Intentionalism and Textualism Yield Strikingly Different Results in Interpreting the Meaning of the Uniform Division of Income for Tax Purposes Act: A Tale of Two Cities

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The Supreme Courts of Virginia and Pennsylvania recently construed two separate sections of the Uniform Division of Income for Tax Purposes Tax Act (UDITPA).[2] The two courts took drastically different paths in interpreting and applying the provisions of the venerable Act, now 65 years old. The results in both cases are controversial, or at least outside of the mainstream of previous interpretations of the Act's provisions. Although UDITPA is clearly showing its age, and survives in something like its original form in only a handful of states, many of its provisions still provide the foundation for apportioning business profits in the great majority of states. No single agreed-upon model for the allocation and apportionment of business income has emerged to replace it. It follows that we should probably try to agree on the best means of interpreting its provisions.

Part One: Textualism in Richmond

The UDITPA apportionment formula employs three evenly weighted factors to determine the extent of a taxpayer's "business activity" in the states in which it operates. The formula is then used to approximate the taxpayer's relative earnings in those states. There is no serious disagreement among scholars or courts that the property and payroll factors were intended to represent the contributions of the state of production to income generation. Nor is there any serious disagreement that the sales factor was intended to represent income-generating contributions of the marketplace.

Currently, the great majority of states either weight the sales factor more heavily in their apportionment formulas or rely exclusively on the sales factor in determining how income should be apportioned. Although the equally weighted three factor formula was once described by the U.S. Supreme Court as the benchmark by which other formulas should be measured,[3] only four states continue that standard for all taxpayers.[4]

In *Virginia Department of Taxation v. R.J. Reynolds Tobacco Co.,*[5] the Virginia Supreme Court considered how to apply UDITPA's property factor calculation. The operation of UDITPA's property factor is described in three sections of the Act. Section 10 provides that the factor should be calculated by comparing property used in the state to property used everywhere. Section 11 provides that property owned by the taxpayer should be valued at original costs, while Section 12 provides for averaging the value of property at the beginning and end of the tax year.

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[1] For identification purposes only. The views expressed herein do not necessarily represent the views of the Multistate Tax Commission or its member states.
[2] 7A West's Uniform Laws Annotated, Part 1, 141 (West Pub. 2002), available at: Uniform Laws Commission, Division of Income for Tax Purposes - Uniform Law Commission (uniformlaws.org) (last visited February 2023).
[3] *Container Corporation of America v. Franchise Tax Board,* 463 U.S. 159, 170 (1983).
[4] Hawaii, Kansas, North Dakota, and Oklahoma. Source: Bloomberg Tax Research; Corporate Tax Chart Builder. Other states may use the formula for particular businesses or industries.
[5] 868 S.E.2d 429 (Va. 2022).

The Virginia Supreme Court focused its attention on a single word in Section 10, namely, what it means for the taxpayer to have "used" property it owned during the tax year, for purposes of including that property in the numerator and denominator of the taxpayer's property factor. The property at issue—tobacco—is so closely identified with Virginia's history and culture that it appears on one of the original seals[6] of the Colony of Virginia.

Like many agricultural products, tobacco must be aged before it is ideally suited for consumption. Tobacco generally is aged for one to two years before it is ready for processing into cigarettes, and as fortune would have it, the climate of Virginia is an ideal one for such aging to occur. The tobacco is placed in a warehouse with natural ventilation and allowed to do its thing, with virtually no human involvement after that. R.J. Reynolds buys a lot of leaf tobacco, ages it in a large Virginia warehouse and then ships the product to North Carolina for processing into cigarettes.[7]

The Virginia legislature adopted UDITPA in 1960 "in response to the recommendations of the National Conference of Commissioners on Uniform State Laws."[8] Virginia continues to employ a "UDITPA-based statute"[9] to the current day, including UDITPA's property factor calculation (with a minor modification) as Va. Code Sec. 58.1-409.[10] Virginia also adopted many provisions in the Multistate Tax Commission's 1974 Model General Allocation and Apportionment Regulation,[11] including the model's directives for applying UDITPA's property factor sections, with several modifications. One sentence of the MTC's model regulation that Virginia incorporated into its own regulation provides that, "property under construction during the taxable year (except inventorial goods in process) shall be excluded from the property factor until actually used."[12]

A. While UDITPA's Property Factor Appears Straightforward, Its Application Quickly Reveals its Ambiguous Nature

To the Virginia court, there was no ambiguity in how the term "used" was employed in the statute describing the property factor, and thus the court was bound by the plain meaning of the statute. This finding precluded any resort to extrinsic evidence of as to how the legislature might have viewed that phrase in the context of UDITPA as a whole. The court explained:

> [t]his Court will look no further than, and is bound by, the plain meaning of the word "used," i.e., "to put into action or service" or "[t]o employ for the accomplishment of a purpose." *Webster's Third New International Dictionary* 2523 (1993); *Black's Law Dictionary* 1853, 1855 (11th ed. 2019).

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[6] seal of the Virginia colony - Bing images.
[7] *R.J. Reynolds*, 868 S.E.2d at 430.
[8] *Corporate Executive Board Company v. Virginia Department of Revenue*, 822 S.E.2d 918, 921 (Va. 2019).
[9] *Id.*
[10] "The property factor is a fraction, the numerator of which is the average value of the corporation's real and tangible personal property owned and used or rented and used in the Commonwealth during the taxable year and the denominator of which is the average value of all the corporation's real and tangible personal property owned and used or rented and used during the taxable year and located everywhere, to the extent that such property is used to produce Virginia taxable income and is effectively connected with the conduct of a trade or business within the United States and income therefrom is includable in federal taxable income."
[11] www.mtc.gov.
[12] 23 VAC 10-120-160(A)(4).

> We are required to defer to the circuit court's finding of fact that the storage of the leaf tobacco in the Danville Facilities is not necessary for the aging process. The leaf tobacco will age regardless of where it is kept. In fact, the circuit court found, and Lorillard's witness testified, that Lorillard does "absolutely nothing" to the leaf tobacco and that the leaf tobacco "just sits there" in the warehouse where it is stored.[13]

The Court did grant that a regulation directly on point could be considered, but after agreeing with the circuit court that 23 VAC 10-120-160(A)(4) did not "contemplate aging agricultural raw materials in its categories of property that are used" held that the tax department's reliance on analogies drawn from the regulation were "unnecessary and inapposite."[14]

Significantly, the Virginia court stressed that the taxpayer and the tax department had both agreed that "there is no ambiguity in the Code's employment of the term 'used.'"[15] *Black's Law Dictionary* defines "ambiguity" in part as "doubtfulness or uncertainty of meaning or intention."[16] Where the parties to a dispute agree that a word or phrase is unambiguous, but advance completely divergent meanings for the word or phrase in good faith, it should be incumbent upon a court to make further inquiry as to whether the term might be ambiguous after all.

Is the phrase "used in this state during the tax period" ambiguous? Returning to *Black's Law Dictionary*, three relevant types of ambiguity are identified: (a) calculated ambiguity; (b) latent ambiguity; and (c) patent ambiguity. "Used in the state" would be considered a latent ambiguity: it is susceptible to multiple interpretations when applied to particular circumstances. For example, must the property in question be used directly, or merely indirectly, such assets pledged as collateral for a business loan? And there is often a temporal aspect of "used in the state" that the Virginia court might have considered. Presumably inventory already on store shelves would be considered "used" even though it might not be sold immediately, but how about a two-year supply of aviation fuel purchased by an airline when prices were low?

As it happens, other courts have had occasion to consider the application of "used" in constructing UDITPA's property factor, and it is unfortunate that the Virginia court did not consider those precedents. In *Alaska, Department of Revenue v. Amoco Production Co.*,[17] the question presented was whether oil and gas leases in the state should be included in the property factor, where the leases had been declared to be unproductive in a prior year. The court noted that exploration and development of such property was the core of the taxpayer's unitary business, and all property connected to that activity was accordingly "used" by the taxpayer as contemplated by UDITPA.

Similarly, the Massachusetts Supreme Judicial Court in 1990 had the occasion to consider whether an oil company's undeveloped acreage should be included in the taxpayer's property factor denominator.[18] The Commissioner of Revenue argued against it, noting that the taxpayer conducted no tests on the property, did no drilling, and in fact never "touched" the property during the tax year. The Supreme Judicial Court was unimpressed by the argument, holding that "although the unoperated acreage may not be producing

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[13] *R.J. Reynolds*, *supra*, at 434.
[14] *Id.*
[15] *Id.*
[16] *Black Law Dictionary*, 10th Ed., p. 97.
[17] 676 P.2d 595 (Ak. 1984).
[18] *Commissioner of Revenue v. Exxon Corporation*, 551 N.E.2d 36 (Ma. 1990).

income directly, the search [for new sources of petroleum and natural gas]…contributes directly to the taxpayer's income-generating activity."[19] The same court reached a similar conclusion a year later regarding a utility's ownership of two power plants then under construction, holding that the property was being "used" during the tax year where the construction was necessary to meet regulatory mandates for future service needs.[20]

The court might also have looked to the UDITPA's official comments, promulgated in 1957 but significantly amended in 1966, for guidance in construing "used in the state." The commentary to Section 10 provides that:

> The property is to be included in the numerator and denominator is property producing the net income to be apportioned. If net income from property is allocated property under Section 5 through Section 8, such property should be excluded in constructing the fraction.[21]

The comment suggests that the relevant inquiry is whether the property can be considered part of the taxpayer's unitary business. R.J. Reynolds' stores of tobacco drying out in its Virginia warehouse would surely be considered an asset of the unitary business, even though it would not be manufactured into cigarettes until the following the tax year. [22]

In 1971 the Multistate Tax Commission issued its proposed Model General Allocation and Apportionment Regulation in an attempt to clarify some of UDITPA's provisions.[23] The MTC's hearing officer noted that UDITPA's delineation of property "owned or rented and used" by the taxpayer was ambiguous in that "and" could be applied in either a disjunctive or conjunctive sense. The hearing officer put the question to William Pierce, UDITPA's chief drafter, who answered that "and" was meant to be disjunctive: all property owned by the taxpayer during the tax period should be included in the factor, regardless of whether it was actually put to use. The hearing officer felt the proposed model did not "come to grips" with that question, but the model did echo the UDITPA official comments in drawing a distinction between property used in the unitary business and property related to non-unitary activity.

As finally approved by the MTC's members in 1973,[24] the model regulation provided that, with the exception of property under construction, property that is acquired for unitary business purposes, including reserves, is included in the property factor. Such property remains in the factor until it is formally abandoned or sold, or until "the lapse of an extended period of time (normally, five years) during which the property is no longer held for use in the trade or business."[25] The provisions of the 1973 Model General Allocation and Apportionment Regulation have been adopted (to varying degrees) by virtually all UDITPA states, including Virginia, bringing considerable uniformity to the application of UDITPA.

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[19] *Id.* at 39.

[20] *Commissioner of Revenue v. New England Power Company*, 582 N.E.2d 543 (Ma. 1991). The court noted that Massachusetts had not adopted the MTC's model regulation *excluding* property under construction from the property factor. *Id*. at 546.

[21] Uniform Laws Commission, Division of Income for Tax Purposes - Uniform Law Commission (uniformlaws.org) (last accessed February 2023).

[22] *See, e.g., Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 788 (1992)(purchase of futures contracts).

[23] https://www.mtc.gov/wp-content/uploads/2023/02/HORartIVoftheCompact.pdf

[24] https://www.mtc.gov/wp-content/uploads/2023/02/AllocaitonandApportionmentReg.pdf. The model regulation was not modified by the Commission until 1988; the property factor provisions were modified in 2003.

[25] MTC General Allocation and Apportionment Regulation IV.10.(b), available at: FINAL-APPROVED-2018-Proposed-Amendments-042020.docx (live.com).

The latent ambiguities of UDITPA's property factor provisions are not limited to when property is "used" in the business. Almost every phrase in the three sections pertaining to the calculation of the factor have been debated and litigated at one point or another. Examples include whether the factor should include intangible drilling costs,[26] whether a contractual agreement for warehouse space constitutes a "lease,"[27] whether a mileage credit is a "sublease" of a railroad car or something else,[28] whether the value assigned to videotaped television programming should include re-broadcast rights,[29] and whether property leased to another is "used" by the taxpayer.[30]

B. The Criticality of Determining Whether Ambiguity Exists.

Certainly, there is nothing unusual in the Virginia court's rigid dichotomy between ambiguous and non-ambiguous terms, nor the extent to which that finding dictated the court's conclusion as to the legislature's intent. Every court now holds that unless there is finding that a particular word or phrase is susceptible of multiple reasonable interpretations, the court cannot consider any extrinsic evidence of legislative intent at all. "We are all textualists now", Justice Kagan famously proclaimed in her tribute to Justice Scalia's contributions to jurisprudence in 2015, and that has been especially true in the field of taxation.[31]

But does this binary approach make sense when applied to UDITPA, or any one provision within it? The Act contains just 19 substantive sections, many of them only a single sentence long. We should not assume that the drafters of UDITPA believed that they could dedicate just 1,659 words to establish the definitive rules by which the incomes of every business operating within the United States should be divided among 51 taxing jurisdictions—or that a single word or phrase in a particular provision could do so.

The drafters of the federal Internal Revenue Code, by comparison, believed it necessary to use at least 2,412,000 words to establish the tax liability of our citizenry and businesses, and then felt it advisable to add another seven million words in the federal tax regulations to clarify and to fill in some important gaps in the Code itself.[32]

It would be a mistake, therefore, for courts to apply the same analytical tools and assumptions in construing the states' adopted versions of UDITPA as they apply to the federal tax code. The structure of UDITPA, its brevity, and in particular its equitable apportionment provisions, discussed *infra*, suggest that UDITPA was intended to guide tax administrators and taxpayers operating in good faith in reaching uniform and equitable results. That is, UDITPA's terms were never intended to be applied in a dogmatic fashion that would defeat the broader purposes of the statute.

C. The Peculiar Role of That Ambiguity Plays in Tax Litigation.

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[26] *Atlantic Richfield Corporation v. Department of Revenue*, 717 P.2d 613 (Or. 1986).
[27] *Foodways National, Inc. v. Crystal, Commissioner of Revenue Services,* 654 A.2d 1228 (Conn. 1995).
[28] *International Mines and Chemical Corp. v. Heitcamp*, 417 N.W.2d 791 (N.D. 1987).
[29] *Matter of Meridith Corp. v. Tax Appeals Tribunal of Dept. of Tax & Fin*., 956 N.Y.S.2d. 585 (N.Y. App. Div., 3rd. Dept. 2012)
[30] *Illinois Tool Works, Inc. v. Lindley*, 436 N.E.2d 220 (Oh. 1987).
[31] Harvard Law School, The Antonin Scalia Lecture Series: A Dialogue with Justice Elena Kagan on the Reading of Statutes, YOUTUBE (Nov. 25, 2015) https://www.youtube.com/watch?v=dpEtszFT0Tg.
[32] Federal Tax Laws and Regulations are Now Over 10 Million Words Long | Tax Foundation (last accessed February 2023.).

While Virginia's brief-in-chief in the *R.J. Reynolds* appeal remains under seal, it is easy to understand why the state may have declined to raise the potential ambiguity of the provision to support its argument. In too many cases, the canon of statutory construction that "ambiguities in tax statutes are to resolved against the tax agency" has been applied almost as a statutory command, not a rule of decision to be employed as a last resort when no extrinsic evidence of legislative intent is available.[33] It is a rule in search of a reason to justify it.[34] It is also a rule that makes no sense in the context of interpreting UDITPA's provisions, because UDITPA is not a tax imposition statute.

The Ohio Supreme Court decision in *U.S.B. Financial Services, Inc. v. Levin*[35] is one of the few cases to discuss why that particular canon of statutory construction has no application in the context of apportionment disputes. The court considered the matter in the context of a taxpayer engaged in general banking and securities trading, the latter activity being conducted primarily outside Ohio. The taxpayer argued that UDITPA's gross receipts definition should be construed in its favor to allow its securities trading receipts to be counted at gross, not the net amount actually realized on sales. The court wrote:

> [UDITPA] does not define the subjects of taxation; instead, it sets forth the method for determining the Ohio share of an interstate business. Any particular construction of the apportionment formula might cut in favor of a taxpayer in one case but against a taxpayer in the next… . As a result, logic militates against applying the [statutory construction canon] in this context.[36]

D. Is All of UDITPA Ambiguous?

If the property factor calculations of UDITPA—which on the surface appear so straightforward—can be considered ambiguous, does that suggest that all of UDITPA's provisions could similarly be considered to be ambiguous? In a word, yes. To be sure, the extent of latent ambiguity in UDITPA is not as all-encompassing as Mary McCarthy's description of the veracity of Lillian Hellman's works: "Every word she writes is a lie, including 'and' and 'the.'"[37] But the extent of latent ambiguity should not be underestimated, either. The very first phrase of UDITPA, prefacing the definitional section, contains a

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[33] *See, e.g., Ex Parte Uniroyal Tire Co.,* 779 So.2d 227, 231 (Al. 2000)("We consider this case within the context of two well-settled rules. First, "[t]axing statutes must be construed most strictly against the taxing authority and most favorably for the taxpayer.").

[34] The Connecticut Supreme Court has described a more nuanced approach to applying the axiom that tax statutes should be construed against the tax collector. In *United Illum. Co. v. City of New Haven*, 692 A.2d 742, 760 (Conn. 1997) the court explained that:

> this long-standing axiom of statutory construction applied to taxing statutes is an important guideline to legislative meaning, but it cannot displace the result of careful and thoughtful interpretation.
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> Second, taken literally, the axiom proves too much, because there are few, if any, tax or other statutes that are free from "any ambiguity." It may well be that the axiom's proper application is to cases in which, after the court has engaged in the interpretive process and the arguments are essentially in equipoise--that is, the legislative meaning is nonetheless in doubt--the axiom applies to resolve the case in favor of the taxpayer. In this sense, it would operate as a kind of interpretive tiebreaker.

[35] 893 N.E.2d 811 (Oh. 2008).

[36] *Id*. at 817.

[37] https://quoteinvestigator.com/2016/09/18/every-word/

latent ambiguity: "As used in this Act, unless the context requires otherwise:" One could read "requires" as something necessary to avoid contradiction with another term in the statute, or perhaps it could mean "necessary to avoid an irrational result" or perhaps just an "inequitable" result. This can also be seen as an example of what *Black's Law Dictionary* describes as a "calculated" or "deliberate" ambiguity, a purposeful decision to leave a little play in the joints.

By contrast, the first full sentence in UDITPA following that preface, Article I's definition of "business income", was surely not intended to be ambiguous. Yet the definition is infamous for its patent ambiguities as well as its latent ambiguities.[38] It may be the most ambiguous sentence ever written into a tax statute.

For sixty years, courts have struggled with its cipher-like instructions and twisted sentence structure without ever reaching a final resolution as to its meaning. The Kansas Supreme Court was the first appellate court to confront the definition, in *Western Natural Gas Co. v. McDonald*,[39] gamely suggesting UDITPA's drafters may have wanted to reflect the distinction between ordinary sales of inventory and bulk sales in the Uniform Bulk Sales Act. Some courts thought the phrase contained two tests—transactional and functional—while some saw a single test,[40] and still other courts saw a "liquidation exception" to the functional test. [41]

The California Supreme Court did its best to end the long-standing debate over the business income definition in *Hoechst-Celanese v. Franchise Tax Board.* [42] The court's rigorous analytical reasoning, use of extrinsic evidence of legislative intent, and consideration of UDITPA's uniformity purposes should serve as a guide to other courts construing the Act.

By the time the court took up the business/non-business distinction in 2001, the definition's ambiguity was beyond dispute. Nonetheless, the court felt bound to describe the definition's many semantic twists that had perplexed so many courts. With that hurdle cleared, the court turned to extrinsic evidence of legislative intent. The court explained that the business income definition related to the evolution of the unitary business concept in California. The precise language of the enigmatic second phrase, the so-called "functional test", was lifted verbatim from a series of ancient State Board of Equalization cases holding that income from the sale of non-inventory assets constituted unitary business income.[43] The court then noted that the official comments to UDITPA supported the view that the second phrase constituted a separate test from the first, turning on whether the assets had been used in the unitary business. But the decisive factor for the court was fulfilling UDITPA's purpose of bringing uniformity to state taxation. The court wrote:

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[38] "(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."

[39] 446 P.2d 781 (Ks. 1968).

[40] *Ex Parte Uniroyal Tire Co*., 779 So.2d 227 (Al. 2000); *Phillips Petroleum Co. v. Iowa Dep't of Revenue & Fin*., 511 N.W.2d 608 (Iowa 1993).

[41] *Lenox, Inc. v. Tolson*, 548 S.E.2d 513 (N.C. 2001).

[42] 22 P.3d 324 (Ca. 2001).

[43] *Appeal of Houghton Mifflin Co.,* 3 SBE 344 (3/28/46); *Appeal of International Business Machines Corp.,* 6 SBE 5 (10/7/54).

> Although courts in other jurisdictions that have adopted the UDITPA have disagreed over the existence of a separate functional test, the state legislatures in these jurisdictions have not. In four of the five states where the state court rejected the functional test, the state legislature amended the definition of business income to include such a test.[44]

Despite the herculean efforts of the California Supreme Court, *Hoechst-Celanese* did not end the controversy over the business income definition, even in California.[45]

We have now covered the *first* sentence of UDITPA. Just to close the loop, it should be noted that the *last* sentence of UDITPA, instructing that the provisions of UDITPA "are to be liberally construed to effectuate its general purpose to make uniform the laws of the states that enact it",[46] is another example of "calculated" or "deliberate" ambiguity. Reasonable people can disagree on what a "liberal" construction might entail. Does it include disregarding some of the written words of the statute in order to further the statute's larger purposes?

Part II: Intentionalism in Harrisburg

The city of Harrisburg lies in a verdant valley just 218 miles up the highway from Richmond, about the same distance separating London and Paris.[47]

Sitting in Harrisburg, the Pennsylvania Supreme Court on February 22, 2023 issued its long-awaited decision in *Synthes USA HQ, Inc. v. Commonwealth,*[48] resolving a long-standing disagreement within the state over the meaning of UDITPA's Section 17. That section provides for the sourcing of receipts derived from sales "other than the sale of tangible personal property," *i.e.,* sales of services, and receipts from licensing or selling intangible personal property.[49] Section 17 has generated its share of confusion and controversy, second only to Section 1's business income definition.

A. The Meaning of Section 17's Undefined Terms: "Income Producing Activity" and "Costs of Performance" and How they Reflect the Marketplace for a Taxpayer's Services

Section 17 has two distinct clauses, uneasily separated by a comma, and as with the case of the business income definition, the controversy in the state tax world has centered on how much weight should be given to the words on either side of that comma. Section 17 reads in its entirety:

> 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

[44] *Hoechst-Celanese*, 22 P.3d at 336.
[45] *Jim Beam Brands Inc. v. Franchise Tax Board*, 34 Cal. Rept. 3d 874 (Ca. App., 1st Dist. 2005).
[46] UDITPA, Art. 19.
[47] 160 years ago, the close proximity of the two cites encouraged General Robert E. Lee to take his mighty army north from Richmond to try capture Harrisburg. Lee's army made it as far as Gettysburg, some 38 miles short of his goal, before retreating in defeat.
[48] No. 11 MAP 2021, available at: J-16-2022mo - 105441324213340331.pdf (pacourts.us)
[49] "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." See 72 P.S. § 7401(3)2.(a)(17).

> 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.

The focus of the section is thus on where income-producing activity occurs, with the "costs of performance" measure having a secondary application only after the income producing activity has been identified. The "all or nothing" nature of the assignment rule also suggests that the identification of where costs were incurred was intended to be a secondary consideration. But in practice, locating the "cost of performance" is often seen as the initial and more critical inquiry.

Synthes USA HQ is described in the opinion as a separately incorporated entity with its primary business location in Pennsylvania. It provided research and development and "management services" (accounting, legal, procurement, human resources, and information technology) to its out-of-state affiliates; the affiliates in turn manufactured and sold medical devices throughout the country.[50]

On the taxpayer's originally filed return for the 2011 tax year, it sourced its receipts from providing its services to Pennsylvania based on its understanding of the location of its costs of performance. It then filed claims for refund in 2014 arguing for "destination-based" sourcing, which would have reduced its tax liability to the state by approximately $2 million.[51]

The Pennsylvania Department of Revenue has had a long-standing interpretation of Section 17 that holds that both "income-producing activity" and "cost of performance" are terms inextricably tied to the taxpayer's delivery of the service to its customer. The Department's position finds support in the history and overall structure of UDITPA, which suggests that the sales factor was intended to represent the contributions of the marketplace in generating income. And, as discussed below, "income-producing activity" must mean something other than *all* activity undertaken by a corporation, as that interpretation would render "income-producing" surplusage. It follows that the relevant "costs of performance" measurement must be similarly constrained, serving some purpose other than assigning receipts to the single state where a business has more general operational expenses than any other state.

The Pennsylvania Attorney General's office had a very different view on how Section 17 should be applied to a service-based corporation like Synthes. Providing a service has measurable costs, it argues, and the location those costs can be geographically identified. Measuring where "costs of performance" are incurred is the critical aspect of Section 17—irrespective of other supposed goals—which cannot be casually disregarded in applying the statutory test.

This long-standing conflict between the state's two agencies resulted in a less than ideal situation: while the state's Board of Finance consistently followed the Department of Revenue's interpretation, taxpayers appealing those determinations to the Commonwealth Court could expect to settle with the Attorney General Office that handled such appeals.[52] The *Synthes* case ended that uneasy state of repose. The Attorney General's office announced it would contest the refund claim in the Commonwealth Court, and

[50] *Synthes* Majority Opinion, p. 3.
[51] *Id*., p. a4.
[52] *Id*. p. 7.

the Department of Revenue successfully fought to intervene in opposition to the Attorney General as a party in interest. [53]

The Pennsylvania Supreme Court began its analysis (after describing the arguments of the parties) by concluding that the critical phrases in Section 17, "income-producing activity" and "costs of performance", are ambiguous terms. The court reasonably concluded that the differing interpretations offered by the parties and the Commonwealth Court's justices were sufficient to demonstrate the statute's ambiguity.[54]

The court then turned to extrinsic evidence of legislative intent, including the history and purpose of UDITPA. Relying on its own prior precedent[55] and various academic sources[56] the court held that the purpose of the sales factor in UDITPA was to reflect the contributions of the marketplace in generating income. The court saw no reason why the drafters would have chosen a different purpose for the sales factor when it came to income from services. The court then concluded that Section 17's ambiguous provisions should be construed in a manner that reflected the marketplace for the taxpayer's services to effectuate the legislature's intent.

While acknowledging the importance of achieving a common construction of uniform laws such as UDITPA, and further acknowledging that its interpretation of the statute conflicted with regulations of the Multistate Tax Commission, the court noted that Pennsylvania had not adopted those regulations.[57] The court also concluded, correctly, that the 2013 amendment to Section 17 (72 P.S. § 7401(3)2.(a)(17)) to explicitly impose market-based sourcing for services had no bearing on the legislature's original intent in adopting UDITPA. In the end, four justices concluded that the statute should be read to reflect the legislature's intention to account for the contributions of the marketplace, despite the legitimate concerns over the application of the "costs of performance" language. One justice dissented, arguing the court was bound by the plain meaning of the statute.

The court was on solid grounds in concluding that the phrase "income-producing activity", standing alone, could evidence an intent to source income to the location where services were delivered. As mentioned above, everything a for-profit business does is presumably directed to the production of income, so "income-producing activity" must be construed to refer to something other than the location of all business activity. With that understanding, interpreting the phrase to refer to the location where a customer receives the benefit of the service is reasonable. Otherwise, Section 17's "all or nothing" rule for costs of performance would mean that service receipts would generally be sourced to the state where corporate headquarters are located, for that state would likely have a greater proportion of fixed costs than any other state. Had that been the intent of UDITPA's drafters, they would presumably have directed that all service receipts be assigned to commercial domicile and left it at that.

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[53] *Id.* at 8. Looking in from the outside, it is impossible to know why the parties decided to contest the *Synthes* matter when previous claims were settled. It may have something to do with the timing of the case. The legislature had partially resolved the issue by mandating market-based sourcing for services, beginning with the 2014 tax year.

[54] *Id.* at 50.

[55] *Commonwealth v. Gilmour Mfg. Co.,* 822 A.2d 676 (Pa. 2003)

[56] John A. Swain, *Reforming the State Corporate Income Tax: A Market State Approach to the Sourcing of Service Receipts,* 83 Tul. L. Rev. 285 (2008).

[57] *Id*. at 50-51.

The court also cited *DirecTV v. Department of Revenue*,[58] where the South Carolina Court of Appeals held that "income producing activity" referred to the activity for which payment was received, drawing a distinction between acts merely preparatory to providing a service and the service itself. In that case, the service its South Carolina customers were paying for was providing satellite TV broadcasting into their homes. Everything that occurred previously, from buying content to launching satellites into space, was merely preparatory.[59]

Although not cited by the Pennsylvania court, perhaps the best indication of what UDITPA's drafters had in mind regarding Section 17 comes from the contemporaneous writing of its principal drafter, William J. Pierce. In October 1957, in the pages of the periodical *Taxes*,[60] Professor Pierce acknowledged that Section 17 was thought to be an "adequate" means of sourcing receipts only for some types of service activity. For other types of services, resort to UDITPA's alternative apportionment Section 18 would be necessary to achieve an appropriate outcome. Professor Pierce wrote:

> If we assume that the activity involved is the servicing of industrial equipment, the formula provided in the uniform act would be easily applied and the result appears equitable. In contrast, assume that the sales item involved is advertising revenue received by a national magazine publisher. The state of activity would be difficult, if not impossible, to ascertain, so it would appear that this type of income may well be apportioned on the same basis as subscription income.
>
> The national conference considered this problem at length and concluded that for certain types of income, exceptions would have to be established by tax collection agencies, since no formula seemed to be satisfactory for every conceivable situation. Generally, it was felt that the provisions of Section 17 were the best that could be designed to cover the greater proportion of cases.[61]

In these few sentences, Professor Pierce identified how the "cost of performance" test worked to ensure the market-based sourcing for providers of personal services, anticipated some of the problems that would come when applied to other types of service providers, and identified the drafter's solution to the conundrum: application of Section 18's alternative apportionment provisions.

B. The Role of Section 18's Alternative Apportionment Provisions.

The Pennsylvania court was justified in concluding that UDITPA's sales factor was intended to reflect the marketplace for services. The court might have done more to explain how "costs of performance" was intended to further that outcome in the context of professional services, but not in other contexts.

The litigants in *Synthes,* however, might have considered another approach altogether. When, as here, there is no serious dispute that the standard apportionment formula has failed in its purpose, consideration should be given to invoking the alternative apportionment provisions of UDITPA's Section 18.

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[58] 804 S.E.2d 633 (S.C. App. 2017).

[59] Id. at 642. Significantly, South Carolina's equivalent to Section 17, S.C. Code Sec. 12-6-2290, does not reference the UDITPA cost of performance standard.

[60] *Taxes,* Vol. 35, No. 10, p. 747 (October 1957).

[61] *Id.* at 780-81.

Section 18 provides that in the event the standard apportionment and allocation provisions of UDITPA fail to reflect the business activity of the taxpayer within the taxing state, the taxpayer may petition for, or the tax administrator may require, "the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."[62] The grant of authority to vary the standard apportionment formula to achieve a more equitable outcome is extraordinarily broad and open-ended. Nothing in the text of Section 18 suggests it could not have been used as a basis for crafting a market-based outcome in *Synthes* or in many other factual circumstances.[63]

Of course, the whole of Section 18 is also the embodiment of a calculated ambiguity, calling for discretion in its application. Courts and taxing authorities have struggled to define the parameters of that discretionary authority. While that is a topic for another day, it should be noted that the official comments to UDITPA reflect an understanding that Section 18 would be applied broadly in a variety of circumstances.[64] Seven of the 16 official comments reference use of Section 18 to modify the standard apportionment formula to when necessary to allow application to particular circumstances or to allow for a fairer reflection of business activity.

One comment in particular, pertaining to the sourcing of sales of tangible property, has more than a tangential application to the *Synthes* case.[65] The comment to Section 16 provides that where a subsidiary sells manufactured goods to its out of state parent, which in turn sells those goods back into the state, the subsidiary's sales factor might be modified to more fairly reflect its business activity. In other words, the subsidiary's sales factor could be adjusted to use the parent's sales factor, since the subsidiary's income-producing activity is more realistically seen as occurring where the parent sells the finished product.

The reported facts in the *Synthes* case reflect a similar dynamic. Synthes "sells" all of its services—research and development, corporate governance, and procurement—to its subsidiaries which in turn manufacture and market medical products to customers nationally. Synthes' economic activity is so

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[62] 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; (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.

[63] *See, e.g., Vodafone v. Roberts*, 486 S.W.3d 496 (Tenn. 2016), approving the use of Section 18 where the taxpayer argued that none of its receipts from providing cell phone service to Tennessee customers should be sourced to that state because its costs of performance for its nationwide activities was slightly greater in New Jersey than any other state.

[64] The Official Comment to Section 18 provides in part:

"Section 18 is intended as a broad authority, within the principle of apportioning business income fairly among the states which have contact with the income, to the tax administrator to vary the apportionment formula and to vary the system of allocation where the provisions of the Act do not fairly represent the extent of the taxpayer's business activity within the state."

[65] Official Comment to Section 16. The comment provides in part: "The Section does not specify how sales from a subsidiary in the state to an out-of-state parent, such as a marketing corporation who thereupon redirects the goods back into the state should be treated. If returns are not consolidated under existing state tax law, it may be necessary to use Section 18 to make a fair representation of the business income in this situation."

intricately tied to its subsidiaries, it would be hard say that there is a marketplace for Synthes' services that is severable from the sales of medical products by its subsidiaries. That is, Synthes and its subsidiaries appear to be engaged in a single economic enterprise, justifying combined reporting in states that would permit or require it. As a separate-entity reporting state, Pennsylvania must deal with what is arguably an economic fiction for purposes of income calculation,[66] but Section 18 permits it to ignore that fiction when it comes to apportioning Synthes' income in an equitable manner.

Conclusion

UDITPA can and should be recognized as a work of great wisdom that has succeeded in bringing needed uniformity to state tax practices, but it contains passages that can be misinterpreted to reach foolish and inequitable results. The Act is intended to guide the allocation and apportionment of income and does not represent an attempt to definitively address all possible applications of its provisions. The Act has numerous latent and intentional ambiguities, and some patent ones as well. The states adopted UDITPA with the explicit purpose of binging uniformity to state taxation while ensuring that income is fairly and rationally apportioned. Courts should accordingly apply the statute as a whole to effectuate its purposes, including the equitable provisions of Section 18, even when that provision is not explicitly invoked by one or more of the parties. Construing individual words or provisions in UDITPA in isolation without reference to the Act's purposes is folly.

[66] *But see*, *GTE v. Revenue Cabinet*, 889 S.W.2d 788 (Ky. 1994)(permitting combined reporting to more fairly reflect income).