to adopt Hearing Officer’s Position: Industry will not support the proposal if it does not address burden of proof (BOP) and other Section 18 procedural issues. At least one state felt that there is no harm in making burden of proof explicit. Industry stated that the Commission’s draft might be more balanced as between state revenue departments and taxpayers if BOP were addressed in the statute. Some states felt BOP is more appropriately addressed in regulation.

Suggested reasons not to adopt Hearing Officer’s Position: Burden of proof is a procedural issue that is not appropriately addressed in a uniform statute.

2. Should Section 18 prohibit the tax administrator from imposing a penalty on a taxpayer (except in cases where the transactions at issue are the result of tax avoidance such as sham transactions, or lack economic substance, do not reflect arm’s length pricing, violate the step transaction doctrine, or otherwise reflect a tax avoidance strategy), when the tax administrator has successfully invoked alternative apportionment but the taxpayer complied with the general apportionment rules in filing its return? Report, p. 29.

Current draft position: None.

Suggested reasons to adopt Hearing Officer’s Position: In support of his position, the hearing officer stated in his report that a taxpayer cannot normally “be expected to anticipate that a tax administrator will successfully displace the statutory provisions on apportionment with an alternative method.”

Suggested reasons not to adopt Hearing Officer’s Position: Penalty is a procedural issue that is not appropriately addressed in a uniform statute. Several states stated that penalty would not be imposed in this scenario, unless there was a previous final ruling contrary to the taxpayer’s position. States generally felt that this is a matter to be addressed under existing state procedures.

3. Should Section 18 prohibit the tax administrator from retroactively revoking his prior approval of a taxpayer’s alternative apportionment method, unless there has been a material change in, or a material misrepresentation of, the facts provided by the taxpayer upon which the tax administrator reasonably relied? Report, p. 31

Current draft position: None.

Suggested reasons to adopt Hearing Officer’s Position: Would make the Commission’s draft more balanced as between state revenue departments and taxpayers.

Suggested reasons not to adopt Hearing Officer’s Position: Already provided for in some states’ laws. Including such a provision in a uniform statute could have unintended consequences.

4. Should the use of alternative apportionment under Section 18 be limited to isolated, limited or non-recurring situations? Should the state be required to address issues arising from a common fact pattern or common filing position by regulation rather than by invoking Section 18? Report, p. 32.

Current draft position: None.

Suggested reasons to adopt Hearing Officer's Position: If an apportionment filing position is common within an industry, addressing any problems with that filing position should be addressed by regulation.

Suggested reasons not to adopt Hearing Officer's Position: It is appropriate to apply Section 18 on audit, because multiple taxpayers often adopt the same apportionment stance as the result of common advice from tax counsel.

5. Should the Executive Committee consider the Hearing Officer's redraft of Article IV.1 (a) and (e) (definitions of apportionable and non-apportionable income)? Report, p. 53.

Current draft position: The current draft uses the conjunctive "and" between the definitions of the transactional and the functional tests in Article IV.1 (a)(i)(A) and (B).

Reason in support of Hearing Officer's recommendation: The Hearing Officer would replace "and" with the disjunctive "or" "to eliminate any possible ambiguity." The use of the conjunctive "and" in the current statute has resulted in considerable litigation over the question of whether there is one test for apportionable income or two independent tests. While the states have generally prevailed that there are in fact two independent tests, a number of state courts reached a contrary result which required legislative action in those states to replace the conjunctive with the disjunctive. *Compare, Polaroid Corp. v. Offerman*, 507 S.E. 2d 284 (NC 1998) (two independent tests) *with Ex Parte Uniroyal Tire Company*, 779 So. 2d 227 (AL 2000) (one test), overturned due to legislative action Alabama Sp.Sess. Act 2001-1113.

Reason not to adopt Hearing Officer's position: The issue of whether UDITPA establishes one or two tests for apportionable income has essentially been resolved, either judicially or through legislation. Eliminating the disjunctive would be unnecessary in those states where the issue is resolved.

6. Should receipts from hedging transactions and the treasury function be included in the receipts factor under Article IV.1 (g)? Report, p. 107.

Current draft position: These receipts are removed from the receipts factor.

Hearing Officer's position: Removing these receipts from the receipts factor would be a bad precedent that could well lead to unintended consequences if taxpayers subsequently argue that other receipts should be similarly removed. Draft Art. IV.17 (a)(4)(ii)(C) already throws these receipts out and therefore it is unnecessary to address this issue in the definition of gross receipts.

Committee discussion: The straw poll indicated majority support for removing these receipts from the receipts factor. However, one state indicated it was willing to agree with the Hearing Officer recommendation and two states abstained.

7. Should the Executive Committee consider the Hearing Officer's two alternative drafts of Article IV.1 (g) (definition of gross receipts)? Report, p. 111.

Current draft position: Only receipts from transactions in the regular course of business are included in the receipts factor.

Hearing Officer's position: The draft's definition of gross receipts as limited to receipts from application of the transactional test is not supported by United States Supreme Court precedent, and may result in unfair apportionment out of all reasonable relation to how income is generated. It can also lead to taxpayer characterization of an activity so as to reduce the apportionment percentage in a state, resulting in litigation and uncertainty. Eliminating a receipt from the receipts factor should be done on a case by case basis under Section 18.

Committee discussion: This issue generated the most division in the straw poll. Five states expressed a preference for the current draft while four states would consider adopting the Hearing Officer's recommendation. Three states abstained.

## Straw Poll (February 25, 2014)

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1. Should Section 18 contain an explicit provision stating that the party invoking alternative apportionment should have the burden of proof that the statutory conditions for alternative apportionment have been satisfied? Should the burden of proof be the same for either the taxpayer or the tax administrator? Hearing Officer Report ("Report"), p. 27.

Draft	Hearing Officer Report
WA, MI, ND, Arkansas, MA, CO, MT	MO, Alabama, Idaho (not opposed, more equitable to taxpayers), OR

COMMENTS: NC – Legislature would require burden of proof provision

## Straw Poll (February 25, 2014)

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2. Should Section 18 prohibit the tax administrator from imposing a penalty on a taxpayer (except in cases where the transactions at issue are the result of tax avoidance such as sham transactions, or lack economic substance, do not reflect arm's length pricing, violate the step transaction doctrine, or otherwise reflect a tax avoidance strategy), when the tax administrator has successfully invoked alternative apportionment but the taxpayer complied with the general apportionment rules in filing its return? Report, p. 29.

Draft	Hearing Officer Report
WA, MI (understands the Hearing Officer's take on the issue), ND (understands the Hearing Officer's take on the issue), MO, Alabama, Arkansas (Hearing Officer proposed change would conflict with statute), MA, NC, CO, MT	Idaho (more equitable to taxpayers), Oregon (leans favorably)

COMMENTS: AL (wants to retain imposition of penalty for future years)

## Straw Poll (February 25, 2014)

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3. Should the Executive Committee consider the Hearing Officer's redraft of Article IV.1 (a) and (e) (definitions of apportionable and non-apportionable income)? Report, p. 53.

Draft	Hearing Officer Report
MO, Arkansas, MA, CO, OR (leaning)	MI (tentatively), ND (tentatively), Idaho, NC.

COMMENTS: WA, AL, MT abstain

## Straw Poll (February 25, 2014)

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4. Should receipts from hedging transactions and the treasury function be included in the receipts factor under Article IV.1 (g)? Report, p. 107.

Draft	Hearing Officer Report
MI, MO, AL, ID (tough sell in legislature), Arkansas, MA, NC, CO, OR,	WA (inclined to go with this)

COMMENTS: ND, MT abstain

## Straw Poll (February 25, 2014)

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5. Should the Executive Committee consider the Hearing Officer's two alternative drafts of Article IV.1 (g) (definition of gross receipts)? Report, p. 111

Draft	Hearing Officer Report
Idaho, Arkansas (but can live with alternative Version 1), MA, CO, OR,	NC (ok that Executive Committee consider)

COMMENTS: WA, MI, ND, MO, AL, MT abstain

## Straw Poll (February 25, 2014)

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6. Should Section 18 prohibit the tax administrator from retroactively revoking his prior approval of a taxpayer's alternative apportionment method, unless there has been a material change in, or a material misrepresentation of, the facts provided by the taxpayer upon which the tax administrator reasonably relied? Report, p. 3

Draft	Hearing Officer Report
WA (covered in existing law), MI, ND, MO, AL, MA, OR, MT	Idaho, Arkansas, NC

COMMENTS: CO (abstain)

## Straw Poll (February 25, 2014)

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7. Should the use of alternative apportionment under Section 18 be limited to isolated, limited or non-recurring situations? Should the state be required to address issues arising from a common fact pattern or common filing position by regulation rather than by invoking Section 18? Report, p. 32.

Draft	Hearing Officer Report
WA, MI, ND, AL, Idaho, Arkansas, MA, NC, CO, OR, MT	MO (not opposed)

COMMENTS

**Multistate Tax Commission**  
**Proposed Amendments to Multistate Tax Compact Article IV (UDITPA)**  
**Comparison of Uniformity Committee to Hearing Officer Recommendations**

Amendments per Uniformity Committee*	Amendments per Hearing Officer
<p>Art. IV. 1</p> <p>(a) “<del>Business</del> Apportionable income” means:</p> <p style="padding-left: 20px;">(i) <u>all income that is apportionable under the Constitution of the United States and is not allocated under the laws of this state, including:</u></p> <p style="padding-left: 40px;">(A) <u>income arising from transactions and activity in the regular course of the taxpayer’s trade or business, and <del>includes</del></u></p> <p style="padding-left: 40px;">(B) <u>income arising from tangible and intangible property if the acquisition, management, <u>employment, development, and</u> or disposition of the property <del>constitute integral parts of is</del> or was related to the operation of the taxpayer’s regular trade or business operations; and</u></p> <p style="padding-left: 20px;">(ii) <u>any income that would be allocable to this state under the Constitution of the United States, but that is apportioned rather than allocated pursuant to the laws of this state.</u></p> <p>Art. IV.1 (e) “<del>Non-business apportionable</del> income” means all income other than <del>business apportionable</del> income.</p> <p>(Corresponding technical changes to remained of r Article IV are necessary to rename “business income” as “apportionable income.”)</p>	<p>Art. IV. 1</p> <p>(a) “Apportionable Income” means:</p> <p style="padding-left: 20px;">(i) all income that is apportionable under the Constitution of the United States and is not allocated under the laws of this state, including but not limited to:</p> <p style="padding-left: 40px;">(A) income related to the operation of the taxpayer</p> <p style="padding-left: 40px;">(B) income from tangible and intangible property if the acquisition, management, employment, development, or disposition of the property is, or was, related to, or part of, the operation of the taxpayer’s trade or business.</p> <p>Art. IV.1(e) “Non-apportionable income” means all income other than apportionable income.</p>

<p>Art. IV. 18.</p> <p>(a) If the allocation and apportionment provisions of this Article 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:</p> <ol style="list-style-type: none"> <li>(1) Separate accounting;</li> <li>(2) The exclusion of any one or more of the factors;</li> <li>(3) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this State; or</li> <li>(4) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.</li> </ol> <p>(b)</p> <p><u>(1) If the allocation and apportionment provisions of this Article do not fairly represent the extent of business activity in this State of taxpayers engaged in a particular industry or in a particular transaction or activity, the tax administrator may, in addition to the authority provided in section (a), establish appropriate rules or regulations for determining alternative allocation and apportionment methods for such taxpayers.</u></p> <p><u>(2) A regulation adopted pursuant to this section shall be applied uniformly, except that with respect to any taxpayer to whom such regulation applies, the taxpayer may petition for, or the tax administrator may require, adjustment pursuant to Section 18(a).</u></p>	<p>Art. 18.</p> <p>(1) If the allocation or apportionment provisions of this Article 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, any reasonable method to effectuate an equitable allocation and apportionment of the taxpayer's income.</p> <p>(b)(1) If the allocation or apportionment provisions of this Article do not fairly represent the extent of business activity in this State of taxpayers that are engaged in, or representative of, a particular industry, or that engage in a particular transaction or activity of general applicability, then a [tax administrator] that requires a reasonable method to effectuate an equitable allocation and apportionment of income that it applies uniformly to such industry, or to such transactions or activities, shall publish that method in appropriate rules or regulations.</p> <p>(b)(2) Rules or regulations adopted pursuant to this Section shall be applied uniformly, except that with respect to any taxpayer to whom such regulation applies, the taxpayer may petition for, or the [tax administrator] may require, adjustment pursuant to Section 18(a).</p> <p>(c) The party petitioning for, or the [tax administrator] requiring, the use of any method to effectuate an equitable allocation and apportionment of the taxpayer's income pursuant to (a), must prove by [Drafter's note: insert standard of proof here]: (1) that the allocation or apportionment provisions of this Article do not fairly represent the extent of the taxpayer's activity in this State; and (2) that the alternative to such provisions is reasonable. The same burden of proof shall apply whether the taxpayer is petitioning for, or the [tax administrator] is requiring, the use of any reasonable method to effectuate an equitable allocation and apportionment of the taxpayer's income.</p>
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	<p>(d) If the [tax administrator] requires any method to effectuate an equitable allocation and apportionment of the taxpayer's income, he or she cannot impose any civil or criminal penalties solely because the taxpayer reasonably relied on the allocation and apportionment provisions of this Article in filing a return.</p> <p>(e) A taxpayer that has been permitted by the [tax administrator] to use a reasonable method to effectuate an equitable allocation and apportionment of the taxpayer's income shall not have the permission revoked with respect to transactions and activities that have already occurred unless there has been a material change in, or a material misrepresentation of, the facts provided by the taxpayer upon which the [tax administrator] reasonably relied.</p>
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<p>Art. IV. 4  <del>“Sales Receipts” means all gross receipts of the taxpayer that are not allocated under Sections 4 through 8 of this Act paragraphs of this article, and that are received from transactions and activity in the regular course of the taxpayer’s trade or business; except that receipts of a taxpayer other than a securities dealer from hedging transactions and from the maturity, redemption, sale, exchange, load or other disposition of cash or securities, shall be excluded.</del></p> <p>See also Attachment F for corresponding technical changes necessary to rename “business income as “apportionable income”</p>	<p>Art. IV. 4  <b>Alternative One</b>  “Receipts” means gross receipts of the taxpayer that are received from, or associated with , transactions or activities generating apportionable business income defined in AR. IV.1.”</p> <p><b>Alternative Two</b>  “Receipts’ means gross receipts of the taxpayer that are received from, or associated with, transactions or activities generating apportionable business income defined in Ar. IV.1, excluding substantial amounts of such gross receipts from an incidental or occasional sales of fixed asset or other property that was, or is, related to, or part of, the operation of the taxpayer’s trade or business.”</p>
<p>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 <u>two times</u> the sales factor, and the denominator of which is <del>three</del> <u>four</u>.</p> <p>*As changed by the Executive Committee:</p> <p>Art. IV. 9  All business income shall be apportioned to this State by multiplying the income by a fraction, [State should define its factor weighting fraction here. Recommended definition: “the numerator of which is the property factor plus the payroll factor plus two times the sales factor, and the denominator of which is four.</p>	<p>Art. IV. 9  No recommended changes.</p>

<p>Art. IV. 17</p> <p>(a) Sales, other than sales of tangible personal property described in <u>Section 16</u>, are in this State if the taxpayer's market for the sales is in this state. The taxpayer's market for sales is in this state:</p> <p>(a) <del>The income producing activity is performed in this State; or</del></p> <p>(b) <del>the income producing activity is performed both in and outside this State and a greater proportion of the income producing activity is performed in this State than in any other State, based on costs of performance.</del></p> <p>(1) <u>in the case of sales, rental, lease or license of real property, of and to the extent the property is located in this state;</u></p> <p>(2) <u>in the case of rental, lease or license of tangible personal property, if and to the extent the property is located in this state;</u></p> <p>(3) <u>in the case of sales of a service, if and to the extent the service is delivered to a location in this state; and</u></p> <p>(4) <u>in the case of intangible property,</u></p> <p style="padding-left: 2em;">(i) <u>that is rented, leased or licensed, if and to the extent the property is used in this state, provided that intangible property utilized in marketing a good or service to a consumer is "used in this state" if that good or service is purchased by a consumer who is in this state; and</u></p> <p style="padding-left: 2em;">(ii) <u>that is sold, if and to the extent the property is used in this state, provided that:</u></p> <p style="padding-left: 4em;">(A) <u>a contract right, government license, or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area is "used in this state" if the geographic area includes all or part of this state;</u></p> <p style="padding-left: 4em;">(B) <u>receipts from intangible property sales that are contingent on the productivity, use, or disposition of the</u></p>	<p>No recommended changes.</p>
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intangible property shall be treated as receipts from the rental, lease or licensing of such intangible property under subsection (a)(4)(i); and  
(C) all other receipts from a sales of intangible property shall be excluded from the numerator and denominator of the sales factor.

(b) If the state or states of assignment under subsection (a) cannot be determined, the state or states of assignment shall be reasonably approximated.

(c) If the taxpayer is not taxable in a state to which a sale is assigned under subsection (a) or (b), or is the state of assignment cannot be determined under subsection (a) or reasonably approximated under subsection (b), such sale shall be excluded from the denominator of the sales factor.

(d) [The tax administrator may prescribe regulations as necessary or appropriate to carry out the purposes of this section.]