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by David Uri Ben Carmel

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In this article, Ben Carmel looks at recent Multistate Tax Commission hearings regarding its proposed model apportionment regulations involving sales of other than tangible personal property.

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The Multistate Tax Commission is conducting hearings to update — again — its model apportionment regulations involving sales of other than tangible personal property (OTPP). The MTC describes its project as follows:

> At its August 2, 2022, meeting, the Uniformity Committee agreed to undertake a project and form a work group to review its model receipts (sales) sourcing regulations for income apportionment purposes, including special industry regulations and more recently adopted market-based sourcing regulations. The goal of this project is to identify updates, corrections, or conforming changes, to consider issues that may not be sufficiently addressed by existing model regulations, and to make recommendations to the committee for its action.[1]

This is a formidable task with no prospect of obtaining a "correct" answer. Realistically, the most that can be sought is to develop methods acceptable to most MTC member states for at least several years.

The MTC deserves credit for undertaking this project. Leading this task brings to mind the fable about mice that agree that they will be safer if an antagonistic cat will be fitted with a bell. The idea is perfect — except that none will risk belling the cat. Here, there is a long-standing charge that the OTPP sourcing rules in the Uniform Division of Income Tax Purposes Act are ill-suited to an economy that has long since tilted toward sales of services and digital activities. Also, there have been several prior attempts to address the issue. Therefore, kudos to the MTC for taking the leading role in this effort.

Limitations on This Apportionment Project

Critically important is that the project, by its very mandate, is not an economic nexus project. As such, the project does not consider requirements for establishing personal jurisdiction or meeting tax presence requirements, whether under the due process clause or the commerce clause.[2] Therefore, throughout this process and in any revision to the model regulations, the MTC should remind all interested parties that this is an apportionment

[1] Multistate Tax Commission, MTC Model Receipts Sourcing Regulation Review Work Group (last accessed June 9, 2023).

[2] Unless the context indicates otherwise, references in this article to tax presence are to the required connections to the state under the due process and the commerce clauses.

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project only. To that effect, in a March 16 letter, I submitted the following comment to the MTC:

> This letter is submitted in furtherance of my comments provided during today's meeting of the Multistate Tax Commission ("MTC") Model Sourcing Regulations Work Group ("Group"). The Group's mandate is to "to review [the MTC's] model receipts (sales) sourcing regulations for income apportionment purposes, including special industry regulations and more recently adopted market-based sourcing regulations." See the Group's cover page on the MTC's Internet site (accessed today).
>
> Consistent with the Group's limited role of reviewing sourcing rules for "income apportionment purposes" (whether pertaining to the trucking industry, financial institutions, broadcasters, or any other business activity), all Group work products should clearly state that any recommended method of income sourcing has no relevance to the determination of a business's tax presence in a jurisdiction. That is, the analysis of tax presence — including via any variant of economic nexus — must be conducted independently of these income sourcing regulations.
>
> Fortunately, language for this purpose already exists. Illinois income tax regulation 100.9720.a) concludes with the statement that:
>
> "However, the fact that Article 3 of the IITA [Illinois Income Tax Act] requires a non-resident taxpayer to allocate or apportion income to this State does not create a presumption that the taxpayer has nexus."
>
> For present purposes, that language could be revised to provide that:
>
> "However, the fact that these sourcing rules require a taxpayer to allocate or apportion income to this State does not create a presumption that the taxpayer has nexus with the State."

Reinforcing the need for this caution, during that March 16 meeting, counsel for the MTC observed that some states are already using their market-based apportionment rules to test for tax presence. Knowing that this misapplication is occurring, the MTC should include in all draft and final versions of the model regulations a section stating that the regulations' purpose is limited to apportioning income. Absent such a statement, states adopting the model regulations will be tempted to misapply them.

UDITPA's Purposes

In 1957, the Uniform Law Commission adopted UDITPA. The stated goals for UDITPA were to fairly apportion the income of multistate businesses[3] among the states in which that income was earned and to ensure, to the extent possible, that 100 percent of a business's net income[4] was subject to tax (that is, neither 90 percent nor 110 percent of that income would be taxed).[5] The Multistate Tax Compact became effective in 1967 and included UDITPA as one of its components.

Significantly, "fair" apportionment does not equate to "exactly correct" apportionment. In *Moorman Manufacturing*,[6] the U.S. Supreme Court addressed a commerce clause challenge to Iowa's single-factor (sales) apportionment scheme. The taxpayer in *Moorman* did not raise a serious due process challenge,[7] and the Court said that to satisfy due process clause requirements for apportionment "the income attributed to the State must be rationally related to values connected with the taxing state."[8]

In contrast, the commerce clause claim in *Moorman* was strenuously litigated. In response,

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[3] This article uses "businesses" to refer to corporations. While in general the principles analyzed here also apply to noncorporate entities, such things as flow-through issues, aggregate-entity approaches, and multitiering of noncorporate entities add complexity to tax presence and apportionment analyses. We leave consideration of these and other relevant issues for other articles.

[4] The remainder of this article uses the term "income" to mean "net income" and "income tax" to mean "net income tax."

[5] The commission included a prefatory note to UDITPA stating that:

> The need for a uniform method of division of income for tax purposes among the several taxing jurisdictions has been recognized for many years and has long been recommended by the Council of State Governments. There is no other practical means of assuring that a taxpayer is not taxed on more than its net income. At present, the several states have various forumlae for determining the amount of income to be taxed, and the differences in the formulae produce inequitable results.

[6] *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978).

[7] *See id.*, 437 U.S. 267, at 275, esp. at fn. 9.

[8] *Id.* at 272-273 (citations omitted).

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the majority of the Court threw up its hands. It held that any requirement of multistate uniformity in apportionment formulas must be made by Congress, noting that the taxpayer's argument regarding duplicative taxation could not be limited to apportionment issues. Three justices dissented: William J. Brennan Jr. needed only one page for his dissent: Iowa's apportionment formula did not fairly apportion income because it did not reflect the business activity in the state. And Lewis F. Powell Jr. and Harry Blackmun dissented even more vigorously, concluding that Iowa's apportionment formula discriminated against interstate commerce and accusing the Court of "avoid[ing] its constitutional duty" by refusing to decide the matter.[9]

Limitations on UDITPA's Applicability

Constitutional limits on the states' ability to impose income taxes on remote businesses (that is, businesses having no in-state property, employees, or representatives) and the states' income apportionment rules serve different purposes. Thus, UDITPA's stated goals of fair and full apportionment provide no insight into whether a business is taxable in a state.

Rather, one must first determine that a state has personal jurisdiction over a remote business and that the business has tax presence in the state before there is any cause to apply the jurisdiction's apportionment principles.[10] It is also necessary to determine whether the business activity to be taxed is part of a larger, unitary-business before considering apportionment issues. In one of the best-known phrases regarding multistate taxation, the Supreme Court said as much in *Mobil Oil*,[11] when it wrote that: "The linchpin of apportionability in the field of state income taxation is the unitary business principle." Therefore, before applying a state's apportionment method, one must be confident that personal jurisdiction exists, and that tax presence exists, and that the remote business is (or is not) part of a unitary group. Apportionment considerations are fourth.[12]

The significance of prioritizing state income tax issues and of the low standard used under the commerce clause to determine the validity of an apportionment scheme are analyzed below. For a state to impose its income tax on a remote business:

- the state must have personal jurisdiction over the business under the 14th Amendment's due process clause; and
- the nexus between the state, the business, and the taxed activity must satisfy the requirements of the U.S. Constitution's due process and commerce clauses.[13]

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[9] *Id.*, 437 U.S. 267, at 296. Powell's dissent is tightly reasoned and well written. And the merit of Brennan's conclusion is undiminished by the passage of time. Both opinions are highly recommended reading.

[10] Unless otherwise stated, "determine" and "determination" are used here in a general sense not involving a tribunal of any sort. Thus, businesses routinely self-determine that they have income tax presence in a jurisdiction. Likewise, state departments of revenue must satisfy themselves that a remote business has tax presence before issuing a tax assessment against that business. Regarding the latter's determinations: Federal and state courts alike have reduced their willingness to defer to administrative agency determinations, even on matters presumptively within the narrow expertise of the agency (*see, e.g.*, *Kisor v. Wilkie*, No. 18-15, 139 S. Ct. 2400 (2019); and *Tetra Tech EC Inc. v. Wisconsin Department of Revenue*, 914 N.W.2d 21 (Wis. 2018)). Plainly, there should be no judicial deference to determinations by revenue departments regarding personal jurisdiction over remote business — a matter on which every court is expert.

[11] *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 439 (1980).

[12] There is a long-standing question as to whether a business can be said to have "no income tax presence" in a state without first knowing whether any of the business's unitary affiliates has income tax presence in that state. The question becomes even more contentious when federal P.L. 86-272 applies to the business. Each version of the question is an example of the *Joyce-Finnigan* dispute, named after two decisions by the California State Board of Equalization (*Appeal of Joyce Inc.* (SBE 66-SBE-070, 11-23-66), and *Appeal of Finnigan Corp.* (88-SBE-022, SBE 8-25-88)). *Joyce-Finnigan* has been addressed by many states and in innumerable articles and speeches. One of the best pieces is by Pierre Vogelenzang, "More Commentary on *Finnigan*," *Tax Notes*, July 29, 1991, p. 603, in which the author observes that: "The role of jurisdictional questions in the *Joyce-Finnigan* controversy becomes readily apparent by focusing on the root cause of that controversy. In a nutshell, the problem arises because, on the one hand, the apportionable base of a combined report group, and accordingly the California net income of such a group, is determined on a groupwide basis, whereas California's jurisdiction to tax is determined on a separate corporation basis."

While this article follows the *Joyce* approach (*i.e.*, jurisdiction and tax presence are determined on a separate corporation basis), if one rejects the statement that "California's [or any other state's] jurisdiction to tax is determined on a separate corporation basis," apportionment is relegated to the fifth consideration, after (1) analysis of the remote business's personal jurisdiction, (2) analysis of the remote business's tax presence in the state, (3) analysis of unitary status, (4) determination of whether the unitary group has personal jurisdiction and tax presence in the state and, then, (5) determination of the amount of the business's income taxed in the state.

Apportionment, therefore, is the fourth (or fifth) consideration in determining a business's income tax liability to a state.

[13] U.S. Const. Amend. XIV and Art. I, section 8, cl. 3. Notably, imposition of a tax might be prevented because of other federal provisions, including the foreign commerce clause (which adds two requirements to the standard commerce clause analysis) or federal preemption (*see, e.g.*, the Internet Tax Freedom Act, 47 U.S.C. section 151 note). Likewise, the tax must satisfy requirements of the state's constitution and enabling statutes.

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Personal Jurisdiction Must Be Evaluated on a Per-Defendant Basis

The U.S. Supreme Court has issued a long list of decisions directly involving personal jurisdiction questions, and has been especially active in this area since 2011.[14] In addition, in June 2023 the Court decided another personal jurisdiction case, and for more than a year it has been considering whether to grant a petition for certiorari in a yet another case.[15] At issue in each of these cases is the meaning of personal jurisdiction under the due process clause.

These cases, in combination with their predecessors, are complex and the principles they adduce can be difficult to apply. Moreover, evaluating possible specific jurisdiction — the type of jurisdiction relevant to the taxation of remote businesses — requires understanding each business's unique circumstances, especially the extent to which this business's contacts within the state are continuous and systematic, and are the source of the state's claim:

> The contacts needed for [specific] jurisdiction often go by the name "purposeful availment." The defendant, we have said, must take "some act by which [it] purposefully avails itself of the privilege of conducting activities within the forum State." The contacts must be the defendant's own choice and not "random, isolated, or fortuitous." They must show that the defendant deliberately "reached out beyond" its home — by, for example, "exploi[ting] a market" in the forum State or entering a contractual relationship centered there. Yet even then — because the defendant is not "at home" — the forum State may exercise jurisdiction in only certain cases. The plaintiff's claims, we have often stated, "must arise out of or relate to the defendant's contacts" with the forum.[16]

For two recent decisions applying personal jurisdiction principles and requiring an analysis specific to each defendant's circumstances, see *Schaeffer v. Singlecare Holdings LLC*[17] and *Kapila v. RPTJ Ltd.*[18]

In *Schaeffer*, North Carolina's Supreme Court analyzed possible personal jurisdiction over certain corporate and individual defendants. As to the corporate defendants, the court found personal jurisdiction: "Corporate Defendants intentionally reached out to North Carolina to conduct business activities in the state, and the claims at issue in this litigation arise from or are related to those activities."[19] However, the court reached the opposite conclusion regarding the individual defendants (the corporate defendants' CEO and executive vice president), stating:

> [we] conduct the same minimum contacts test for Individual Defendants as we have for Corporate Defendants. . . . Schaeffer's pleadings and affidavit do not provide a factual basis to conclude that Individual Defendants themselves engaged in sufficient activities giving rise to or related to the subject matter of the claims to be subjected to jurisdiction in North Carolina courts.[20]

In *Kapila*, Florida's Court of Appeal analyzed whether Florida courts have personal jurisdiction over an out-of-state partnership, stating:

> The question of whether a nonresident is "doing business" or "engaged in a business venture" in Florida depends on the unique facts presented in each case. Each case must be judged on its own facts.

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[14] *E.g., J. McIntyre Machinery Ltd. v. Nicastro*, 564 U.S. 873 (2011); *Goodyear Dunlop Tires Operations S.A. v. Brown*, 564 U.S. 915 (2011); *Daimler AG v. Bauman*, 571 U.S. 117 (2014); *Walden v. Fiore*, 571 U.S. 277 (2014); *Bristol-Myers Squibb Co. v. Supreme Court of California*, 582 U.S. 255 (2017); *Ford Motor Co. v. Montana Eighth Judicial District*, 592 U.S. __, Nos. 19-368 and 19-369 (2021). The cases involve both general jurisdiction (the state in which the defendant is essentially at home, *e.g.*, the state of its incorporation) and specific jurisdiction (in which a defendant has a sufficient degree of conduct in a state to be subject to that state's jurisdiction regarding that conduct).

[15] *Mallory v. Norfolk Southern Railway Co.*, 600 U.S. __, No. 21-1168 (June 27, 2023); and *Cooper Tire & Rubber Co.*, No. 21-926. In contrast to the many personal jurisdiction cases, since 1995 the Court has issued only one decision involving an issue central to state corporate income taxation (*MeadWestvaco v. Illinois Department of Revenue*, 553 U.S. 16 (2008)). *South Dakota v. Wayfair Inc.*, 138 S. Ct. 2080 (2018), was a sales tax case involving commerce clause issues.

[16] *Ford*, Nos. 19-368 and 19-369, slip op. at 5-6 (citations omitted).

[17] *Schaeffer v. Singlecare Holdings LLC*, No. 321PA21 (N.C. Apr. 6, 2023).

[18] Dist. Ct. App. Fl. No. 2D22-837 (Feb. 17, 2023) (internal citations and quotation marks omitted).

[19] *Schaeffer*, No. 321PA21, at 3.

[20] *Id.* at 23-24.

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> We cannot resort to a mechanical test, but must judge the quality and nature of the activity involved. While certain general principles may be said to prevail[,] the application of these principles will be governed by the factual situation presented by a particular record.[21]

Further, because none of the Supreme Court's recent personal jurisdiction cases involves subnational taxes, extra care is required in applying the lessons of the cases (and relevant precedents potentially reaching back more than a century) to state attempts to tax the income of remote businesses that did not self-conclude that they are subject to that state's jurisdiction. But whatever facts and principles contribute to the particularized analysis, it is doubtful that a state's decision via its income tax apportionment rules to deem some types of sales to be sourced to the state will contribute anything useful to this jurisdictional analysis.

Moreover, the requirement that the analysis must be conducted with reference to each taxpayer presents difficulty for states seeking to assert personal jurisdiction and tax presence based on market-based sales factor data. To date, these states have been under a misimpression that their choice — under the expansive possibilities of apportionment permitted under *Moorman* — to source sales of OTPP this way or that way or some other way determines whether a business is subject to the state's income tax. That belief is incorrect.

Personal Jurisdiction: Internet Vendors to Receive Special Protection?

In the Court's 2021 decision in *Ford* (quoted above), the majority opinion and both concurrences took care to acknowledge that controlling principles of personal jurisdiction might not apply to internet vendors.[22] The justices appeared to be concerned that tests of continuous activity and purposeful availment lose their meaning within an internet environment and have signaled that they are prepared to consider new rules for e-commerce.

The *Ford* Court's message has been received. For a recent example, see *LaRocca v. Invasix Inc. and InMode Ltd*.[23] *LaRocca* involved a personal injury claim in Texas against a foreign business having no employees, property, or office in the state. The foreign business's only alleged connections with Texas were via the activities of an affiliate, a trade name used by both it and that affiliate, and "a website that provides a 'locator' function to aid customers in locating Texas providers who use its products."[24]

As is required when evaluating personal jurisdiction, the federal court analyzed this specific defendant's contacts with Texas. Regarding the company's internet site, the court concluded:

> This website, however, is not directed to Texas in particular; it does not amount to the kind of contact that could support jurisdiction. . . . *See Admar Int'l, Inc. v. Eastrock, L.L.C.*, 18 F. 4th 783, 787 (5th Cir. 2021) (noting that a website accessible from a particular state does not create sufficient contacts to support personal jurisdiction in that state). . . . LaRocca has failed to establish that [the defendant] purposely directed its activities toward Texas or purposefully availed itself of the privileges of conducting activities here. Accordingly, the Court lacks personal jurisdiction over [the defendant] in this suit. [25]

In sum, personal jurisdiction principles are abstract and too often are under-analyzed when tax presence is being considered. However, for multistate and multinational businesses, consideration of personal jurisdiction circumstances is essential. And, if one were to

[21] *Kapila* at 5-6 (internal citations and quotation marks omitted). After examining that defendant's specific circumstances, the court concluded that Florida courts have personal jurisdiction over the defendant.

[22] This was analyzed in detail in David A. Fruchtman, "After *Ford* — Personal Jurisdiction for E-Commerce Vendors," *Tax Notes State*, Apr. 26, 2021, p. 379.

[23] *LaRocca v. Invasix Inc. and InMode Ltd.*, No. 4:21-CV-03792 (S.D. Tex. Mar. 7, 2023).

[24] *Id.* at 6.

[25] *Id.* at 8 (citation omitted). An in-depth analysis of post-*Ford* personal jurisdiction developments for internet businesses is beyond the scope of this article. For citations to a collection of relevant cases, see *Petition for Certiorari in HANWJH, Petitioner v. NBA Properties Inc.*, Dkt. No. 22-467 (U.S. Jan. 9, 2023).

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speculate as to the future of personal jurisdiction for remote, internet-based businesses, it is fair to predict greater protections for those businesses.

Shift to Market-Based Apportionment of Sales of OTPP

UDITPA, as approved in 1957 by the ULC, apportioned receipts from sales of OTPP based on where the income-producing activity occurred. Under UDITPA section 17, "sales, other than sales of tangible personal property, are in this state
if: . . . (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."

While UDITPA does not define "costs of performance," the phrase is defined in MTC model regulations as: "direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer."[26]

While more could be written, by now two points are clear: First, in 1957 when the ULC adopted UDITPA and in 1967 when UDITPA was incorporated into the compact, sales of OTPP were sourced on an origin-state basis, as determined by the seller's costs of performance. Second, UDITPA provided no support for a claim that a sale of OTPP to a recipient in a remote jurisdiction created personal jurisdiction for the vendor in that destination state.

Consider the following example. Service Provider (SP) is incorporated and headquartered in State A and provides all its services from State A. SP has a sales office and one employee in State B. SP does not have any employees, representatives, or property outside of states A and B. SP's customers are scattered throughout the United States. In some years, SP makes sales to customers in states G, H, and I. SP does not have any employees, representatives, property, or physical presence of any type in states G, H, or I. SP, therefore, has personal jurisdiction and income tax presence in states A and B, but does not have such jurisdiction or presence in states G, H, or I.

States A, B, G, H, and I apportion income under UDITPA, with each state also using the MTC's apportionment regulations that source the income-producing activity by the location of the business's direct costs of performance. Under the applicable apportionment rules, all of SP's sales are apportioned to State A.

After many years, State G changes its equally weighted three-factor apportionment formula to instead apportion based on a sales factor only, with sales of OTPP being sourced according to where the benefit of the sale is received (that is, market-based sourcing). In addition, it adopts a law asserting "economic nexus" for any company making in-state sales of any amount.

No doubt, State G's revenue department officials will want to analyze the acceptability of its new sourcing regime based on the holding of *Moorman*'s majority and other commerce clause authorities. But that is not where the analysis begins.

The first question is whether State G has personal jurisdiction over SP. State G cannot mass-produce personal jurisdiction over remote businesses by changing its income tax sales sourcing rules. Instead, State G's revenue department officials must gather facts specific to SP demonstrating that under the due process clause SP is subject to the jurisdiction of State G's courts. Perhaps that jurisdiction exists, and perhaps it does not exist. But State G's change in its apportionment rules cannot create that jurisdiction.

Second, State G must gather facts specific to SP demonstrating that it has tax presence in the state under both the due process and commerce clauses. Some facts will tend to support a finding under both clauses (and for personal jurisdiction purposes). However, the Supreme Court has repeatedly said that proving tax presence under the due process clause is not identical to proving tax presence under the commerce clause — and it is not obvious that even that latter would be satisfied by State G's change to its apportionment formula.

After these issues and any questions of unity are answered, one might reach State G's new mechanism for apportioning sales of OTPP.

[26]MTC Regulation IV.17.

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This, then, returns us to the narrow purpose of this article: To avoid misapplication of market-based apportionment rules, the MTC should include a section in all draft and final versions of its updated model sourcing regulations stating: "The fact that these sourcing rules require a taxpayer to allocate or apportion income to this State does not create a presumption that the taxpayer has nexus with the State." ■

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