

THE PROJECT TO REVISE UDITPA

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1.01 INTRODUCTION

UDITPA² addresses one of the most fundamental features of state corporate income and franchise taxes – division of the tax base among the multiple states in which a taxpayer does business. The Act was developed by the Uniform Law Commission over 50 years ago, in 1957. It’s been enacted, in whole or in part, by thirty-four states either as a stand alone statute, as part of the Multistate Tax Compact, or both. The economy has changed significantly since 1957. Though much of UDITPA continues to work well, states are facing pressures to amend or clarify a handful of its provisions. Chapter 1.02 of this paper describes the history of UDITPA – its development and enactments. Chapter 1.03 is a snapshot of adherence to UDITPA today. Chapter 1.04 asks whether its time for UDITPA to be revised and describes the controversy surrounding that question. In Chapter 1.05, we explore substantive issues and possible amendments, assuming there will be a review. Chapter 1.06 recommends policy criteria that would form the basis for choosing among all the various possible amendments. And finally, in Chapter 1.07 we offer some concluding remarks.

This paper reflects the authors’ perspective that a UDITPA review is needed. States cannot ignore the accumulating pressures from economic change and have begun to address them unilaterally. Model amendments will give state legislatures something to draw on as they address these pressures and will help maintain a reasonable level of uniformity. We believe there are five UDITPA provisions that merit the costs of undertaking a review:

- 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)

In order to properly evaluate alternatives, we also believe it is important to establish a set of policy criteria that reflects the legitimate concerns of states and taxpayers.

² Uniform Division of Income for Tax Purposes Act.

1.02 HISTORY OF UDITPA

[1] Development of UDITPA by the Uniform Law Commission.

[a] The Uniform Law Commission

UDITPA is a product of the Uniform Law Commission, previously commonly known as the National Conference of Commissioners on Uniform State Laws. The ULC was founded in 1892 as a forum for crafting nonpartisan, model uniform laws for state consideration. Its first meeting was attended by seven states. But by 1912, all states – which numbered 44 at the time – were sending at least one representative to the meetings.

Today, the ULC is comprised of approximately 300 commissioners from different jurisdictions. There are commissioners from each State, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. Each jurisdiction determines, usually by statute, the method of appointment and the number of commissioners to appoint. Commissioners must be members of the bar; and while some serve as state legislators, most are practitioners, judges, and law professors. Most financial support for the ULC is appropriated by the state legislatures.

ULC has a well established process for developing its model laws. The process starts with consideration by a Scope and Program Committee, which investigates and makes a recommendation to the Executive Committee on whether a uniform law (or revisions to a uniform law) in a particular area would be desirable and practicable. The ULC Executive Committee considers this recommendation, and if it approves, establishes a Drafting Committee. The Drafting Committee is comprised of several Commissioners and one or more advisors. A “Reporter” is appointed as primary drafter. Once a draft has been produced, it will be read at a minimum of two consecutive annual meetings. After the readings, the draft is submitted to a vote of the full Commission. Each state is allowed only one vote, and at least 20 states must vote in favor of a draft in order for it to be approved. Commissioners become advocates for adoption of the new model law in their home states.

Since its founding, ULC has promulgated over 200 model laws. Some have become truly foundational in their subject area. These include the Uniform Commercial Code, the Uniform Partnership Act, Model State Administrative Procedures Act and many others.³

[b] Development of UDITPA

The model UDITPA is certainly one of ULC’s many successful contributions to state uniformity. The Act was designed for use in states that levy

³ See: <http://www.nccusl.org/Update/DesktopDefault.aspx?tabindex=2&tabid=60>.

taxes on, or measured by, net income. Its purpose is to provide a model formula for apportioning a multistate corporation's income tax base, however the State defines that base, among the several taxing jurisdictions in which the corporation does business. The theory underlying UDITPA is the unitary business principle, which allows for formulary apportionment as a "rough approximation" of the share of a multistate corporation's tax base that is attributable to a particular state.

This unitary business principle and formulary apportionment derive from a series of U.S. Supreme court opinions from the 1870s and 1880s.⁴ Most of these cases deal with application of property tax to railroads. At that time, a type of property tax known as the capital stock tax was the dominant form of state taxation, and the railroads were one of the few industries that operated routinely in several states. But after Congress instituted a federal corporate income tax in 1909,⁵ the states soon followed, and by the 1920's the same unitary business principle and formulary apportionment concepts that had developed in the property tax arena were now being applied in the context of the state corporate income tax.⁶

The need for a model corporate income tax apportionment formula quickly became apparent. One commentator wrote in 1934 that "the tax methods are almost as numerous as the taxing jurisdictions."⁷ For years, the Counsel of State Governments recommended a model law be developed.⁸ And in 1933, the

⁴ See, e.g., *Adam's Express v. Ohio State Auditor*, 166 U.S. 185 (1897). In *In re State Railroad Tax Cases*, 92 U.S. 575, 608 (1875), the U.S. Supreme Court explained that:

[A] railroad must be regarded for many, indeed for most, purposes as a unit. The track of the road is but one track from one end of it to the other, and except in its use as one track is of little value. In this track as a whole each county through which it passes has an interest much more important than it has in the limited part of it lying within its boundary. Destroy by any means a few miles of this track within an interior county ... its effect upon the value of the remainder of the road is out of all proportion to the mere local value of the part of it destroyed ... It may well be doubted whether any better mode of determining the value of that portion of the track within any one county has been devised than to ascertain the value of the whole road and apportion the value within the county by its relative length to the whole."

92 U.S. 575 at 608.

⁵ The Corporation Excise Tax Act of August 5, 1909, c. 6, 36 Stat. 11, 112.

⁶ See, e.g., *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920); *Bass, Ratcliff & Gretton v. State Tax Commission*, 266 U.S. 271 (1924).

⁷ Mudge, F.W., 1934. "The Taxation of Business Corporations." In Elmer D. Fagan and C. Ward Macy (eds), *Public Finance: Selected Readings*. London: Longmans, Green and Co.

⁸ For more information on the Counsel of State Governments, see: <http://www.csg.org/>.

National Tax Association did propose a model law that included a single business tax on corporate income and a three-factor formula. But the NTA rule did not take hold.⁹

It was the ULC promulgation of UDITPA that ultimately resonated with the states. The ULC “Reporter,” or primary drafter, for the UDITPA project was Prof. William J. Pierce of the University of Michigan Law School. Pierce’s draft was submitted to the Federation of Tax Administrators for review and comment, and the FTA invited the states to a conference in Chicago in May of 1957 to discuss the draft with Pierce and George V. Powell, chairman of the ULC committee on allocation and apportionment. Only eight states sent representatives, which was evidence of their initial coolness toward collaboration on the project.¹⁰

The ULC adopted UDITPA at its annual meeting in July 1957, and the House of Delegates of the American Bar Association approved it the following week.¹¹ The model UDITPA incorporates what was essentially the existing practice in a number of states at the time: an equal-weighted three factor formula – property, payroll and sales – and definitions to distinguish unitary business income, which is apportioned using the formula, from non-unitary (non-business) income, which is allocated as a whole to a particular state.

[2] Adoption of UDITPA and the Multistate Tax Compact

At first, the model UDITPA received little attention from the states. Between 1957 and 1964 only three states - Alaska, Arkansas, and Kansas - had adopted it. By the mid-1960’s, this persistent lack of uniformity led Congress to seriously consider preemptive legislation. Congress had formed the Willis Committee, which performed an extensive study and found that although “each of the state laws contains its own inner logic, the aggregate of these laws – comprising the system confronting the interstate taxpayer – defies reason.”¹² The Willis Committee found the benefits of increased uniformity so compelling that it

⁹ Hildreth, W. Bartley, Matthew N. Murray, and David L. Sjoquist, 2005. “Cooperation or Competition: The Multistate Tax Commission and State Corporate Tax Uniformity.” *State Tax Notes, Tax Analysts Special Report*, December 5, 2005, p. 828; citing to Hunter, Merlin Howard, and Harry Kenneth Allen. 1940. *Principles of Public Finance*. New York: Harper and Brothers Publishers.

¹⁰ See Warren, John, 2005. “UDITPA—A Historical Perspective.” Presentation to the Multistate Tax Commission Annual Meeting, July 28, 2005.

¹¹ Lyons, *The Uniform Division of Income for Tax Purposes Act*, 19 OHIO ST. L.J. at 41.

¹² H.R. Rep. No. 952, 89th Cong., 1st Sess., Pt. VI, at 1143 (1965). The Willis Committee’s study was sanctioned by Title II of Pub. L. 86-272, 73 Stat. 555, 556 (1959), to consider additional issues surrounding adoption of that Act.

recommended federal legislation to, among other things, establish a uniform state income tax base (at federal AGI) and a uniform state apportionment formula (equal weighted two factor - property and payroll).¹³

The States rallied to head off federal intervention and protect their sovereignty. Many adopted UDITPA directly into their statutes. Some adopted it by enacting the Multistate Tax Compact, Article IV of which incorporates UDITPA nearly word for word.¹⁴ The Compact became effective in 1967 when the required minimum of seven states had enacted it.¹⁵ The Compact also created the Multistate Tax Commission as its administrative agency,¹⁶ and charged the Commission with several responsibilities. One of these responsibilities is interpretation of Article IV, UDITPA, through promulgation of proposed model uniform regulations.¹⁷

Today, forty-seven states and the District of Columbia are members of the Multistate Tax Commission. Twenty of those jurisdictions have adopted the Multistate Tax Compact by Statute. Another twenty-eight have joined the Commission as either sovereignty or associate members. (See Table Appendix C)

1.03 UDITPA TODAY

Adoption of UDITPA by the states, though not verbatim or in lock-step uniformity, clearly made significant progress toward addressing the concerns expressed in the 1965 Willis Report. Of the forty-seven states with a corporate income tax, thirty-six have adopted all or substantial parts of the Act.¹⁸ The remaining eleven states employ at least some of its concepts.¹⁹ With state passage of UDITPA, uniformity in state apportionment statutes increased significantly, and the creation of the Multistate Tax Commission greatly improved the likelihood for uniform interpretation of those statutes through adoption of model regulations.

¹³ H.R. Rep. No. 952, 89th Cong., 1st Sess., Pt. VI, at 1139ff (1965).

¹⁴ Some states have enacted both UDITPA and the Compact.

¹⁵ The U.S. Supreme Court upheld the validity of the Compact in *United States Steel Corp. v. Multistate Tax Comm'n* (1978) 434 U.S. 452.

¹⁶ Compact, Art. VI.

¹⁷ Compact, Art. VII.1.

¹⁸ Commerce Clearing House, ¶ 11-520, May 27, 2008.

¹⁹ *Id.*

UDITPA has held up remarkably well over the 50 years since it was developed. The States have largely adhered to its provisions. And the provisions that have undergone judicial review have been upheld as constitutional.²⁰ In 1983 the United States Supreme Court noted that UDITPA nicely tracks the unitary business principle and that its three factor apportionment formula not only meets with the Court's approval, but has become "something of a benchmark against which other apportionment formulas are judged."²¹

But all legislation, even model legislation, seems to have a natural life-cycle which causes it to deteriorate, through legislative action or inaction, with each passing session. In the case of UDITPA, states are increasingly moving away from two of its provisions in particular - equal weighting of the three factors, and sales factor sourcing for services and sales of intangible property. In addition, a handful of specific provisions have proven to be unclear. The lack of clarity has made those provisions targets for change or clarification by state regulation, legislation, litigation, and sometimes all three.

1.04 IS IT TIME FOR UDITPA REVIEW?

[1] Genesis of the Current ULC Review Project – Multistate Tax Commission Recommendation

At its May, 2006 meeting, the MTC Executive Committee initiated a project to develop proposed amendments for Art. IV of the Multistate Tax Compact. As mentioned above, Article IV contains UDITPA nearly word for word. In particular, the Committee determined it would focus on Art.IV.17, sales factor sourcing for transactions other than sales of tangible personal property. The MTC Executive Committee noted that other provisions, such as factor weighting, may also merit review, and established an MTC workgroup and drafting committee for this project.

In recognition of the fact that UDITPA is a ULC model rule that has been adopted by more than just the MTC Compact member states, the MTC invited ULC to work simultaneously on developing proposed amendments. The MTC also recognized that the ULC forum reflects a broader base than the MTC's, with greater potential for active participation by legislators and the business community. So in the interest of achieving the broadest uniformity possible, and in recognition of the historic relationship between the ULC and UDITPA, the Commission sent a letter to ULC in September of 2006 suggesting it initiate a

²⁰ 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).

²¹ *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 170, 183, 103 S.Ct. 2933, 77 L.Ed.2d 545 (1983). See also, *Butler Brothers v. McColgan*, 315 U.S. 501, 62 S.Ct. 701, 86 L.Ed. 991 (1942).

project to revise its model UDITPA (See Appendix A). The MTC's hope is that a widely acceptable revised UDITPA could be adopted by the non-Compact member UDITPA states, as well as incorporated into a revised Multistate Tax Compact.

[2] The ULC Response – a Project to Review UDITPA in its Entirety

Section 1.2 of the ULC Constitution states: "It is the purpose of the Conference to promote uniformity in the law among the several states on subjects as to which uniformity is desirable and practicable." ULC formed a Committee in May, 2007, to consider the MTC's recommendation in light of this criteria. Public attendees at the meeting included representatives from the MTC, the Tax Executives Institute, the Counsel on State Taxation, and the Federation of Tax Administrators.

Prior to the meeting, the MTC provided a more detailed recommendation that: (1) ULC should initiate a project to revise UDITPA; (2) policy criteria should be established to guide the choice of amendments; and (3) the focus of the project should be UDITPA Section 17. The memorandum identified four additional provisions that also warrant review: factor weighting, the definition of business income, the definition of gross receipts, and clarification of Section 18 authority regarding distortion relief. The MTC cautioned that expanding the scope of review to include too many existing provisions, or to add additional provisions, could jeopardize the timeliness and enactability of a final product.

In June 2007, the ULC study committee recommended to the ULC Scope and Program Committee that "a drafting committee be formed to revise the Uniform Division of Income for Tax Purposes Act in its entirety,"²² and in August 2007, the ULC Scope and Program Committee adopted that recommendation. A Drafting Committee was formed, and Charles A. Trost was appointed Chair. Richard Pomp²³ and Prentiss Willson²⁴ were named as the project's primary drafters, called "reporters" by the ULC. The first drafting committee meeting was held May 30-31, 2008. In a February press release, ULC stated that the purpose of this initial meeting was to gain some initial input on scope from interested parties.²⁵

²² See Memorandum from Charles A. Trost, Chair of the Study Committee, to Committee on Scope and Program. June 8, 2007.

²³ See, Biography of Richard Pomp.
<http://www.nccusl.org/Update/Docs/UDITPA/Pomp%20CV.pdf>

²⁴ See, Biography of Prentiss Willson
<http://www.nccusl.org/Update/Docs/UDITPA/Willson%20CV.pdf>

²⁵ See http://nccusl.com/Update/Docs/UDITPA/UDITPA_PressRelease_021308.pdf

[3] The Controversy

Although the ULC Drafting Committee's May 2008 meeting was well attended, few were there to discuss UDITPA's substantive provisions. The main focus of the meeting became a discussion of whether the project should proceed at all. Several organizations voiced, and continue to voice, strong opposition to the project. These organizations include the Committee on State Taxation, a National Conference of State Legislatures Task Force on Communications and Electronic Commerce, the American Legislative Exchange Council, and the Tax Executives Institute. One taxpayer coalition expressed the view that "[n]o matter the starting point, uniformity in corporate tax treatment is contrary to the legislative desire to serve constituencies."²⁶ Even if legislatures did find some value in corporate tax apportionment uniformity, "[g]iven the plentitude of demographic, statutory and political differences among states it is quite clear that the proposed revision of UDITPA is neither desirable nor practicable"²⁷ Another coalition of large corporate taxpayers advised that "uniformity in state taxation requires federal action."²⁸ The Counsel on State Taxation expressed similar views.²⁹ And the American Legislative Exchange Council reflected that "a uniform tax on corporate income contravenes ALEC's mission to support state sovereignty."³⁰ A representative of the Council on State Taxation commented that he was "leery of spending five years on project that will prove fruitless."³¹

Others disagreed. Several state agency representatives and legislators wrote to support the uniformity project. The Federation of Tax Administrators,

²⁶ Letter from Steven Kranz to Charles Trost, p.3. May 14, 2008.
http://www.nccusl.org/Update/Docs/UDITPA/UDITPA_Sutherland%20Kranz_Opposition_051408.pdf

²⁷ *Ibid.*

²⁸ Letter from coalition of large corporate taxpayers titled "In Opposition to the Project to Revise the Uniform Division of Income for Tax Purposes Act." Undated, received July 7, 2008.
http://www.nccusl.org/Update/Docs/UDITPA/UDITPA_Coalition%20in%20Opposition_070708.pdf

²⁹ Oral comments of Doug Lindholm, Executive Director of the Council on State Taxation, made during the May 2008 Drafting Committee meeting. Reported in "UDITPA Revisions Debated at Initial Meeting of Drafting Committee." June 3, 2008. CCH Tax Tracker News.

³⁰ American Legislative Exchange Council Resolution to Oppose [ULC] Effort to Rewrite the Uniform Division of Income for Tax Purposes Act.
http://www.nccusl.org/Update/Docs/UDITPA/UDITPA_ALECRresolution.pdf

³¹ Oral comments of Doug Lindholm. *Supra.* June 3, 2008. CCH Tax Tracker News.

whose membership includes all state departments of revenue, expressed the view that no-one can realistically deny business has changed significantly over the last 50 years, and as a result “there are several features of UDITPA...that cry out for examination.”³² Both the MTC and the FTA, as well as several individual tax administrators, explained that state legislators will have no choice but to address these issues whether ULC moves forward or not, and that the interests of uniformity, simplification, compliance and efficient tax administration would best be served if there were uniform model amendments available for legislatures to consider.³³ A representative from the California Franchise Tax Board noted that ULC is in “a unique position” to produce a uniform, well-considered act, given that it is “without an agenda or a constituency” to satisfy; if a uniform act is developed, there will be “movement toward it” even if adoption is not immediate.³⁴ The MTC already provides a nucleus of states likely to adopt a revised UDITPA. Several proponents commented on the need to preserve a reasonable level of uniformity in order to avoid excessive duplicative taxation, which could invite federal preemption and jeopardize state sovereignty.³⁵

[4] Current Project Status

[a] The ULC Project to Review UDITPA

The ULC Executive Committee determined at its July 2008 meeting that it would re-designate the current “Drafting Committee” as a “Study Committee.” This change signals ULC’s continuing willingness to consider whether the project should go forward. The Study Committee retains the current Drafting Committee membership, with three new advisors in addition to the original advisors from the American Bar Association. The three additional advisors represent the National Conference of State Legislatures, the American Legislative Exchange Council, and the Counsel on State Governments. The Committee will meet again in March of 2009 to discuss the pro’s and con’s of moving forward.

³² Letter from Linda Tanton, President of the Federation of Tax Administrators, to Charles Trost. July 8, 2008.
http://www.nccusl.org/Update/Docs/UDITPA/UDITPA_FedTaxAdmin_070808.pdf

³³ See, e.g., Letter from Joe Huddleston, Executive Director of the Multistate Tax Commission, to Charles Trost. July 7, 2008.
http://www.nccusl.org/Update/Docs/UDITPA/UDITPA_MTC_070708.pdf ; Letter from Royce Chigbrow, Chairman of the Idaho State Tax Commission, to John Sebert, Executive Director of ULC. June 13, 2008.
http://www.nccusl.org/Update/Docs/UDITPA/UDITPA_IdahoTaxComm_061308.pdf

³⁴ Oral comments of Benjamin Miller, representative from California Franchise Tax Board, made during the May 2008 Drafting Committee meeting. Reported in “UDITPA Revisions Debated at Initial Meeting of Drafting Committee.” June 3, 2008. CCH Tax Tracker News.

³⁵ See, e.g., Letter from Joe Huddleston, *supra* note 32.

[b] The MTC Project to Review Compact Article IV.

The MTC is committed to addressing five specific UDITPA provisions incorporated in Article IV of the Multistate Tax Compact. These are:

- 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)

A survey of MTC membership showed virtually unanimous support for review of these provisions, as well as for limiting the review to just these provisions.³⁶ As noted above, MTC has formed a drafting committee to begin the work of forming a recommended amendment for each of these Compact provisions. MTC's preference and intent is to work through the ULC process in developing these recommendations. Our goal is to adopt the ULC's model UDITPA amendments as the MTC proposed Compact amendments. This is the approach that was followed in 1967, when the ULC's original UDITPA was incorporated nearly whole cloth into the Multistate Tax Compact. And we believe this is the best approach to follow again today as we consider amendments to the Act. It will enable the broadest participation and uniformity possible.

1.05 WHAT ARE THE POSSIBLE ISSUES TO ADDRESS?

The ULC Drafting (now Study) Committee is charged with reviewing UDITPA in its entirety. Accordingly, in preparation for its May 2008 meeting, the ULC Reporters had asked for input on all UDITPA provisions.³⁷ The Reporters also asked for comment on whether UDITPA should be expanded to cover issues that are currently outside its scope, such as combined reporting, partnership rules, a definition of unitary business, nexus, or procedural issues (e.g., a model tax court or "pay to play.")³⁸

[1] UDITPA's Current Provisions

³⁶ See survey results in Appendix B. Approximately 70% of compact member states, and 50% of all member states, responded to the survey.

³⁷ See, UDITPA Issues to Consider for Revision (April, 2008).
http://www.nccusl.org/Update/Docs/UDITPA/UDITPA_Issues.pdf

³⁸ *Id.*

[a] Sales Factor Sourcing for Services and Intangibles
(UDITPA § 17)

Nearly everyone who sees any merit in a UDITPA review recognizes this provision as the one most critically in need of amendment. It is the main driver of the entire effort. Under the current UDITPA, this rule sources receipts from services and intangibles to the state with the greater income producing activity as measured by the cost of performance (known as the COP rule).³⁹

The rule has been very problematic and recent years have seen a marked trend for states to amend the provision in some way. The major problem is that it does not fulfill the purpose of the sales factor: to reflect the contribution of the market states. Rather, the cost of performance rule tends to source receipts to production states, and thus duplicates the function of the property and payroll factors. This duplication of the production factors is particularly counter-productive for states that have moved to more heavily weight the sales factor as a means of encouraging the location of production in the state for economic development purposes (see discussion on factor weighting, below).

In addition, the “income producing activity” and “cost of performance” determinations have been difficult to administer when applied to taxpayers performing multistate services, and may sometimes produce anomalous results. First, the boundaries of “income producing activity” are critical to the apportionment outcome, but they are nearly impossible to objectively identify. One must know what the income producing activity is before one can identify the costs associated with it. Even if income producing activity is capable of being identified, its calculation through cost of performance is riddled with difficulty. The terminology is vague and difficult to define.⁴⁰ And if the cost of performance could be reasonably determined, the rule assigning receipts to the state with the greatest cost of performance can produce arbitrary results in situations where income-producing activities are taking place over many states.⁴¹

³⁹ **Section 17.** Sales, other than sales of tangible personal property, are in this State if:
(a) the income-producing activity is performed in this State; or
(b) 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.

⁴⁰ For example, should activities be viewed on a transaction by transaction basis or viewed in the aggregated when determining the costs of performance? Should costs of performance and direct costs include fixed costs or only variable costs? Should depreciation be included? Should common costs be included and if so how should they be sourced? Categorizing costs as fixed, variable, common or otherwise would be very difficult.

⁴¹ One example might be a telecommunications company with a multistate network. If there were 32 states with 3% of the network cost and 1 state with 4%, the entire receipt may be sourced to the one state with only slightly more cost of performance.

The UDITPA drafters acknowledged from the beginning that the COP rule was given short shrift.⁴² This fact reflects the practical realities of the time. In 1957 most of the economy was mercantile and manufacturing. The major service industries of the time, financial organizations and public utilities, were excluded from UDITPA altogether. Regarding what was left of the service economy, William Pierce - the original primary drafter - wrote in 1957 that he expected frequent resort to the equitable relief provision of UDITPA § 18.⁴³

The concern with this provision has only grown over the years, as service sector income has increased much faster than income from other sectors.⁴⁴ The utilization of intangible property rights as a source of income has also intensified. In addition, significant portions of the major industries that were excluded from the rule, regulated financial services and public utilities, have arguably fallen within UDITPA's scope as they have been deregulated. Thus, a considerably higher percentage of the economy is subject to UDITPA §17 today than was the case in 1957.

At the same time that more of the economy's income is falling under § 17, the movement of states toward heavily weighting the sales factor⁴⁵ is intensifying the provision's significance in determining how income from these growing economic sectors is apportioned. These trends are combining to place increasing emphasis on what was recognized from the beginning as a "default" rule. Shortcomings in UDITPA §17, which states could live with in the 1960's, are now presenting increased uncertainty, administrative burden, and risk of non-uniformity and revenue losses.

For the time being, there remains a fairly high degree of uniformity overall. But a number of states have begun to address these concerns unilaterally. Many more are considering such a move. States are moving away from the UDITPA provision, and doing so in a non-uniform manner. At least eighteen states now deviate from the COP rule as follows:

⁴² Pierce, William J., "The Uniform Division of Income for State Tax Purposes." *TAXES*, Tax Magazine; Vol. 35, No. 10, October, 1957; See also, Warren, John S.; "UDITPA – A Historical Perspective." presentation to the Multistate Tax Commission Annual Meeting; July 28, 2005.

⁴³ *Id.* p. 780.

⁴⁴ The service industry alone created more than half of all new jobs nationally between 1992 and 1997; see U.S. Census Bureau, 1997 Economic Census: Comparative Statistics, 1987 SIC Basis.

⁴⁵ See section 1.06 [b].

- Where Benefit Received: California, Georgia, Michigan, Ohio, Wisconsin, Utah⁴⁶
- Where Service Received: Maine, Minnesota⁴⁷
- Where Service is Performed: Connecticut (relative time spent performing service), New Jersey, New York (relative time, value or other reasonable measure), Rhode Island (relative time spent performing service), South Carolina (relative time spent performing service), Texas (relative value of services performed)⁴⁸
- Proportional COP (as opposed to “the greater”): Mississippi, North Carolina (option to use relative time spent performing service)⁴⁹ [Note: North Carolina states that they do not use, nor have they ever used, cost of performance for sourcing services, contrary to what is indicated.]

Many states have that have not yet revised their general rule, have nonetheless taken significant steps away from it by adopting a myriad of special rules that now cover large segments of its original scope.⁵⁰

The MTC recommends that the COP rule be revised. Ideally, the rules for services and intangible property should be coordinated with the rule for tangible property and should reflect market sourcing. The current MTC special rules

⁴⁶ *California*: Senate Bill 15 (February 19, 2009)
Georgia: Ga. Comp. R. & Regs. r 560-7-7-.03;
Michigan: Mich. Comp. Laws §208.1305(2); Mich. Comp. Laws §208.53;
Ohio: Ohio Rev. Code Ann. §5733.05(B)(2)(c);
Wisconsin: Wis. Stat. §71.25(9)(dh);
Utah: Utah Code Ann. §59-7-319(3)(a).

⁴⁷ *Maine*: Me. Rev. Stat. Ann. tit. 36, §5211.16;
Minnesota: Minn. Stat. §290.191(5).

⁴⁸ *Connecticut*: Conn. Gen. Stat. §12-218;
New Jersey: N.J. Stat. Ann. §54:10A-6(B)(4);
New York: N.Y. Comp. Code R. & Regs. tit. 20, §4-4-3(f);
Rhode Island: R.I. Gen. Laws §44-11-14(a)(2);
South Carolina: S.C. Code Ann. §12-6-2280(C)(2);
Texas: 34 Tex. Admin. Code §3.557(e)(33).

⁴⁹ *Mississippi*: Miss. Code Ann § 27-7-23(c)(3); Miss. Reg. 35.III.8.06(III)(9)(c);
North Carolina: N.C. Gen. Stat. §105-130.4(l)(3).

⁵⁰ The MTC has developed model special apportionment rules for financial institutions and virtually all of the large common carriage industries, including telecommunications, airlines, railroads, trucking companies, and television and radio broadcasting, *available at* <http://www.mtc.gov/Uniformity.aspx?id=496> .

generally use a market sourcing approach.⁵¹ There are several options for amendment that should be considered.⁵²

[b] Definitions (UDITPA § 1)

Two UDITPA provisions have been especially prone to litigation and/or the need for legislative clarification. These are the definitions of business income and gross receipts.⁵³

[i] Definition of Business Income

Today, a majority of states have interpreted the term “business income” to provide two tests for identifying apportionable business income: a transactional test and a functional test.⁵⁴ But the language of the Act is not very clear and some states have held UDITPA provides only a transactional test. In states where the courts found only a transactional test, the legislatures have generally followed up with a statutory amendment to clearly add the functional test.⁵⁵ There has also

⁵¹ See, e.g., MTC Model Special Apportionment Rule for Telecommunications and Ancillary Services (2008); MTC Model Special Apportionment Rule for Television and Radio Broadcasting (1995).

⁵² The MTC recommends a policy criteria be established as a basis for comparing the various amendment options. See Section [1.06], below.

⁵³ UDITPA §§ 1(a) and 1(g), respectively.

⁵⁴ CCH Commentary, Multi-Corp-Income, *Distinction Between Business and Non-Business Income* (2007). See also, e.g., *Hoechst Celanese Corp. v. Franchise Tax Board*, 25 Cal.4th 508 (2001); *Laurel Pipeline Co. v. Commonwealth*, 615 A.2d 841 (Pa. 1994); *Texaco-Cities Service Pipeline Co. v. McGaw*, 695 N.E. 2d 481 (1998); *Polaroid Corp. v. Offerman*, 349 NC 290 (1998); *Willamette Industries, Inc. v. Oregon Department of Revenue*, 331 Or 311 (2000); *Kemppel v. Zaino*, 746 N.E. 2d 1073 (Ohio, 2001).

Section 1(a). “Business income” means income arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations.”

⁵⁵ See, e.g.:

Alabama: Ala. H.B. 7 (Dec. 28, 2001) amending Ala. Code Sec. 40-27-1.1. *Superseding Uniroyal Tire Co. v. State Department of Finance*, 779 So.2d. 227 (Ala. 2000).

Iowa: Iowa Code § 422.32. *Superseding Phillips Petroleum v. Iowa Department of Revenue and Finance*, 511 N.W. 608 (Iowa 1994).

Kansas: K.S.A. 79- 3271(a). *Superseding Appeal of Chief Industries, Inc.*, 255 Kan. 640, 647, 875 P.2d 278 (1994).

New Mexico: N.M. Stat. Ann. § 7-4-2(A). *Superseding McVean & Barlow, Inc. v. New Mexico Bureau of Revenue*, 88 N.M. 521, 543 P.2d 489, cert denied 546 P.2d 71 (1975).

Tennessee: Tenn. Code Ann. § 67-4-2004. *Superseding Associated Partnership I, Inc. v. Huddleston*, 889 S.W.2d 190 (Tenn. 1994).

been a trend over the last few years for states to adopt legislation defining business income simply as all income apportionable under the U.S. Constitution.⁵⁶

The MTC recommends this UDITPA provision defining business income be amended. 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, then 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.

[ii] Definition of “sales”

UDITPA defines “sales” as “all gross receipts of the taxpayer....” But the term “gross receipts” is not defined.⁵⁷ Many states have confronted the question of whether the term “gross receipts” includes return of investment principal in the case of the repayment of a loan or a short-term investment of working capital. The MTC has promulgated two model regulations interpreting the existing language of UDITPA and the Compact to exclude returns of principal. This approach is consistent with the current rule in the overwhelming majority of states that have addressed the issue.⁵⁸ Some states have held that a return of a

⁵⁶ See, e.g.:

Illinois: 35 ILCS 5/1501(a)(1);

Kansas: K.S.A. 79-3271(a);

Minnesota: Minn. Stat. §290.17 Subd.4.(a);

North Carolina: N.C. Gen. Stat. §105-130.4(a)(1);

Pennsylvania: 72 P.S. §7401(3)2.(a)(1)(A).

⁵⁷ **Section 1(g)**. “Sales’ means all gross receipts of the taxpayer not allocated under Sections 4 through 8 of this Act.”

⁵⁸ According to research performed by the California Franchise Tax Board, the following states do not treat returned principal as a receipt in a sales factor or a factor equivalent to a sales factor: Arkansas (Ark. Code Ann. § 26-51-1403, subs. (f)(1) and (m)(1)(A)); Colorado (Colo. Rev. Stat. § 39-22-303, subd. (4)(b)); Connecticut (Conn. Gen. Stat. § 12-218, subd. (c)(3)); Florida (Fla. Stat. § 220.15, subd. (5)(a)); Georgia (Ga. Code Ann. § 48-7-31, subs. (c)(1), (d)(1)(C)); Hawaii (Code of Hawaii Rules § 18-235-38-03, subd. (f)); Idaho (Idaho Admin. Rules 35-01.01.570, subd. .03); Illinois (Ill. Admin. Code 100.3380, subd. (c)(5)); Indiana (*Sherwin-Williams Co. v. Indiana Dep’t of State Revenue* (Ind. Tax 1996) 673 N.E.2d 849.); Iowa (Iowa Admin. Code §§ 701-54.2.2(422), subd. (2)(f), 701-59.28 (422)); Kansas (Kan. Stat. Ann. § 79-3285); Kentucky (Ky. Revenue Cabinet Tax Policy 41P170, 06/01/1983.); Louisiana (La. Rev. Stat. § 47:287:92, subd. (B)(2)); Maine (Me. R. 80 (18-125 CMR 801), subs. .08(B)(1), (2)); Maryland (Md. Regs. Code 03.04.03.08, subd. (C)(3)(d)); Massachusetts (Mass. Gen. L. § 38, subd. (f)); Michigan (*H.J. Heinz Co., Inc. v. Dep’t of Treasury* (Mich. 1992) 494 N.W.2d 850); Minnesota (Minn. Stat. § 290.191, subd. (5)(a)(5)); Mississippi (Miss. Income Tax R. 806, subd. (III)(B)(9)(c)); Nebraska (Neb. Rev. Stat. § 77-2734.10, subd. (1)); New Hampshire (N.H. Admin. Rules, Rev. 304.05, subs. (b), (c)); New Jersey (N.J. Admin.

taxpayer's property is inconsistent with the commonly-understood concept of a "sale"; other states have found that UDITPA's definition of "sales" could include returns of principal, but nonetheless exclude such amounts to prevent distortion of the sales factor. Although States have had to fill this gap with litigation, legislation or regulation, the uniform result has been to exclude returns of principal.

MTC recommends the definition of "sales" used in UDITPA be clarified to define "gross receipts" and to exclude return of investment principal in the case of the repayment of a loan or a short-term investment of working capital.

[iii] Other Definitional Issues

The Reporters have raised other definitional issues regarding the meaning of the terms "commercial domicile," "compensation," "financial organization," and "public utility." The MTC suggests that 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.

[c] Exclusions (UDITPA § 2)

Section 2 excludes financial organizations and public utilities from UDITPA.⁵⁹ The original drafters indicated these highly regulated industries were

Code 18:7-8.9; *AT&T v. Director, Division of Taxation* (N.J. Sup. Ct. App. Div. 1984) 476 A.2d 800; New Mexico (N.M. Admin. Code 3.5.19.11, subd.(A)(4)); North Carolina (N.C. Gen. Stat. § 105-130.4, subd. (a)(7)(d)); New York (N.Y. Tax Law §§ 208, subd. (d), 210, subd. (3)(b) [for investment activities of non-investment company, such investment activities assigned on the basis of an investment allocation percentage determined by activities of securities issuer and not by the taxpayer's activities]); Ohio (Ohio Rev. Code Ann. § 5733.05, subd. (B)(2)(c)); Oklahoma (Okla. Admin. Code 710:50-17-71, subd. (1)(A)(i)); Oregon (Or. Rev. Stat. § 314.665, subd. (6)(a); Or. Admin. R. 150-314.665(6)(c), subds. (1)(a), (b)); Pennsylvania (Pa. Stat. Ann. § 7401, subd. (3)(2)(a)(1)(E); *Commonwealth v. General Electric Co.* (1963) 412 Pa. 123, 194 A.2d 139); Rhode Island (R.I. Gen. Laws § 44-11-14, subd. (2)(v); R.I. Reg. CT 04-04, subd. (2)(d)); Texas (Tex. Admin Code 3.549, subds. (b)(5), (e)(27)); Utah (Utah Admin. Code R865-6F, subd. (8)(1)(J)(3)(a)(2)); Virginia (Va. Public Document Ruling nos. 91-272, 91-212); Washington (Wash. Rev. Code § 82.02.080); West Virginia (W.Va. Admin. Dec. no. 93-233 RN [Aug. 11, 1997]); and Wisconsin (Wis. Stat. § 71.04, subd. (7)(f)(5)). *See also, General Motors Corp. V. Franchise Tax Bd.,* 39 Cal.4th 773, 139 P.3d 1183 (Cal.,2006).

⁵⁹ **Section 2.** "Any taxpayer having income from business activity which is taxable both within and without this state, other than activity as a financial organization or public utility or the rendering of purely personal services by an individual, shall allocate and apportion his net income as provided in this Act."

unique and already adequately covered by existing state rules. Many of these industries have now been deregulated. Should they continue to be excluded? The section also excludes an individual rendering purely personal services. The Reporters suggest this exclusion was meant to recognize that individuals are subject to personal income tax, a separate tax regime that typically taxes residents on their worldwide income and provides a credit for income taxes paid to other states. Is there any reason to bring individuals within UDITPA?

The MTC recommends the question of whether to include financial institutions and public utilities should be considered in the context of amendments to section 17. Hopefully a general sales sourcing rule for services can be developed that will eliminate the need for so many industry specific rules.

[d] The “Subject to Tax” Criteria (UDITPA § 3)

Section 3 sets forth the rule for when a taxpayer is taxable in another state and, therefore, becomes an apportioning taxpayer.⁶⁰ The Reporters have pointed out that, arguably, the first clause is unnecessary because it is swallowed by the second clause. They ask if it is necessary to clarify whether mere jurisdiction to tax, in the absence of an actual tax levy, is sufficient to trigger a need to apportion income. Another question is what rules should be applied to determine if a corporation is taxable by a foreign country? The MTC suggests this provision is working reasonably well. Potential improvements would not justify the additional time and complexity, and would diminish our ability to get critical amendments enacted.

[e] Allocation of Non-Business Rents and Royalties (UDITPA § 4 – 8)

The provisions set out in UDITPA sections 4 through 8 provided rules for allocating nonbusiness rents and royalties from certain assets.⁶¹ The Reporters

⁶⁰ **Section 3.** “For purposes of allocation and apportionment of income under this Act, a taxpayer is taxable in another state if (1) in that state he is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or (2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.”

⁶¹ **Section 4.** Rents and royalties from real or tangible personal property, capital gains, interest, dividends or patent or copyright royalties, to the extent that they constitute nonbusiness income, shall be allocated as provided in paragraphs 5 through 8 of this Article.

Section 5. “(a) Net rents and royalties from real property located in this state are allocable to this state.

(b) Net rents and royalties from tangible personal property are allocable to this state:

(1) if and to the extent that the property is utilized in this state, or

suggest these provisions may become less important if UDITPA's business income definition is broadened. They note some odd results that follow under the existing provisions: e.g., tangible property is taxed where located, otherwise it is taxed at the taxpayer's commercial domicile; under what circumstances would the "otherwise" occur? Patent and copyright royalties are sourced to where they are used (section 8); but, if they're sold, then the proceeds are sourced to the taxpayer's commercial domicile (section 6(c)).

(2) in their entirety if the taxpayer's commercial domicile is in this state and the taxpayer is not organized under the laws of or taxable in the state in which the property is utilized.

(c) The extent of utilization of tangible personal property in a state is determined by multiplying the rents and royalties by a fraction, the numerator of which is the number of days of physical location of the property in the state during the rental or royalty period in the taxable year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the taxable year. If the physical location of the property during the rental or royalty period is unknown or unascertainable by the taxpayer tangible personal property is utilized in the state in which the property was located at the time the rental or royalty payer obtained possession."

Section 6. "(a) Capital gains and losses from sales of real property located in this state are allocable to this state.

(b) Capital gains and losses from sales of tangible personal property are allocable to this state if:

(1) the property had a situs in this state at the time of the sale, or

(2) the taxpayer's commercial domicile is in this state and the taxpayer is not taxable in the state in which the property had a situs.

(c) Capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state."

Section 7. "Interest and dividends are allocable to this state if the taxpayer's commercial domicile is in this state."

Section 8. "(a) Patent and copyright royalties are allocable to this state:

(1) if and to the extent that the patent or copyright is utilized by the payer in this state, or

(2) if and to the extent that the patent or copyright is utilized by the payer in a state in which the taxpayer is not taxable and the taxpayer's commercial domicile is in this state.

(b) A patent is utilized in a state to the extent that it is employed in production, fabrication, manufacturing, or other processing in the state or to the extent that a patented product is produced in this state. If the basis of receipts from patent royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the patent is utilized in the state in which the taxpayer's commercial domicile is located.

(c) A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the basis of receipts from copyright royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the copyright is utilized in the state in which the taxpayer's commercial domicile is located."

While issues have arisen around these provisions, the MTC suggests the provisions are working well overall. Issues associated with the provisions do not rise to a level that warrants model amendment efforts.

[f] Factor Weighting (UDITPA § 9)

UDIPTA calls for an equal-weighting of the property, payroll and sales factors.⁶² But as of January 1, 2008, only ten states exclusively require an equal-weighted formula. Seven of those ten are Multistate Tax Compact members. Although states are moving away from the three-factor equal-weighted formula, they are at least moving away in the same direction – toward more heavily weighting the sales factor. Thirty-seven states now at least double weight the sales factor. And eleven of those thirty-seven states apportion based on the sales factor only.⁶³ (See Table, Appendix D)

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 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. 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.

With less than 25% of the states adhering to the current rule, MTC believes this provision is worthy of study and an attempt to find a workable rule that states can adopt. Several options should be considered.

[g] The Property Factor (UDITPA § 10 - 12)

⁶² **Section 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 the sales factor, and the denominator of which is three.”

⁶³ *State Apportionment of Corporate Income*; Federation of Tax Administrators http://www.taxadmin.org/fta/rate/corp_app.html.

Section 10 sets forth the property factor rule.⁶⁴ The Reporters have raised several questions around this provision, including: should intangible property be included in the property factor? If so, where should it be treated as located (where the licensee operates (e.g. manufactures) or where ultimate customer is located)? Where should marketing intangibles be located? If marketing intangibles can be said to be associated with the location of the market, does the sales factor take care of properly reflecting this activity? Should the property be depreciated? If so, should the depreciation reflect market value, or a federal or state tax value? Is “8 times the annual rental rate” still a good reflection of the value of rental property? Should there be a throwback or throwout rule for outer-jurisdictional property, such as property in outer-space or on the high seas?

All are excellent questions. But before embarking on a property factor review, we should ask whether the considerations that led the original drafters to produce this rule in 1957 are likely to have changed significantly. Has this provision raised problems that are not adequately addressed and answered through regulations or U.S. Supreme Court consideration?⁶⁵ The MTC does not recommend this provision as a focus for amendments.

[h] The Payroll Factor (UDITPA § 13)

Section 13 sets out the payroll factor.⁶⁶ The Reporters ask whether there should be a rule for handling affiliated payroll companies, and if so, are there circumstances where such a rule should be extended to nonaffiliated independent contractors. What about affiliated payroll companies (leased employees)? How should stock options be treated?

The Reporters have identified pressing issues associated with this factor. On balance, however, MTC is of the view that potential improvements to this rule

⁶⁴ **Section 10.** “The property factor is a fraction, the numerator of which is the average value of the taxpayer’s real and tangible personal property owned or rented and used in this state during the tax period and the denominator of which is the average value of all the taxpayer’s real and tangible personal property owned or rented and used during the tax period.”

Section 11. “Property owned by the taxpayer is valued at its original cost. Property rented by the taxpayer is valued at eight times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from sub-rentals.”

⁶⁵ *See, e.g., Polar Tankers v. City of Valdez*, U.S.S.C. No. 08-310, considering the constitutionality of a type of property tax apportionment “throwout” rule that could have implications for income tax throwout and throwback provisions.

⁶⁶ **Section 13.** “The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the tax period by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the tax period.”

would not justify the additional time and controversy their resolution would engender, which could diminished ULC's ability to get critical amendments timely enacted.

[i] Sales Factor Generally (UDITPA § 15)

Section 15 states the basic sales factor rule.⁶⁷ Are there receipts excluded that should be included, or vice versa? For example, should the gross receipts from the sale of assets whose gain has accrued over a long period of time be excluded? MTC does not recommend this provision for amendment, based on our belief that the UDITPA review, to be successful, must focus narrowly on the provisions that are critically in need of modernization. This provision is not one of those in our opinion.

[j] Sales Factor Sourcing for Tangibles (UDITPA § 16)

Section 16 sets forth the rule for sourcing receipts from sales of TPP.⁶⁸ The Reporters ask whether a throwback rule is appropriate. Should it be replaced with a throwout rule? Is it necessary at all? Does the destination rule work for sales to distributors and other intermediaries that will resale the good?

MTC believes this provision is working well. Issues have certainly arisen and created some degree of non-uniformity, but the issues do not rise to the level of concern that would justify an amendment effort that puts other, critical amendments at risk of not being completed.

[k] Distortion Relief Provisions (UDITPA § 18)

Section 18 contains UDITPA's distortion relief provision.⁶⁹ The MTC recommends this provision be clarified to more clearly allow for adoption of

⁶⁷ **Section 15.** "The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period."

⁶⁸ **Section 16.** "Sales of tangible personal property are in this state if:

(a) the property is delivered or shipped to a purchaser, other than the United States government, within this state regardless of the f.o.b. point or other conditions of the sale; or

(b) the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser."

⁶⁹ **Section 18.** "If the allocation and apportionment provisions of this Act 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:

(a) separate accounting;

industry-wide and issue-wide special apportionment rules. John Warren, who represented the State of California at ULC during the drafting of UDITPA, recently remarked:

The original drafters probably thought of Section 18 as a tool to be used to avoid gross distortion under the facts of a particular taxpayer. The adopting states and the MTC, however, have chosen to use it in a much broader way. It has become the authority for devising special factors and formulas for whole industries, and this is to be applauded.

Written comments to the MTC 2005 Annual Meeting; Boise, Idaho

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.

[2] Should the Scope of UDITPA be Expanded?

The MTC recommends against risking progress on critical UDITPA provisions by attempting to address issues beyond the scope of apportionment and the current UDITPA. 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 apportionment issues will allow for broader adoption among states that may have made different policy choices on issues of tax base, nexus, combination or procedural processes.

Trying to address the controversies surrounding these external issues could impede development of badly needed revisions. 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*.⁷⁰

-
- (b) the exclusion of any one or more of the factors;
 - (c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
 - (d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."

⁷⁰ 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

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.⁷¹ 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,⁷² others have not.⁷³ Recent state legislative efforts to make combined reporting explicit have met determined opposition.⁷⁴ 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

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); *Capital One Bank v. Commissioner of Revenue*, 453 Mass. 1, 899 N.E.2d 76 (Mass.,2009).

⁷¹ See, e.g., H.R. 5267, the Business Activity Tax Simplification Act of 2008.

⁷² *Wal-Mart Stores East, Inc. a/k/a Wal-Mart Stores East I, Inc. v. Hinton*, No. 06-CV-3928, 12/31/07, on appeal to the North Carolina Ct. App. No.: COA08-450; *Coca Cola Co. v. Oregon Department of Revenue*, 533 P.2d 788 (Ore. 1975); *Montana Department of Revenue v. American Smelting & Refining Co.*, 567 P.2d 901 (Mont. 1977); *American Smelting & Refining Co. v. Idaho State Tax Com.*, 592 P.2d 39 (Id. 1979); *Caterpillar Tractor Co. v. Lenckos*, 417 N.E.2d 1343 (Ill. 1981); *PMD Investment Co. v. State Dep't of Revenue*, 345 N.W.2d 815 (1984); *Pioneer Container Corp. v. Beshears*, 684 P.2d 396 (Kan., 1984).

⁷³ *Polaroid Corp. v. Comm. of Rev.*, 472 N.E.2d 259 (Mass., 1984); *Sears Roebuck & Co. v. State Tax Assessor*, 561 A.2d 172 (Maine, 1989). See also, Peters, *State Income Tax Problems of Interstate Business*, 33rd 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....”).

⁷⁴ 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>

for nexus, combined reporting and treatment of pass-through entities.⁷⁵ The Commission suggested 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.

1.06 A Policy Criteria for Comparing Options

The MTC's initial recommendation to the ULC Program & Scope Committee in May 2007 included agreement that policy criteria should be established at the outset as a means for evaluating the myriad of possible alternative approaches. The MTC agreed with the criteria suggested by ULC, with a few suggested changes:

1. Is the proposal a simple and workable way to compute the tax base?
 - a. Can the elements of the proposed factor be located geographically?
 - b. Will the proposal facilitate transparency and compliance with tax laws?
 - c. Will the proposal minimize cost of administration for both taxpayers and the state?
2. Does the proposal help assure that income is taxed once and only once - avoiding "nowhere income" - and duplicative taxation ("internal consistency")?
3. Does the proposal reasonably reflect a reasonable sense of how income is earned ("external consistency")?
4. Will the proposal reasonably reflect the level and nature of business activity in the state?

⁷⁵ See MTC model Factor Presence Nexus Standards:

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

MTC model Combined Reporting Statute:

http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Combined%20Reporting%20-%20FINAL%20version.pdf

Since the model was developed West Virginia and Massachusetts have newly enacted combined reporting. West Virginia adopted the model virtually word for word. The Massachusetts statute was based on the MTC model. The MTC model provisions have also been included in proposed combined reporting legislation introduced in Florida HB 1237; Kentucky HB 302; Tennessee SB 3158; and other states as well.

5. Will the proposal promote apportionment of income in fair relation to the benefits, opportunities, services and protections provided by the state?
6. Is the proposal non-discriminatory with respect to both interstate commerce and purely in-state commerce?
7. Does the proposal minimize the opportunity for manipulation of the apportionment result?
8. Will the proposal have an acceptable fiscal impact to the states and to taxpayers?
9. Does the proposal produce an equitable apportionment of the tax base?
 - a. Will the proposal promote horizontal equity by treating taxpayers in the same situation similarly?
 - b. Will the proposal promote vertical equity treating taxpayers who are not in the same situation differently, in an equitable manner?
10. Is the proposal economically neutral? Will it avoid creating economic distortions by giving firms incentives to use one type of production process over another, or to locate property and/or payroll in one geographic area as opposed to another?

1.07 Conclusion

For over a half century, UDIPTA has been the basis for our uniformity efforts. The changing economy has created a situation where states must consider amendments to these tax base apportionment rules. ULC can provide states a revised model uniform Act to guide them in these considerations.



Working Together Since 1967 to Preserve Federalism and Tax Fairness

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September 6, 2006

Mr. Robert A. Stein, Esq.
Chair, Committee on Scope and Program
National Conference of Commissioners
on Uniform State Laws
211 E. Ontario Street, Suite 1300
Chicago, IL

Dear Mr. Stein:

The Multistate Tax Commission has undertaken a project to draft model proposed uniform amendments to Article IV of our Multistate Tax Compact. The Compact became effective in 1967, and Article IV incorporates NCCUSL's 1957 model Uniform Division of Income for Tax Purposes Act nearly word for word. Twenty states have essentially adopted UDITPA through the Compact, and another twenty or so states have adopted UDITPA as a separate act. In the interest of preserving the broadest state uniformity possible, we invite NCCUSL to work with us to simultaneously review and draft model proposed amendments to UDITPA and Article IV of the Compact.

We believe it is essential to act quickly. After 40 years, our Compact states are facing inevitable pressure to change their methods of statutory apportionment. Nearly every aspect of the apportionment rules merit some level of reconsideration. In particular, there is widespread agreement that sales factor sourcing for transactions other than sales of tangible goods (Art. IV, §17 of the Compact and §17 of UDITPA) is the provision most in need of overhaul. A number of states are in various stages of addressing these provisions unilaterally. Our organization is very concerned that stand-alone, state-by-state amendments will quickly result in substantial disuniformity. In the context of income tax apportionment, disuniformity inevitably results in either duplicate taxation or less than full apportionment for multistate taxpayers.

We believe model amendments or a complete rewrite are critical to preserving the original uniformity goals of UDITPA and the Compact. And we would appreciate an opportunity to discuss with you in detail how we might best move forward together with this project.

Sincerely,

Joan Wagnon
Secretary, Kansas Department of Revenue
Chair, Multistate Tax Commission

Joe Huddleston
Executive Director
Multistate Tax Commission

**RESULTS OF MTC 2008 STATE SURVEY
ON SCOPE OF UDITPA AMENDMENTS**

Do you agree with the recommendation that scope of review should include:	Yes%	No%
Sales factor numerator sourcing for receipts from transactions other than sales of tangible personal property (UDITPA §17)	100	0
Factor Weighting (UDITPA §9)	84	16
Definition of Business Income (UDITPA §1(a))	100	0
Definition of Gross Receipts (UDITPA §1(g))	100	0
Distortion Relief Provision (UDITPA §18)	100	0

Do you think the recommended scope of review should be expanded to include:	Yes%	No%
Other Specific UDITPA Provisions - Please identify in attached comments	16	84
All UDITPA Provisions	5	95
Nexus Provisions (Not currently addressed in UDITPA)	5	95
Combined Reporting (Not currently explicitly addressed in UDITPA)	5	95
Tax Base Provisions (Not currently addressed in UDITPA)	0	100
Procedural Provisions (Not currently addressed in UDITPA)	0	100
Pass-through Entities (Not currently addressed in UDITPA)	20	80
Other Tax Provisions – please identify provisions in attached comments	0	100

Should the recommended policy criteria for evaluating alternatives be established?	100%	
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Multistate Tax Commission Membership

Compact Members	Sovereignty Members	Associate & Project Members	Non-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 Washington	Georgia Kentucky Louisiana Maryland New Jersey West Virginia Wyoming	Arizona Connecticut Florida Illinois Indiana Iowa Maine Massachusetts Mississippi Nebraska New Hampshire New York North Carolina Ohio Oklahoma Pennsylvania Rhode Island South Carolina Tennessee Vermont Wisconsin	Delaware Nevada Virginia

Appendix D

STATE APPORTIONMENT OF CORPORATE INCOME
(Formulas for tax year 2008 -- as of January 1, 2008)

ALABAMA	3 Factor	NEBRASKA	Sales
ALASKA	3 Factor	NEVADA	No State Income Tax
ARIZONA (2)	75% Sales, 15% Property & Payroll	NEW HAMPSHIRE	Double wtd. Sales
ARKANSAS	Double wtd. sales	NEW JERSEY (1)	Double wtd. Sales
CALIFORNIA	Double wtd. sales	NEW MEXICO	Double wtd. sales/3 Factor
COLORADO	3 Factor/Sales & Property	NEW YORK (3)	Sales
CONNECTICUT	Double wtd. sales/Sales	NORTH CAROLINA	Double wtd. sales
DELAWARE	3 Factor	NORTH DAKOTA	3 Factor
FLORIDA	Double wtd. sales	OHIO	60% Sales, 20% Property & Payroll
GEORGIA	Sales	OKLAHOMA	3 Factor
HAWAII	3 Factor	OREGON	Sales
IDAHO	Double wtd. sales	PENNSYLVANIA	70% Sales, 15% Property & Payroll
ILLINOIS	Sales	RHODE ISLAND	3 Factor
INDIANA (3)	70% Sales, 15% Property & Payroll	SOUTH CAROLINA (4)	Double wtd. sales/Sales
IOWA	Sales	SOUTH DAKOTA	No State Income Tax
KANSAS	3 Factor	TENNESSEE	Double wtd. sales
KENTUCKY	Double wtd. sales	TEXAS	Sales
LOUISIANA	Sales	UTAH	3 Factor/Double wtd. sales
MAINE	Sales	VERMONT	Double wtd. sales
MARYLAND	Double wtd. sales/Sales	VIRGINIA	Double wtd. sales
MASSACHUSETTS	Double wtd. sales	WASHINGTON	No State Income Tax
MICHIGAN	Sales	WEST VIRGINIA	Double wtd. sales
MINNESOTA (3)	81% Sales, 9.5% Property & Payroll	WISCONSIN	Sales
MISSISSIPPI	Accounting/3 Factor	WYOMING	No State Income Tax
MISSOURI	3 Factor/sales	DIST. OF COLUMBIA	3 Factor
MONTANA	3 Factor		

Source: Compiled by FTA from various sources.

Note: The formulas listed are for general manufacturing businesses. Some industries have special formula different than those reported. A slash separating two formula's indicate taxpayer option.

(1) 3-factor formula is used for corporations not subject to the corporation business franchise tax.

(2) Corporations using this formula must release financial data to the Legislative Budget Committee, otherwise use double weighted sales.

(3) State is phasing in a single sales factor. Weightings will change each year until 100% sales factor in 2011 for Indiana, and 2013 for Minnesota.