A Tale Of 2 State Tax Sourcing Decisions: The Pa. Court's Path

By **Bruce Fort** (March 29, 2023)

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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 Act, or UDITPA, but took drastically different paths in interpreting and applying the provisions of the venerable act.[1]

The results in both cases are controversial, or at least outside the mainstream of previous interpretations of the act's provisions.

At 65 years old, UDITPA is clearly showing its age — surviving in something like its original form in only a handful of states — but 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 try to agree on the best means of interpreting its provisions.

Part one of this article examined how the Virginia Supreme Court's recent use of a textualist approach to statutory construction in Virginia Department of Taxation v. R.J. Reynolds Tobacco Co. precluded consideration of UDITPA's broader purposes.

Part two considers whether intentionalism, as employed by the Pennsylvania Supreme court in its recent decision in Synthes USA HQ Inc. v. Commonwealth is the more appropriate means of construing UDITPA's phrases given its many latent ambiguities and reliance on equitable alternatives.

A Tale of Two Cities Part 2: Intentionalism in Harrisburg

On Feb. 22, the Pennsylvania Supreme Court issued its long-awaited decision in Synthes, 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.[3] Section 17 has generated its share of confusion and controversy, second only to Section 1's business income definition.

Section 17's Undefined Terms Intended to Reflect Marketplace for Taxpayer's Services

Section 17 has two distinct clauses, uneasily separated by a comma, and as with the business income definition, 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 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 costs 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.[4]

On the taxpayer's originally filed return for the 2011 tax year, it sourced its receipts from providing services to Pennsylvania based on its understanding of the location of its costs of performance.

In 2014, it filed refund claims arguing for destination-based sourcing, which would have reduced its tax liability to the state by approximately $2 million.[5]

The Pennsylvania Department of Revenue has had a long-standing interpretation of Section 17 that holds that both "income-producing activity" and "costs 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-generating 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 of how Section 17 should be applied to a service-based corporation like Synthes. Providing a service has measurable costs, it argued, and the location of 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 — that 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's office that handled such appeals.[6]

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 the Department of Revenue successfully fought to intervene in opposition to the attorney general as a party in interest.[7]

After describing the arguments of the parties, the Pennsylvania Supreme Court began by recognizing 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.[8]

The court then turned to extrinsic evidence of legislative intent, including the history and purpose of UDITPA. Relying on its own prior precedent[9] and various academic sources,[10] 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 reflects 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.[11]

The court also concluded, correctly, that the 2013 amendment to Section 17 — Title 72 of Pennsylvania Statutes, Section 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 ground in concluding that the phrase "income-producing activity," standing alone, could evidence an intent to reflect 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 corporate headquarters, 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.

The court also cited the 2017 decision in DirecTV Inc. v. South Carolina Department of

Revenue, 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.[12]

In that case, the service for which South Carolina customers were paying was providing satellite TV broadcasting into their homes. Everything that occurred previously, from buying content to launching satellites into space, was merely preparatory.[13]

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, Pierce acknowledged that Section 17 was thought to be an adequate means of sourcing receipts only for some types of service activity.[14] For other types of services, resorting to UDITPA's alternative apportionment provisions in Section 18 would be necessary to achieve an appropriate outcome. 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.
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> 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.[15]

In these few sentences, Pierce identified how the costs of performance test worked to ensure the market-based sourcing for providers of in-person 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.

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 should have done more to explain how the costs of performance test was intended to further that outcome in the context of personal 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.

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."[16]

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.[17]

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.[18] 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.[19] The comment to Section 16 provides that where a subsidiary sells manufactured goods to its parent, who in turn sells those goods back into the state, the subsidiary's sales factor might be modified to include those in-bound sales to more fairly represent 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 that in turn manufacture and market medical products to customers nationally.

Synthes' economic activity is so intricately tied to its subsidiaries that it would be hard say that there is a marketplace for Synthes' services that is severable from the sales of medical products by its affiliates. 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, but Section 18 permits it to ignore that fiction when it comes to apportioning Synthes' income in an equitable manner.[20]

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.

States adopted UDITPA with the explicit purpose of bringing 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. It would be folly to construe individual words or provisions in UDITPA in isolation without consideration of the act's purposes.

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[1] 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).

[2] No. 11 MAP 2021, available at: J-16-2022mo - 105441324213340331.pdf (pacourts.us).

[3] "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).

[4] Synthes, majority opinion, p. 3.

[5] Id., p. 4.

[6] Id. p. 7.

[7] 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.

[8] Id. at 50.

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

[10] 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).

[11] Id. at 50-51.

[12] DirecTV Inc. v. South Carolina Department of Revenue, 804 S.E.2d 633 (S.C. App. 2017).

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

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

[15] Id. at 780-81.

[16] "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."

[17] 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.

[18] 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."

[19] 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."

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