Multistate Tax Commission

EUGENE F. CORRIGAN, Executive Director

Exec Comm

February 22, 1983

TO: Members of Executive Committee

FROM: Gene Corrigan

RE: March 8 meeting of Executive Committee

Chairman Kent Conrad has called a meeting of the Executive Committee for Tuesday, March 8; it will take place in Room 718 of the Colorado Department of Revenue at 1375 Sherman Street, Denver. The meeting will begin at 8:30 and will last until approximately 4:00 P.M.

The agenda will be:

1. Minutes of prior meeting.
2. Financial and budget report.
3. Review of proposed 1983-4 budget
4. Report on legal activities.
5. Review of Attorney Search situation.
6. Interviews of two leading candidates for legal position.
7. Audit program status report.
8 Airline Regulation recommendation.
9. Membership report.
10. Report on Safe Harbor Lease Recommendation.
11. Status of Tax Consistency Task Force.
12. Vacancy on Executive Committee.
13. New business.

We suggest that you arrange for sleeping rooms at the Governor's Court Hotel. It is located at 1776 Grant Street and was formerly known as the Radisson Hotel. The phone number is 303-861-2000. You should mention that you qualify for the government rates, which are $50.00 for a single room and $60.00 for a double room.

If you prefer for us to make your reservation, please let us know.

This notice is being sent to the tax administrators of all member states along with an invitation to attend the meeting and to suggest any other agenda items which they may wish to have included.

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Multistate Tax Commission

EUGENE F. CORRIGAN, Executive Director

March 1, 1983

TO: EXECUTIVE COMMITTEE

FROM: GENE CORRIGAN

RE: AIRLINE REGULATION

The MTC's drafting of an airline regulation has always been based upon the assumption that all of an airline's net income should be attributable to some terrestrial location for corporate income tax purposes. The MTC has called this the "full accountability" approach. It has sought cooperation from the airlines, mainly through the Air Transport Association, in trying to develop a formula which would utilize information which is readily available under the normal operating procedures of the airlines. When it became known, several years ago, that the CAB would be phasing out, the ATA informed the MTC that certain information, upon which a then contemplated formula was based, would no longer be available. The MTC thereupon re-evaluated formula possibilities and worked further with the ATA and airline personnel in an attempt to arrive at a workable formula in the age of deregulation.

Throughout the years, the airlines have always maintained that the "full accountability" approach of the MTC is unjustified and undesirable. They argue that they favor a full accountability approach, too, in that they would attribute all income "somewhere". The MTC has expressed dissatisfaction with this approach in that it has the effect of treating much airline income as extra-terrestrial in nature, as income which remains in the skies (which is where the airlines maintain that it is truly earned) and which never comes down.

The airlines would accomplish their purposes by using a "line-haul" or "revenue passenger miles" formula. Such a formula has been accepted by some states over the years; moreso in earlier years than in recent ones. Increasing sophistication on the part of the state tax administration personnel has resulted in increasing dissatisfaction with the line-haul formula, which might be termed the "E.T. income attribution formula" of the airlines, hereinafter called E.T. #1. Yet the states have had

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great difficulty in arriving at agreement on a formula which would be fair, reasonable and workable. Their efforts have consistently been thwarted by the airlines' attitude that any fully terrestrial formula position on the part of the states would demonstrate the unreasonableness of the states by unfairly attributing to governmental units on land income which was earned in the air.

Under the E.T.#1 approach, all of an airline's revenue passenger miles (RPM's) are included in the denominator of a one-factor formula, but the only RPM's which are included in the numerator of a state's formula are those which are flown in a state by a plane which lands there. A variation, one which the airlines view as a concession and which we will call the E.T.#2 approach, attributes to the state so-called "flyover" RPM's by planes which do not land within the state on a particular trip but which are operated by an airline which does land planes within the state. Under no circumstances would the airlines agree that flyover miles subject an airline to the jurisdiction of a state in which its planes never land; the U.S. Supreme Court would undoubtedly agree with them, especially if the airline is not otherwise subject to the jurisdiction of the state. The airlines insist, however, that such RPM's remain in the denominator of the formula. The result is E.T. income.

The effect of the two approaches can be demonstrated:

1. Airline X flies planes in, out of, and between New York, Chicago, and Los Angeles. On some trips, it flies directly between New York and Los Angeles, a one-leg trip; on others, it stops in Chicago and then continues on in the second leg of the trip. The trip is, say, 2,000 miles in length. On both trips, the plane flies approximately twenty miles from the New York airport to the New
Jersey border, 100 miles in Illinois, and 120 miles from the Nevada border to the Los Angeles airport. For purposes of simplicity, we will assume that the length of both trips is the same and that the amount of mileage over Illinois is the same despite obvious variables between the two trips.

Under the E.T.#2 approach, the attribution percentage calculation would be:

New York	Illinois	California	Total
$\frac{20}{2{,}000} = 1\%$	$\frac{100}{2{,}000} = 5\%$	$\frac{120}{2{,}000} = 6\%$	12%

Under the E.T.#1 approach, the Illinois portion would be eliminated on the one-leg trip from New York to Los Angeles, reducing the total percentage of income available to taxation by states to 7% (New York's 1% + California's 6%). On the two-leg trip, 5% would be attributed to Illinois, raising the total accountable income to 12%.

The remaining income, 93% in the case of the direct coast to coast flight and 88% in the case of the two-leg flight would escape all state taxation. The airlines consider this to be justified by the realities of their business. The member states of the MTC do not.

The airlines maintain that they have, after much disputation among themselves, taken three steps toward a middle position aimed at partially accommodating the states. The first, which we will call the E.T.#2 approach, attributed flyover miles to states in which the airline operated. Thus, E.T.#2 would attribute 5% of airline X's income to Illinois on the flyover flight as well as on the two-leg flight, raising the total income accounted for to 12% in both instances. The second concession, which we will call the E.T.#3 approach, would take into account ground (i.e. airport) property and personnel in a three-factor formula in which property, payroll and revenue factors would be included but in which RPM's would determine the amount of flight equipment, of flight personnel and of total revenue which would be included in the numerator of those factors. The airlines did not like this, but it was a concession.

For example, assume further facts: airline X has total ground payroll of $1,000,000 in New York, $1,000,000 in Chicago and $1,000,000 in California. It has total payroll, including flight crews, of $5,000,000. It has $10,000,000 invested (at cost) in ground facilities (property) in each of the three cities, and total property, including flight equipment of $100,000,000. Its total revenues for the year are $50,000,000 and its net income is $5,000,000.

Under E.T.#3, the calculations for the 3 states would be:

	New York	Illinois	California		Total
Property:	10,000,000 / 100,000,000	10,000,000 / 100,000,000	10,000,000 / 100,000,000	= 33.3%	
Payroll:	1,000,000 / 5,000,000	1,000,000 / 5,000,000	1,000,000 / 5,000,000	= 66.7%	
Revenue:	1%	5%	6%	= 12.0%	
				112 / 3	= 37.3%

In 1982, the airlines made a further concession along lines upon which they had agreed with California and which they now propose for adoption by the MTC. We will call it E.T.#4. It treats

ground equipment and personnel in the same manner as does E.T.#3, but it also takes a 20% portion of those items into account in a sort of sub-formula to determine the revenue factor. Thus:

Property		.333
Payroll		.667
Revenue	$\frac{.20(.333 + .667)}{2} + .8(.12) =$	
	$.1 + .096 =$	.196
		$\frac{1.196}{3} = 39.87\%$

One of the alleged infirmities of all of these formulas is that they do not take into account revenue freight miles. Freight is an increasingly important item on passenger lines; yet the distortion appears not to be of great significance in distributing income among the states, and the airlines have refused to suggest anything which would be any more accurate within the F.T. concept. On the other hand, these formulas appear to be inappropriate for some airlines which are primarily freight haulers. Further reference will be made to this consideration later in this discussion.

By early 1978, the MTC, after extensive communication with the airlines under circumstances in which the airlines refused to countenance fully terrestrial (F.T.) income, had devised a formula which was based upon RPM's but in which any miles not attributed to any state would be excluded from the denominator of the RPM formula (hereinafter called the F.T.#1 approach). In March of that year, the MTC conducted a hearing concerning a regulation based upon that formula. At that hearing, the ATA representative objected strenuously, maintaining that the airlines had not had sufficient input and demanding a meeting with the member tax administrators of the MTC. The MTC's Executive Director, in an effort to ensure that the airlines had ample opportunity for input in the deliberation process even beyond that which they had already enjoyed, agreed at that time to work further with the airlines toward something acceptable, provided that it was within what we have here called the F.T. concept. The airlines simply continued to refuse to countenance the F.T. concept. They did, however, negotiate with individual states to arrive at working agreements.

When the Executive Director renewed his efforts in early 1980 to move toward a uniform approach, the airlines were moving toward E.T.#2. Since then, they have gradually moved through E.T.#3 to E.T.#4, their present position. They still maintain that E.T.#1 is the correct position, and there appears to exist within the airline industry some bitter disagreement with any straying from that position. Nevertheless, the industry appears to be resigned to accepting E.T.#4 as the basis for an MTC regulation. But it is adamant in its opposition to any F.T. approach.

Under the F.T. approach which is incorporated into the proposed regulation, airline X's income would be distributed as follows, the total mileage in the three states which have jurisdiction over the airline amounting to only 240 miles:

New York	Illinois	California	Total
$\frac{20}{240} = 8.33\%$	$\frac{100}{240} = 41.67\%$	$\frac{120}{240} = 50\%$	100%

Liaison work with the airlines during 1980, 1981 and 1982 caused the MTC to adjust its approach in an effort to reduce the necessary information to a minimum and to ensure that even that information would be readily available and easily obtained. Toward that end, it explored alternatives to F.T.#1. In doing so, it considered variations which took into account not only RPM's but revenue ton miles, specific flight crew sizes and payrolls, takeoffs and departures. Since all of these possibilities were considered within the F.T. concept, the airlines were always reluctant to contribute to this review, individual representatives of the airlines and of the ATA being very concerned that they never become vulnerable to criticism from their cohorts for having contributed to the development or adoption of <u>any</u> F.T. approach.

The Executive Director gradually came to the conclusion that, within the F.T. concept, a weighted arrival and departure approach (F.T.#2) was adequate to produce a reasonable approximation of income attributable to each state. This conclusion was supported anonymously by some airline personnel. While other items could be taken into account, it appears that they would produce only insignificant variation in income distribution and would do so at the expense of a substantial complication of the calculation process and of a great increase in the effort required to make the income distribution determination, all of which amounted to an unjustified increase in the burdens placed on both taxpayers and tax administrators.

Even the arrival and departure approach, however, was somewhat analogous to counting all of the legs in a herd of cattle and then dividing by four in order to arrive at the number of animals. Since each departure is matched by an arrival, it should not be necessary to count both. Departures alone should be adequate for formula purposes. Obviously, however, a small plane's departure should not have the same significance in the formula as does a large one's. Therefore, the formula weights departures by the cost of the particular type of plane.

This F.T.#2 approach assumes that payroll and revenue production will vary in roughly the same proportion as the cost of the plane. Obviously, this will not always be the case. Nevertheless, the overall effect for an airline's total operations over the course of a year should be that F.T.#2 will accomplish the rough approximation required by Due Process.

In late 1981, the Executive Director referred to the MTC's Uniformity Committee a proposed airline regulation into which was incorporated the F.T.#2 approach. The Committee accorded extensive attention to the proposal and offered suggested improvements which were incorporated into the regulation which it proposed that the Executive Committee approve in July of 1982. The Executive Committee did so unanimously, recommending that the Commission adopt the regulation at the general session of its annual meeting two days later. However, the Executive Director was concerned that the regulation was substantially different from that on which the 1978 hearing had been conducted. Therefore, when the recommendation came up before the general session in the form of a resolution for adoption, he requested that the resolution be amended to recommend a hearing on the new proposal. That request was granted despite the apparently unanimous desire on the part of both the Uniformity Committee and the Executive Committee that the proposed regulation be approved immediately.

In accordance with the revised resolution of the Commission at its annual meeting in July, the MTC conducted a hearing on F.T.#2 on December 6, 1982. At that hearing, the airlines attacked the general process by which the new proposal had been arrived at. In response to a question from the Executive Director, however, they admitted that the real basis of their objections was that the MTC had persisted in pursuing the F.T. approach. They insisted that some states would benefit from the F.T. approach at the expense of others, and they expressed great concern about such a possibility. (This contention was most unconvincing, however; the one example which they brought forward did not appear to support their contention at all.)

The airlines continued to insist that, since some of them had managed to obtain different formulas from the states on the basis of either E.T.#4 or something fairly close to it, those states and others would oppose the F.T.#2 approach which had been incorporated into the proposed regulation. The Executive Director responded that he would ask the Executive Committee to allow the airlines to present this contention to the Executive Committee at its next meeting. That has now been arranged for the March 8 meeting.

The entire matter appears to boil down to the question of whether or not the F.T. approach is to be approved. If it is, then the F.T. #2 approach, which is incorporated into the proposed regulation, appears to produce reasonable results for passenger airlines and probably for most freight airlines. It clearly would not, however, be appropriate for Federal Express because of the unique manner in which that airline operates; it flies all of its freight to a central location at the Memphis airport from which it reships to the various destinations, and it does so all in the same day every day. Clearly, a special formula is required for Federal Express. It may be that one or more additional formulas will also be needed for other air freight lines.

The Executive Director also proposes that a note be added to the regulation to make it clear that the definition of "original cost" excludes any consideration of a safe harbor lease cost.

Subject to the considerations indicated in the two paragraphs which immediately precede this one, the Executive Director recommends that the Executive Committee approve the proposed airline regulation and refer it to the Multistate Tax Commission for adoption at the next meeting of the Commission.

cc: All Member TA's
    Dave West, ATA
    Bill Dowd, TWA
    Other Attendees at December 6, 1982 hearing