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Corporate Income Tax – Alternative Apportionment & Section 18 Issues

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Agenda

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- Origin and Role of Section 18
- Interpretations of Section 18
- Burden of Proof
- Remedies
 - *Ad Hoc* Adjudication
 - Regulation
 - States' Administrative Procedure Acts Implications
 - Other Remedies



ORIGIN AND ROLE OF SECTION 18

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Origin and Role of Section 18

- The Uniform Division of Income for Tax Purposes Act (“UDITPA”) was promulgated by the National Conference of Commissioners on Uniform State Laws in 1957 as part of a nationwide effort to promote uniformity among the states in their methods of allocating and apportioning income of multi-state enterprises.
- UDITPA prescribes an equally weighted three-factor apportionment method, consisting of property, payroll, and sales which the drafters of UDITPA perceived to a “rough” approximation that would fairly represent a taxpayer business activity in a state.
- Section 18 of UDITPA permits deviation from the standard formula when it does not “fairly represent the extent of the taxpayer’s business activity in the state” and authorizes the use of an alternative formula “if reasonable.” UDITPA § 18.
- Most states have either adopted UDITPA’s equitable provision or enacted similar provisions.

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Origin and Role of Section 18 (cont'd)

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- In enacting Section 18, the drafters of UDITPA realized that “some alternative method must be available to handle the constitutional problems as well as the **unusual** cases.” William J. Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 *Taxes* 747, 748 (1957).
- The drafters cautioned, however, that “departures from the basic formula should be avoided” and Section 18 should be applied “**only in unusual cases.**”

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UDITPA and the MTC Model Regs

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- UDITPA: If the allocation and apportionment provisions ... 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, if reasonable...**
- MTC REG: Article IV.18. permits a departure from the allocation and apportionment provisions of Article IV only in **limited and specific** cases. Article IV.18. may be invoked only in **specific cases** where **unusual** fact situations (which ordinarily will be **unique and non recurring**) produce incongruous results under the apportionment and allocation provisions contained in Article IV
- MTC REG: In the case of **certain industries** ... the apportionment formula [does] not set forth appropriate procedures Nothing ... shall preclude [the tax administrator] from establishing appropriate procedures ... for determining the apportionment factors for each such industry, but such procedures **shall be applied uniformly.**

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Interpretations of Section 18

What constitutes “Fair Reflection”?

- **MTC Regulation:**
 - **unusual** fact situations (which ordinarily will be **unique and non recurring**) produce incongruous results under the apportionment and allocation provisions contained in Article IV.
- **Microsoft Corp. v. Franchise Tax Bd.**, 39 Cal. 4th 750 (Cal. 2006): The court articulated a two-pronged test for evaluating sales factor distortion, on a quantitative and qualitative basis.
 - Under the qualitative test, the court evaluated whether the gross receipts generated through the treasury function were qualitatively different from the receipts generated from the taxpayer’s principal business.
 - Under the quantitative analysis, the court compared Microsoft’s profit margin from treasury activities with its profit margin from nontreasury activities, the amount of treasury income versus nontreasury income, and the amount of gross receipts from treasury functions with the amount of gross receipts from nontreasury functions.
- **Union Pacific Corp. v. Idaho State Tax Commission**, 83 P.3d 116 (Idaho 2004).
 - The Court held that distortion in one factor does not necessarily result in unfair reflection of the business activity in the state; the other two factors may well mitigate the distortive effect of the third, so that, ultimately, a taxpayer’s business activity in the state is fairly represented through the combination of the three factors in the apportionment formula.

What constitutes an “Unusual Fact Situation”?

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- There is limited guidance as to what constitutes an “unusual fact situation” that leads to an unfair reflection of business activity to warrant a departure from the general apportionment formula.
- Is Section 18 being applied too often?

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Examples of “Unusual Fact Situation”

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- *Bellsouth Advertising & Publishing Corp. v. Chumley*, 2009 Tenn. App. LEXIS 576 (Tenn. Ct. App. 2009): TP engaged in production and distribution of telephone directories.
- Indiana Letter of Finding No. 04-0398 (Sept. 1, 2006): licensing of broadcasting rights to cable and satellite companies.
- *Microsoft Corp. v. Franchise Tax Bd.*, 39 Cal. 4th 750 (Cal. 2006); see also Kansas Dep’t of Revenue Office of Admin. App., No. WFD-P2007-1 (Jan. 8, 2007): treasury function.
- *In re Wal-Mart Stores, Inc.*, No. 06-07, New Mexico Taxation & Revenue Dep’t (May 1, 2006): IHC royalty income
- *Comptroller of the Treasury v. SYL, Inc.*, 375 Md. 78, 825 A.2d 399 (Md. 2003)
- *Union Pacific v. Idaho* (2004)(accounting practice double counted sales)

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Emerging Issues

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- Trend towards single sales factor apportionment or super-weighted sales factor apportionment methods.
 - Does single sales factor “fairly represent business activity”?
 - Will the trend lead to increased use of section 18?
 - Special circumstances with vertically integrated affiliates and combined reporting?
- Section 18 “Fair Reflection” vs. Unconstitutional Distortion
 - The Commerce and Due Process Clauses of the U.S. Constitution require that a tax must be “fairly apportioned” and an apportionment formula must be “fair.” *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977); *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159 (1983).
 - The U.S. Supreme Court has upheld the validity of a single sales factor apportionment methodology. See, e.g., *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978) (holding that that a single-factor apportionment formula is presumptively valid), but see *Hans Rees’ Sons, Inc. v. North Carolina*, 283 US 123 (1931) (finding a due process violation where the disputed single property factor formula dictated a tax on 83 percent of the taxpayer’s income, when it had been shown that only 17 percent of its profits actually had their source in the taxing state).
 - Courts and administrative tribunals have concluded that taxpayers and tax administrators may invoke the equitable apportionment provision without establishing a constitutional violation. *Microsoft Corp. v. Franchise Tax Bd.*, 39 Cal. 4th 750 (2006); *Union Pac. Corp. v. Idaho State Tax Comm’n*, 139 Idaho 572 (2004); *Twentieth Century-Fox Film Corp. v. Dep’t of Revenue*, 229 Or. 220 (1985).

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Burden of Proof

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Burden of Proof

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- Section 18 departure from the standard apportionment formula requires the occurrence of two elements.
- First, the statutorily mandated formula must be shown to not “fairly represent the extent of the taxpayer’s business activity in the state.”
- Second, the alternative apportionment method must be “reasonable” .

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Burden of Proof (*cont'd*)

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- The party requesting an alternative apportionment bears the burden to demonstrate that the standard apportionment does not fairly represent the taxpayer’s business activity in the state.
- The standard of proof a party must bear before resorting to Section 18 varies from state to state:
 - “Clear and convincing evidence” that the standard formula leads to an unreasonable result (CA, IN).
 - “Clear and cogent” evidence (IL; FL; GA).
 - “Preponderance of the evidence” (OR) .

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Burden of Proof (cont'd)

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- Can (or should) the standard vary based on the party carrying the burden of proof? But compare:
 - *American Tel. & Tel. Co. v. Huddleston*, 880 S.W.2d 682 (Tenn. Ct. App. 1994): a taxpayer seeking a variance from the standard apportionment formula prescribed under Tennessee law must provide “clear and cogent evidence” that the standard formula does not fairly represent taxpayer’s business activity in the state and must show “by clear and cogent evidence” that its unusual circumstances warrant the application of an alternative apportionment method.
 - *Bellsouth Advertising and Publishing Corp. v. Chumley*, 2009 Tenn. App. LEXIS 576 (Tenn. Ct. App. 2009): Noted the Commissioner, as the party invoking Section 18, “carried the burden of proof” but did not discuss or analyze what the standard was.

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Remedies

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Ad Hoc Adjudication vs. Regulations

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What should be the remedy if the general apportionment method is found to be distortive?

- **Ad Hoc Adjudication**
 - More flexible.
 - Appropriate where unforeseeable circumstances or problems that are so specialized that application of a general rule would be unfair.
- **Regulations**
 - Limit arbitrariness in the application of policy in individual cases.
 - Promote clarity and uniformity of the law by ensuring that like cases are treated equally.
 - Give rulemaking notice to the affected taxpayers and permit broad participation by stakeholders.

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States' Administrative Procedure Acts ("APA") Implications

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- States are generally given the freedom to choose between rulemaking or *ad hoc* adjudication.
- Many state APAs limit discretion to formulate policy and require tax authorities to issue statements of interpretation and policy by rulemaking.
 - Most states' APAs define the term 'rule' to generally encompass an agency statement of general applicability that implements, interprets, or prescribes law or policy or describes the procedure or practice requirements of an agency. See, e.g., *Fla. Stat. § 120.52(16)*; N.J. Stat. § 52:14B-2(e).

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States' Administrative Procedure Acts ("APA") Implications

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- Some Courts have held that the use of alternative apportionment under Section 18 absent a formal rule making process may constitute *ad hoc rulemaking* in violation of state administrative laws
 - *CBS Inc. v. Comptroller of the Treasury*, 319 Md. 687 (1990)
 - *Northwest Airlines, Inc. v. State Tax Appeal Bd.*, 221 Mont. 441 (1986)
 - *HMN Fin., Inc. & Affiliates v. Comm'r of Revenue*, A09-1164 (Mn. Sup. Ct. May 20, 2010)?
- Some have held otherwise
 - *Comptroller of the Treasury v. SYL, Inc.*, 375 Md. 78 (Md. 2003)
 - *20th Century Fox v. Department of Revenue (Ore.)*, 700 P.2d 1035 (1985)
 - *Crocker Equipment Leasing, Inc. v. Dept. of Rev.*, 314 Or 122 (1992)

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Other Remedies

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- Combined Reporting/Forced Combination
 - See, e.g., *Wal-Mart Stores East, Inc. v. Hilton*, 676 S.E.2d 634 (N.C. Ct. App. 2009).
- Market Sourcing
- Special Industry Apportionment Rules

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QUESTIONS/COMMENTS?

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