



MULTISTATE TAX COMMISSION

## Multistate Tax Compact Article IV Recommended Amendments

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Prepared for

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Executive Committee Members  
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# Outline

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## **I. Executive Summary**

The history of this project dates back to 1957, when the Uniform Law Commission (ULC) promulgated the model Uniform Division of Income for Tax Purposes Act (UDITPA). UDITPA provides a model law for assigning the total taxable income of a multistate corporation among various states in which it is doing business. Article IV of the model Multistate Tax Compact incorporates the UDITPA nearly verbatim. And most, but not all, enacted versions of the Compact do so as well.

The world economy and tax policy preferences have changed substantially over the 55 years since UDITPA was adopted. Certain UDITPA provisions are now significantly outdated. States have begun to revise these provisions unilaterally. Model amendments would help to maintain a reasonable level of uniformity by giving state legislatures something to draw on as they modernize their apportionment statutes. The Commission surveyed its members and identified five provisions in critical need of review:

### **Primary focus –**

1. Sales factor numerator sourcing for services and intangibles ( Compact Art.IV.17)

### **Others –**

2. “Sales” Definition (Compact Art.IV.1(g))
3. Factor Weighting (Compact Art. IV.9)
4. “Business Income” Definition (Compact Art.IV.1(a))
5. Distortion Relief (Compact Art.IV.18)

In September 2006, the Commission recommended to ULC that it initiate a project to revise UDITPA. After soliciting additional comment, ULC initiated a project to “review and revise UDITPA in its entirety.” But in June 2009, after considerable public comment and controversy, the ULC determined that no further work would be undertaken on UDITPA at that time, with the understanding that ULC might reconsider at a later time if substantial support for revising UDITPA becomes apparent. One month later, in July 2009, the Commission Executive Committee directed that “revisions to Article IV of the compact - specifically, the five areas [that the Commission] suggested as the focus for the Uniform Law Commission’s revision project - be referred to the uniformity committee and that [the uniformity committee] come back to the executive committee if the uniformity committee recommends the scope of issues be changed.” The Uniformity Committee, working with a drafting group, has now completed that work.<sup>1</sup>

A recommendation for each of the five provisions is now before the Executive Committee for consideration for public hearing.

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<sup>1</sup> The drafting group included Ben Miller and Mellissa Potter, CA-FTB; Ted Spangler, ID; Michael Fatale, MA; Gary Humphrey, Janielle Lipscomb, and Jeff Henderson OR; and, Joe Garrett and Holly Coons, AL and staff.

## II. Background

### A. Adoption of UDITPA and the Multistate Tax Compact

In 1957, after decades of attempts by various organizations to draft model state corporate income tax apportionment rules, the ULC succeeded in promulgating its model UDITPA. UDITPA distinguishes business income from non-business income, and apportions business income using an equally-weighted average of property, payroll, and sales factors.

But few states had adopted UDITPA when in 1959 the United States Supreme Court decided *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959). *Northwestern States Portland Cement* held that a small sales force and office in a state was sufficient to establish nexus.<sup>2</sup> The decision upset taxpayers' expectations that sales activity associated with interstate commerce would not invoke state taxing authority. Within seven weeks, Congress was holding hearings, and within seven months it had passed P.L.86-272. P.L.86-272 preempted state authority to tax based on the facts of *Northwestern States Portland Cement*, and created a Special Subcommittee on State Taxation of Interstate Commerce of the House Committee on the Judiciary, commonly called the Willis Committee, to study state business taxes.<sup>3</sup>

After 5 years of study, the Willis Committee issued a four volume report, finding in part that although "each of the state laws contains its own inner logic, the aggregate of these laws – comprising the system confronting the interstate taxpayer – defies reason."<sup>4</sup> The Committee found the benefits of increased uniformity so compelling that it recommended federal legislation to, among other things, institute a uniform state income tax base (set at federal AGI) and a uniform state apportionment formula (equal-weighted two-factor formula based on property and payroll).<sup>5</sup> Tax base and apportionment formula are fundamental aspects of state tax policy, the federal pre-emption of which would be a significant affront to state tax sovereignty.

The states rallied to stave off federal intervention and protect their sovereignty. Many adopted UDITPA directly into their statutes. Several enacted the Multistate Tax Compact. And some did both. Most, but not all, of the enacted versions of the Compact include an Article IV, which contains UDITPA nearly verbatim. Some Compact states rely on Article IV as their general apportionment provision. But some rely on general apportionment provisions in other sections of their statutes. And indeed, most, though not all, enacted versions of the Compact include an election which allows a Taxpayer to choose to apportion either by using the Article IV formula or by using the formula provided under "the laws of such States ... without reference to this Compact."<sup>6</sup>

The Compact also created the Multistate Tax Commission as its administrative agency charged with several responsibilities, including development of model rules and regulations

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<sup>2</sup> *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959).

<sup>3</sup> PUB. LAW 86-272, TITLE II, 73 STAT. 555 (1959).

<sup>4</sup> H.R. Rep. No. 952, 89<sup>th</sup> Cong., 1<sup>st</sup> Sess., Pt. VI, at 1143 (1965).

<sup>5</sup> H.R. Rep. No. 952, 89<sup>th</sup> Cong., 1<sup>st</sup> Sess., Pt. VI, at 1139ff (1965)

<sup>6</sup> Compact, Art. III.1

interpreting Article IV.<sup>7</sup> Twenty states are Compact members. Another twenty-seven participate in the work of the Commission as either Sovereignty or Associate members.

## **B. UDITPA Today**

The states' adoption of the Compact and UDITPA, though not in lock-step uniformity, made significant progress toward addressing the concerns expressed in the 1965 Willis Report. By 1978, the U.S. Supreme Court recognized the UDITPA equal-weighted formula as "the prevalent practice,"<sup>8</sup> and a "rough, practical approximation of the distribution of either a corporation's sources of income or the social costs which it generates."<sup>9</sup> But the Court also recognized that "political and economic considerations vary from state to state," and held that a state may constitutionally address those considerations by requiring an alternate formula.<sup>10</sup> Over the 55 years since UDITPA was drafted, the states have done so. Nonetheless the level of uniformity today remains greatly improved relative to that of the late 1950's. Today, of the forty-seven or so states with a corporate income tax, thirty-seven follow all or parts of UDITPA.<sup>11</sup>

## **C. Revision of UDITPA and the Model Compact**

### **1. Early Proceedings at the Commission**

Although UDITPA has held up remarkably well,<sup>12</sup> a handful of important provisions are significantly outdated. In July, 2004, The Commission's State Tax Compliance Initiative Work Group recognized the problem and found that revisions to UDITPA "are clearly needed in the area of sales of services and to address intangibles and the financial services sector" and advised "a cooperative effort with [the ULC]."

In September 2006, after a vote of the Commission's executive committee, the Commission formally recommended to the ULC that it initiate a project to revise its model UDITPA, in particular the provision on sales factor sourcing for services and intangibles. (See Attachment A.) In 2008, the Commission surveyed its members, and with one exception, found 100% agreement that the following five provisions should be the focus of review:

#### **Primary focus:**

1. Sales factor numerator sourcing for services and intangibles (Compact Art.IV.17)

#### **Others:**

2. "Sales" Definition (Compact Art.IV.1(g))

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<sup>7</sup> Compact, Art. VI

<sup>8</sup> *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 279 (1978); see also, *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 170, 183, 103 S.Ct. 2933, 77 L.Ed.2d 545 (1983) (UDITPA's three factor has become "something of a benchmark against which other apportionment formulas are judged.").

<sup>9</sup> *General Motors Corp. v. District of Columbia*, 380 U.S. 553, 561 (1983)

<sup>10</sup> *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 279 (1978)

<sup>11</sup> Commerce Clearing House, ¶ 11-505, April 25, 2012.

<sup>12</sup> The states have largely adhered to its provisions. And the provisions that have undergone judicial review have been upheld as constitutional. See e.g., *Allied Signal v. Dir. Div. of Taxation*, 504 U.S. 765 (1992); *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159 (1983)

3. Factor Weighting (Compact Art. IV.9)
4. "Business Income" Definition (Compact Art.IV.1(a))
5. Distortion Relief (Compact Art.IV.18)

With approximately 70% of compact member states and 50% of all member states responding to the survey, the only provision which did not receive 100% support for review was factor weighting. In the case of factor weighting, 84% of responding states voted in favor of review and 16% voted against review. (See Attachment B.)

## 2. Controversy at ULC

In August 2007, after studying the Commission recommendation and receiving additional input from the Commission, the Federation of Tax Administrators, COST, and others, the ULC determined that it would review and "revise UDITPA in its entirety." A ULC drafting committee was formed and meetings were held to receive additional public comment. At these meetings and in writing, the Commission explained that a revised model is needed in order to preserve a reasonable level of uniformity as states move away from certain outdated provisions.

But Taxpayer representatives and other groups strongly opposed the effort. Steve Kranz of the Sutherland firm expressed the view that "[n]o matter the starting point, uniformity in corporate tax treatment is contrary to the legislative desire to serve constituencies."<sup>13</sup> Even if legislatures did find some value in corporate tax apportionment uniformity, "[g]iven the plentitude of demographic, statutory and political differences among states it is quite clear that the proposed revision of UDITPA is neither desirable nor practicable ...."<sup>14</sup> A coalition of large corporate taxpayers advised that "uniformity in state taxation requires federal action."<sup>15</sup> COST agreed.<sup>16</sup> And two associations of legislators – the American Legislative Exchange Council (ALEC) and the National Conference of State Legislators Task Force on Telecommunications and Electronic Commerce (NCSL Task Force) expressed concern that uniformity is inconsistent with federalism. ALEC wrote that "a uniform tax on corporate income contravenes ALEC's mission to support state sovereignty."<sup>17</sup>

The Commission, FTA, and several individual state tax administrators disagreed. Proponents explained that state legislators will have no choice but to address these issues whether ULC moves forward or not, and that the interests of uniformity, tax simplification, compliance and efficient tax administration would best be served if there were uniform model amendments available for

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<sup>13</sup>Letter from Steven Kranz, Sutherland, to Charles Trost, p.3. May 14, 2008.

<sup>14</sup>*ibid.*

<sup>15</sup>Letter from coalition of large corporate taxpayers titled "In Opposition to the Project to Revise the Uniform Division of Income for Tax Purposes Act." Undated, received July 7, 2008.

<sup>16</sup>Comments of Doug Lindholm, Executive Director of the Council on State Taxation, made during the May 2008 Drafting Committee meeting. Reported in "UDITPA Revisions Debated at Initial Meeting of Drafting Committee." June 3, 2008. CCH Tax Tracker News; COST letter of June 22, 2009 to Dale Higer, Chair, NCCUSL UDITPA study Committee.

<sup>17</sup>American Legislative Exchange Council Resolution to Oppose [ULC] Effort to Rewrite the Uniform Division of Income for Tax Purposes Act.

legislatures to consider.<sup>18</sup> They commented on the need for a model to help preserve a reasonable level of uniformity. Increasing disuniformity could invite federal preemption and jeopardize state sovereignty.<sup>19</sup>

Professor Richard Pomp also spoke in favor of the effort, suggesting that if ULC elected not to revise UDITPA, then ULC should consider repealing it. The NCSL Task Force met in May 2009 and, after hearing testimony from Steve Kranz, COST and others, recommended unanimously that other organizations, including the Multistate Tax Commission, are better positioned than ULC to provide options for UDITPA language.<sup>20</sup>

In June 2009, after considerable public comment and controversy, the ULC discharged its UDITPA Study Committee and explained that no further work would be undertaken on UDITPA at that time, with the understanding that it might re-open the effort at a later time if substantial support for revising UDITPA becomes apparent.

### 3. Back to the Commission

One month later, in July 2009, the Commission Executive Committee directed that “revisions to Article IV of the compact - specifically, the five areas suggested as the focus for the Uniform Law Commission’s revision project - be referred to the uniformity committee and that [the uniformity committee] come back to the executive committee if the uniformity committee recommends the scope of issues be changed.”

The Income & Franchise Tax Uniformity Subcommittee began its effort in December, 2009, with a series of educational presentations from guest experts Professor Richard Pomp, Alva P. Loiselle Professor of Law, University of Connecticut School of Law; Mr. Prentiss Willson, former Ernst & Young National Director of State and Local Tax Practice and Procedure; Professor Michael McIntyre, Professor of Law, Wayne State University Law School; and Professor Charles McClure, Herbert Hoover Business School, Stanford University. A document library for this project was created and contains materials from these presentations. The library is available at: <http://www.mtc.gov/Uniformity.aspx?id=4562>.

Next, the Subcommittee drafted policy guidelines to use throughout the process for comparing alternative proposals. (See Attachment C.) The Subcommittee then determined it would address each of the five provisions in turn, starting with the highest priority, Article IV.17, sales factor numerator sourcing for services and intangibles. The Subcommittee appointed a drafting group,<sup>21</sup> charged with identifying policy questions for the Subcommittee’s consideration

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<sup>18</sup> See, e.g., Letter from Joe Huddleston, Executive Director of the Multistate Tax Commission, to Charles Trost. July 7, 2008; Letter from Royce Chigbrow, Chairman of the Idaho State Tax Commission, to John Seibert, Executive Director of ULC. June 13, 2008.

<sup>19</sup> See, e.g., Letter from Joe Huddleston, *id.*

<sup>20</sup> NCSL Task Force letter of June 19, 2009 to Martha Walters, ULC President, and John Siebert, ULC Executive Director.

<sup>21</sup> The drafting group included Ben Miller and Mellissa Potter, California-FTB; Ted Spangler, Idaho; Michael Fatale, Massachusetts; Gary Humphrey, Janielle Lipscomb, and Jeff Henderson, Oregon; Joe Garrett and Holly Coons, Alabama, and Commission staff, Bruce Fort and Shirley Sicilian.

and then drafting amendments reflecting the Subcommittee's policy answers. The drafting group met weekly throughout this project. The Subcommittee held monthly teleconferences and eight in-person meetings.<sup>22</sup>

In July 2011, after two years of intensive work, the Uniformity Committee recommended amendments for model Compact Art.IV.17 (sales factor numerator sourcing) and Art.IV.1(g) ("sales" definition) to the Executive Committee for consideration for public hearing. The Executive Committee considered the proposals at its meeting in December, 2011. Shortly before that meeting, the NCSL Task Force passed a resolution "encouraging the MTC to establish a transparent process through which elected state policymakers and the taxpaying public can have meaningful input..."<sup>23</sup> In an accompanying letter, the Task Force also asked the Executive Committee to "delay further actions on amending the [Compact] until we [can] meet with the members of the MTC Executive [Committee]."

The Executive Committee did take up the two recommended amendments at its December 2011 meeting, and after discussion, it referred the proposals back to the Uniformity Committee to clarify certain sections of the sales factor numerator sourcing provision. Over the next two months those clarifications were made and were adopted by the Uniformity Committee in January 2012. In March 2012, the Uniformity Committee approved recommended amendments for the remaining three provisions.

All five recommendations are now before the Executive Committee for consideration for public hearing.

### **III. Proposed Model Amendments**

#### **A. Definition of Business Income**

##### **1. Current Language**

The Compact currently defines business income (income to be apportioned among states), and non-business income (income to be allocated to a single state) as follows:

**Art. IV (1)(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.

**Art. IV (1)(e)** "Nonbusiness income" means all income other than business income.

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<sup>22</sup> At various meetings, particularly early in the process, the drafting group and subcommittee received helpful written comments from Diann Smith, Sutherland, and Todd Lard, COST.

<sup>23</sup>



A majority of states have interpreted this definition to provide two tests for identifying apportionable business income: a transactional test and a functional test.<sup>24</sup> The transactional test refers to “income arising from transactions and activity in the regular course of the taxpayer’s trade or business.”<sup>25</sup> It focuses on the frequency and regularity of the transaction that produces the income. For example, income from the sale of taxpayer’s products to its customers would meet the transactional test. The functional test refers to “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.”<sup>26</sup> The functional test focuses on the property that is being disposed in the transaction that produces the income. For example, income from the sale of machinery or equipment that the taxpayer used to produce its product, or otherwise used in its unitary business, would meet the functional test.

However, the language of the Act is not very clear and some state courts have held UDITPA provides only a transactional test.<sup>27</sup> Under this minority view, the words “and includes” make the second clause (the functional test) a qualifying clause that serves to exemplify a certain type of income that is included only if it also fits within the first clause (the transactional test). Under this interpretation, income from the sale of machinery used in the taxpayer’s unitary business would only be included in business income if that type of machinery is sold on a regular basis. For example, a car rental agency that routinely sells and replaces cars used in its rental fleet would treat income from such sales as business income. In states where the courts found that the definition contains only a transactional test, the legislatures generally followed-up with a statutory amendment to clearly add the functional test.<sup>28</sup>

There has also been a legislative trend over the last few years to define business income simply as all income apportionable under the U.S. Constitution.<sup>29</sup> In part, this trend is a reaction to judicial decisions holding that income arising from the liquidation of a business cannot be included

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<sup>24</sup> CCH Commentary, Multi-Corp-Income, *Distinction Between Business and Non-Business Income* (2007). See also, e.g., *Hochst Celanese Corp. v. Franchise Tax Board*, 25 Cal.4<sup>th</sup> 508 (2001); *Gannett Satellite Information Network Inc. v. Montana Dep’t of Rev.*, 348 Mont. 333, 201 P.3d 132 (2009); *Texaco-Cities Service Pipeline Co. v. McGaw*, 695 N.E. 2d 481 (Ill. 1998); *Polaroid Corp. v. Offerman*, 349 NC 290 (1998); *Willamette Industries, Inc. v. Oregon Department of Revenue*, 331 Or 311 (2000); *Kemppel v. Zaino*, 746 N.E. 2d 1073 (Ohio, 2001).

<sup>25</sup> UDITPA § 1(a)

<sup>26</sup> *Id.*

<sup>27</sup> See, e.g., *Uniroyal Tire Co. v. State Department of Finance*, 779 So.2d. 227 (Ala. 2000); *Appeal of Chief Industries, Inc.*, 255 Kan. 640, 875 P.2d 278 (1994); *Phillips Petroleum Co. v. Iowa Dep’t. of Rev. and Fin.*, 511 N.W.2d 608 (Iowa 1993). *Associated Partnership I, Inc. v. Huddleston*, 889 S.W.2d 190 (Tenn. 1994).

<sup>28</sup> See, e.g.:Alabama: Ala. H.B. 7 (Dec. 28, 2001) amending Ala. Code Sec. 40-27-1.1 after *Uniroyal Tire Co. v. State Department of Finance*, 779 So.2d. 227 (Ala. 2000).

Iowa: Iowa Code § 422.32 after *Phillips Petroleum v. Iowa Dep’t of Rev. and Fin.*, 511 N.W. 608 (Iowa 1994).

Kansas: K.S.A. 79- 3271(a) after *Appeal of Chief Industries, Inc.*, 255 Kan. 640, 875 P.2d 278 (1994).

Tennessee: T.C.A. § 67-4-2004 after *Associated Partnership I, Inc. v. Huddleston*, 889 S.W.2d 190 (Tenn. 1994).

<sup>29</sup> See, e.g.:Illinois: 35 ILCS 5/1501(a)(1); Kansas: K.S.A. 79-3271(a); Minnesota: Minn. Stat. §290.17 Subd.4.(a); North Carolina: N.C. Gen. Stat. §105-130.4(a)(1); Pennsylvania: 72 P.S. §7401(3)2.(a)(1)(A).

business income.<sup>30</sup> In a nutshell, the theory behind these decisions is that income can't be "business income" if there is no longer any business. A policy concern with this theory is the potential mismatch from allocating gain on the sale of a unitary asset after apportioning expenses, such as depreciation, associated with that same asset.

Although the definition of "business income" is changing in many states through judicial interpretation and legislative amendment, there remains a high level of uniformity because states have moved largely in the same direction – toward maintaining a broad interpretation of business income. The question is whether the model provision should be amended to clarify the existence of both a transactional and functional test, and to include gain from the sale of unitary business assets.

## 2. Proposed Language

The Uniformity Committee recommends the following amendments:

**Art. IV.1 (a)** "~~Business-Appportionable~~ income" means:

- (i) all income that is apportionable under the Constitution of the United States and is not allocated under the laws of this state, including:
  - (A) income arising from transactions and activity in the regular course of the taxpayer's trade or business, and ~~includes~~
  - (B) income arising from tangible and intangible property if the acquisition, management, employment, development, and or disposition of the property ~~constitute integral parts of is or was related to the operation of~~ the taxpayer's ~~regular~~ trade or business operations; and
- (ii) any income that would be allocable to this state under the Constitution of the United States, but that is apportioned rather than allocated pursuant to the laws of this state.

**Art. IV.1 (e)** "Non-~~business-apportionable~~ income" means all income other than ~~business-apportionable~~ income.

**See also Attachment D for corresponding technical changes necessary to rename "business income" as "apportionable income"**

The proposed language begins with a broad statement of intent to include all income that is apportionable under the constitution, with one exception. The one exception is income that a state would also be constitutionally allowed to allocate to itself. So long as the state has not established a statutory intent to apportion such income (some states do apportion allocable income), that income remains outside the definition of business income, so that it is allocated rather than subject to apportionment. Art. IV.1 (a)(ii) provides the corollary rule that any allocable income which the

<sup>30</sup> *Lennox v. Tolson*, 353 N.C. 659 (2001); *Laurel Pipe Line Co. v. Commonwealth of Pennsylvania Board of Finance and Revenue*, 537 Pa. 205(1994); *Kemppel v. Zaino*, 746 N.E. 2d 1073 (Ohio, 2001); *Blessing/White, Inc. v. Zehnder*, 329 Ill.App.3d 741 (2002).

state *has* statutorily opted to apportion should be included as business income so that it is clear it is to be apportioned using the appropriate formula.

This broad definition is intended to include gains from liquidation of a unitary business, including a liquidation that is a deemed sale of assets under I.R.C. 338(h)(10) and regardless of how the gains are used. To address confusion over how “business income” could include income from selling the business itself, the draft would rename “business income” as “apportionable income.” Corresponding changes would need to be made throughout the Compact Article IV. These are shown in Attachment D.

One option would be to end the definition after this broad statement referencing the constitution. But, constitutional boundaries can be amorphous. In order to provide more statutory guidance, the transactional and functional tests are retained. Under the proposal, business income includes, but is not limited to, income that falls within one of these two tests.

The proposal also clarifies the functional test in four ways. First, the list of activities which describe how property can become integrated into the business are expanded from “acquisition, management, and disposition” to include “employment” and “development” as well. Presumably, “employment” and “development” are contained within the meaning of “management,” but they are now listed explicitly. Second, this list of activities is now connected with an “or” rather than an “and” to clarify that any one of these activities can integrate property into the business.

The third functional test clarification is to delete the word “regular.” In the current rule, both the transactional and functional tests use the word “regular.” This has led to questions of whether “regular” limits the functional test to frequent transactions. The California Supreme Court explained in *Hoechst Celanese*:

In the transactional test—which focuses on the income-producing transaction—‘regular’ modifies ‘course of the taxpayer’s trade or business’ and makes the nature of the transaction relevant. In the functional test — which focuses on the income-producing property — ‘regular’ modifies ‘trade or business operations’ and follows the phrase ‘an integral part of.’ Consequently, ‘regular,’ as used in the functional test, does not refer to the nature of the transaction, and the extraordinary nature or infrequency of the income-producing transaction is irrelevant.

*Hoechst Celanese Corp. v. Franchise Tax Bd.*, 25 Cal. 4th 508, 530 (2001)

Because there is potential for confusion, and little to be gained, by modifying “trade or business” with the word “regular;” the term is deleted.

The fourth functional test clarification is to require that the property be “related to the operation,” rather than constitute an “integral part,” of the taxpayer’s trade or business. In the current rule, the term “integral” is the touchstone for determining whether property has a close enough relationship to the taxpayer to satisfy the functional test. But the term is subject to multiple interpretations. In *Hoechst Celanese*, the California Supreme Court explained that interpreting “integral” as “contributing to” could be unconstitutionally broad, while interpreting

“integral” as “necessary to” or “essential to” would be too restrictive (since no asset would be sold if it were necessary or essential).<sup>31</sup> The Court found that “integral” should be construed somewhere between these two – e.g., “materially contributing to.”<sup>32</sup> The language of the U.S. Supreme Court in *Container* and *Allied Signal* requires that the property from which the income arises performed an “operational” function, that it be “operationally related to” or “related to the operation of” the taxpayer’s business, in order for the income to be apportionable.<sup>33</sup> This phrase – “related to the operation” – was chosen because it is more concrete than “integral part” and it satisfies the concern expressed in *Hoechst* by specifying how the property must contribute to the business – i.e., operationally.

## **B. Factor Weighting**

### **1. Current Language**

Under Compact Article IV, Business Income is subject to apportionment. And Compact Article IV.9 sets out the apportionment formula – an equal-weighting of property, payroll and sales factors:

All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

But as of January 2012, only ten jurisdictions exclusively require the equal-weighted three-factor formula. Seven of these ten are Compact members. Although states are moving away from equal-weighting, they are moving away in the same direction – toward more heavily weighting the sales factor. Thirty-seven states now at least double weight the sales factor. And fourteen of the thirty-seven use the sales factor only. Five of these fourteen are Compact members. Attachment E shows factor weightings by state.

The motivation for this trend is two-fold. First, there is a desire to at least equalize the recognition given to market vs. production states. An equal-weighted formula assigns greater value to the contributions of the production state relative to the market state because two of the three factors – property and payroll – reflect factors of production. When a state double weights the sales factor, it is giving equal weight to the contributions of the production and market states.

Second, some states emphasize the sales factor, and de-emphasize the property and payroll factors, to encourage economic development. Reducing the weight given to property and payroll reduces the apportionment effect of locating jobs and investment in the state. A formula that uses only the sales factor eliminates the apportionment effect. Of course, if all states used the single-sales formula, the economic development advantage for any particular state would disappear.

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<sup>31</sup> *Hoechst Celanese Corp. v. Franchise Tax Bd.*, 25 Cal. 4th 508, 529 (2001)

<sup>32</sup> *Id.* at 530

<sup>33</sup> *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 180, n 19 (1983); *Allied Signal v. Dir. Div. of Taxation*, 504 U.S. 765, 769 and 785 (1992)

With less than 20% of states adhering to the equal-weighted formula, the Commission suggested this provision is worthy of study and an attempt to identify a workable rule that states can adopt.

## 2. Proposed Language

The Uniformity Committee considered five options: (1) retain the current, three-factor equal-weighting, (2) double weight the sales factor, (3) use only a single sales factor, (4) indicate that the weighting is each state’s choice (this approach lacks a uniformity focus, but would acknowledge states’ differing tax policies and the point that states are, in fact, moving in a uniform direction), and (5) allow taxpayers to elect a weighting which will allow it to file uniformly in all or some threshold percentage of states (unlike the taxpayer apportionment election that exists now in Compact Article III.1, this election would be limited to factor weighting and would require a consistent election in some number of other states.<sup>34</sup>). Based on a weighted rank voting procedure, with 1 being the most favored and 5 being the least favored, the Uniformity Committee determined that the double weighted sales formula had the most support among the states:<sup>35</sup>

Art.IV.9 All business income shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus two times the sales factor, and the denominator of which is ~~three~~ four.

The voting results were as follows:

Rank \ Option	Equal Weight	Double Weight	Single Sales	State Option	TP Option
1	4	10	0	2	0
2	9	3	1	3	0
3	0	2	4	6	3
4	3	0	5	5	2
5	0	0	6	0	11
Weighted Rank	34	<b><u>26</u></b>	64	46	72

The Uniformity Committee’s choice of a double weighted sales formula promotes uniformity by moving in the direction of the current trend: emphasizing the sales factor. By taking

<sup>34</sup> Model Compact Article III.1 currently allows a taxpayer to elect to apportion “in the manner provided by the laws of such States ... without reference to this compact, or ... in accordance with Article IV [UDITPA]” without regard to how the taxpayer elects to apportion in any other Compact state.

<sup>35</sup> The voting procedure required each state to rank the proposals from 1 to 5, with 1 the most favored and 5 the least favored. The rankings were then weighted by multiplying the total number of states giving the proposal that numerical rank by the numerical rank; e.g., if a state ranked the single sales factor as fifth (i.e., least) favorite, then the state would assign that proposal 5 points. All states’ points were then added for each proposal and the proposal with the lowest number of points was chosen as the recommendation to the Executive Committee.

this practical step through a double weighted sales formula, the Committee also promotes a reasonable tax policy of giving equal weight to production and market activities.

The Uniformity Committee recognized that there are other, non-tax policy concerns which the Executive Committee may wish to take into account, such as legislative economic development policies. There is wide latitude for adopting an alternative formula. The legal requirements and policy guidelines applicable to alternative formulas are discussed below.

### **i. Legal Considerations**

The U.S. Constitution requires that an apportionment formula be “fair,” and the U.S. Supreme Court has said that for a formula to be “fair” it must be internally and externally consistent.<sup>36</sup> Internal consistency means that “if applied by every jurisdiction, [the formula]... would result in no more than all of the unitary business’ income being taxed.”<sup>37</sup> Any formula that uses one or more of the three factors, regardless of the weightings, would clearly meet the internal consistency test, including a single factor formula.

External consistency requires “that the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated.”<sup>38</sup> Undoubtedly, all activities of a unitary business contribute something to the realization of its income.<sup>39</sup> But no apportionment formula could, or even attempts to, include all factors reflecting all activity. And a legal requirement to do so would certainly defeat the usefulness of formulary apportionment as a “rough approximation.”<sup>40</sup> Even the UDITPA three-factor formula includes only three types of taxpayer activity: property, payroll and sales. These three factors do not exhaust the entire set of factors arguably relevant to the production of income. And none of these three factors is included in its entirety.<sup>41</sup> Despite these omissions, the Supreme Court has acknowledged that the “[t]he standard three-factor formula can be justified as a rough, practical approximation of the distribution of either a corporation’s sources of income or the social costs which it generates.”<sup>42</sup> Having said that, the Supreme Court recognized that “[s]ome methods of formula apportionment are particularly problematic because they focus on only a small part of the spectrum of activities by which value is generated.”<sup>43</sup> Nonetheless, even a single factor formula can provide a reasonable “rough approximation” of income attributable to a state, and the Supreme Court has “generally upheld the use of such formulas...”<sup>44</sup>

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<sup>36</sup> *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 160.

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

<sup>39</sup> See, e.g., *Hans Rees’ Sons, Inc. v. North Carolina*, 283 U.S. 123, 133 (1931)

<sup>40</sup> *Id.* at 271.

<sup>41</sup> The property factor excludes intangible property; the payroll factor may exclude independent contractors; and the sales factor reassigns sales made to the U.S. government on the basis of origination rather than destination.

<sup>42</sup> *General Motors Corp. v. District of Columbia*, 380 U.S. 553, 561 (1983).

<sup>43</sup> *Container Corp.* at 170.

<sup>44</sup> *Id.*, citing to *Moorman Mfg. Co. v. Bair*, *supra* (upholding single sales factor formula and its application to specific taxpayer); *Underwood Typewriter Co. v. Chamberlain*, *supra* (upholding a single property factor formula, which did not include intangible property, and its application to a specific taxpayer). See also, *Hans Rees’ Sons, Inc. v. North*

Any formula, whether a single sales formula or the “benchmark” UDITPA three-factor formula, will occasionally over-reflect or under-reflect income attributable to a state for a particular taxpayer. To be sure, the more narrow the spectrum of activity included in an apportionment formula, the more likely the formula will fail to reflect particular taxpayers’ activity in the taxing state. But the Supreme Court held in *Hans Rees’* that “when the [jurisdiction] has adopted a method *not intrinsically arbitrary*, it will be sustained until proof is offered of an unreasonably and arbitrary application *in particular cases*.”<sup>45</sup> Indeed, the Court has “on occasion found the distortive effect of focusing on only one factor so outrageous *in a particular case* as to require reversal.”<sup>46</sup> As long as the formula is not “intrinsically arbitrary”, it will be applied unless, with respect to a particular taxpayer, it is “out of all appropriate proportion to the business transacted by the [taxpayer] in that State.”<sup>47</sup>

## ii. Policy Considerations

As mentioned above, states may choose to emphasize the sales factor and de-emphasize the property and payroll factors to encourage economic development. If property and payroll count for less in the apportionment formula of state A compared to state B, then a business will have a lower home state tax base if it locates its property and payroll in state A rather than state B. But some authors have cautioned against the single sales factor formula that results when the trend toward emphasizing sales is taken to its extreme:

The three-factor formula based on payroll, property, and sales probably does fairly well at reflecting where income is earned, whether or not sales are double-weighted. By comparison, it is obvious that sales-only apportionment generally does not reflect where income is earned; it would be an unusual economic activity in which neither payroll nor property played a significant role in the creation of income. Indeed, I believe that any weight on sales greater than 50 percent is likely to be too great.

Charles McLure, *A Comprehensive and Sensible UDITPA*, State Tax Notes (Sept. 26, 2005)

[T]he biggest setback to what UDITPA has accomplished is the growing tendency of states to seek a competitive edge in the business location market by changing the apportionment to overweight the sales factor or even make it a single factor. To me, there is a right way and a wrong way to apportion income. You should do it the right way; if you want to adjust the tax burden, you can do it by adjusting the tax rates. That’s the only way you can attain fairness between local businesses and multistate businesses.

John S. Warren, *UDITPA—A Historical Perspective*, 38 State Tax Notes 133 (2005); Mr. Warren represented California during the original drafting of UDITPA.

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*Carolina*, *supra* at 134 (holding a single tangible property factor to be “fair on its face,” but rejecting its application to a specific taxpayer in a particular case as distortive.)

<sup>45</sup> *Id.* at 133 (emphasis added)

<sup>46</sup> *Container Corp.*, *supra* at 182-183; referring to *Hans Rees’ Sons, Inc. v. North Carolina ex rel. Maxwell*, *supra*

<sup>47</sup> *Hans Rees’ Sons v. North Carolina ex rel. Maxwell*, 283 U. S. at 135

The more narrow the scope of activity that the formula takes into account (e.g., sales only vs. three-factor), the more likely the formula will produce distortion as applied to individual taxpayers, and thus the more frequently a state may need to apply section 18 distortion relief.

## **C. Sales Factor**

### **1. Definition of "Sales"**

#### **i. Current Language**

Compact Article IV.1(g). defines "sales" as follows:

'Sales' means all gross receipts of the taxpayer not allocated under Sections 4 through 8 of this Act.

Sections 4 through 8 of the Compact lay out the rules for allocating non-business income. Gross receipts related to income that is "not allocated" would mean gross receipts related to income that is apportioned. And apportioned income is business income. As discussed above, "business income" is income that meets either the transactional test ("income arising from transactions and activity in the regular course of the taxpayer's trade or business") or the functional test ("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"). Gross receipts associated with the transactional test would include, for example, receipts from the sale of the taxpayer's product – its goods or services – to its customers.<sup>48</sup> Gross receipts associated with the functional test could include receipts from the sale of production plant, machinery, or equipment that the taxpayer used to produce its product.<sup>49</sup> It could even include dividends, or receipts associated with capital gain on the sale of a business.

But the Commission's model regulations, in place since 1973, specify "the term 'sales' means all gross receipts derived by the taxpayer from "transactions and activity in the regular course of the trade or business."<sup>50</sup> This regulatory language mirrors the Compact's transactional test. The language of the functional test is not included. And the model regulations explicitly exclude certain types of receipts generally associated with functional test income, such as "substantial amounts of gross receipts from an incidental or occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business."<sup>51</sup>

Other, more recent Commission regulations further limit "sales" by excluding treasury function transactions – such as repayment of a loan, short-term investments of working capital, or other financial activity – even though income associated with the activity could be included in

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<sup>48</sup> Compact Art.IV(1)(a)

<sup>49</sup> Id.

<sup>50</sup> MTC Reg. IV.15.(a)

<sup>51</sup> MTC Reg.IV.18(c)



business income by virtue of the transactional test.<sup>52</sup> Excluding these amounts from the sales factor is consistent with the current rule in the overwhelming majority of states that have addressed the issue.<sup>53</sup> Some states have held that a return of a taxpayer's property, its principal, is inconsistent with the commonly-understood concept of a "sale".<sup>54</sup> Other states have found that UDITPA's definition of "sales" could include returns of principal, but nonetheless exclude such amounts to prevent distortion of the sales factor since the repeated, sometimes overnight, returns of investment principle can significantly increase the sales factor denominator.<sup>55</sup> Some states allow the interest income earned on the principal to be included as gross receipts, but others exclude both the returned principal and the interest income received. Although states have had to fill this gap with litigation, legislation or regulation, one way or another, the result has been to exclude returns of principal.

## ii. Proposed Language

The Uniformity Committee recommends the following amendments:

**"SalesReceipts" means all gross receipts of the taxpayer that are not allocated under Sections 4 through 8 of this Act paragraphs of this article, and that are received from transactions and activity in the regular course of the taxpayer's trade or business; except that receipts of a taxpayer other than a securities dealer from hedging transactions and from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities, shall be excluded.**

**See also Attachment F for corresponding technical changes necessary to rename "sales" as "receipts" where appropriate.**

This proposal would place the transactional test limitation, which has been in the Commission's model regulations since 1973, into the statute. Some would argue that if an item of income is included in the pool to be apportioned, then the related receipt should be included in the sales factor. But the purpose of the apportionment formula is to use some of the taxpayers' activities that can be geographically located as a means of attributing the source of taxpayers' income which is not, by itself, so easily located. Not all activities from which income arises are included in the apportionment formula, only three: property, payroll, and sales. And not all property, payroll or sales are included. Outer-jurisdictional property is not included in the property

<sup>52</sup> MTC Reg. IV(2)(a); MTC Reg. IV.18(c)(4)(A)

<sup>53</sup> Research performed by the California Franchise Tax Board and reported in briefing for *General Motors Corp. V. Franchise Tax Bd.*, 39 Cal.4th 773, 139 P.3d 1183 (Cal.,2006), indicates 36 states exclude returned principal from the sales factor.

<sup>54</sup> *American Telephone & Telegraph Co. v. Director, Division of Taxation*, 4 N.J. Tax 638 (Tax Ct. 1982), aff'd and modified (N.J. Super. App. Div. 1984) 476 A.2d 800, cert. denied (1984) 97 N.J. 627; *Sherwin Williams v. Indiana Dept. of State Revenue*, 673 N.E.2d 849 (Ind. Tax 1996); *Walgreen Arizona Drug Co. v. Arizona Dept. of Revenue*, 97 P.3d 896 (Ariz. App. Div. 1, 2004)

<sup>55</sup> *Microsoft Corp. v. Franchise Tax Bd.*, 139 P.3d 1169 (Cal. 2006); *American Telephone & Telegraph Co. v. State Tax Appeal Board*, 787 P.2d 754 (Mont. 1990); *Sherwin Williams Co. v. Johnson* 989 S.W.2d 710 (Tenn. App., 1998); *Mead Corp. v. Department of Revenue*, 861 N.E.2d 1131 (Ill. App., 1 Dist., 2007)

factor. Independent contractors are not included in the payroll factor. And there is a reasonable policy basis for limiting the types of receipts that are included in the sales factor.

It's generally agreed that the purpose of the sales factor is to reflect the taxpayer's market activity, not its production activity. If that is the case, then the type of receipts that are included in the sales factor should be those that reflect the contribution of the taxpayer's market to the earning of income. It is unnecessary, and may be counter-productive, to include receipts from transactions involving the taxpayer's production property – such as plant, machinery, and equipment – in the sales factor. Including receipts from these types of assets would not reflect the market for the taxpayer's product and could essentially double count the property factor. In a three-factor apportionment formula, the sales factor is intended to balance the property and payroll factors, and it should be defined to offset rather than amplify the contributions of the production states. If the Executive Committee were to adopt a single sales factor, then this analysis may be different. In that case, it may be reasonable to provide for some reflection of the contributions of production states, even if that is accomplished through the sales factor.

Also, basing the definition of “sales” on the purpose of the sales factor has implications for whether to include receipts from the treasury function and other financial activities where there is no “customer” (e.g., receipt of dividends or interest income). If the purpose of the sales factor is to reflect the taxpayer's market for its product, then, unless the taxpayer is a securities dealer, receipts from its treasury function and other financial activities should be excluded. These exclusions are consistent with the Commission's current model regulations.<sup>56</sup> Some states exclude these receipts entirely. Some limit inclusion to net rather than gross receipts. If the problem were only distortion, then a limitation to net may be fine. But if there is also a policy problem of inconsistency with the purpose of the sales factor, or a practical problem of how to source these treasury function receipts, then exclusion may be the better approach. The Committee chose exclusion.

Examples may help explain how the proposal is intended to work:

1. Taxpayer manufactures a tangible product that it sells at wholesale. Taxpayer's income from these sales meets the transactional test and is treated as business income.
  - The gross receipts are “sales” for sales factor purposes.
  - The answer does not change if instead of manufacturing tangible property for sale at wholesale, Taxpayer sells or leases tangible property at retail, sells or licenses intangible property at wholesale or retail, sells or leases real property, or sells a service.
2. In the course of its manufacturing process, Taxpayer produces a byproduct that it sells at retail. Taxpayer's income from these sales meets the transactional test and is treated as business income.

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<sup>56</sup> MTC Reg. IV(2)(a); MTC Reg. IV.18(c)(4)(A)

- The gross receipts are “sales” for sales factor purposes.
3. Taxpayer makes an incidental or occasional sale of a large piece of equipment that it used to manufacture its product. The income from this sale meets the functional test and is treated as business income.
    - The gross receipts are not “sales” for sales factor purposes.
  4. Taxpayer routinely sells and replaces a certain type of equipment used in the production of its product (e.g., fleet vehicles). Taxpayer’s income from these sales meets the transactional test and is treated as business income.
    - The gross receipts are “sales” for sales factor purposes.
  5. Taxpayer makes an installment sale and receives interest income on the installment payments.
    - The interest on installment payments is included as gross receipts for sales factor purposes.
  6. Taxpayer is not a securities dealer, but earns interest income from short-term investment of working capital. This income meets the transactional test and is treated as business income.
    - The gross receipts are not “sales” for sales factor purposes.
  7. Taxpayer is not a securities dealer, but earns income from hedging transactions which were entered into mainly to control for variation in input prices. The income from these transactions meets the transactional test and is treated as business income.
    - The gross receipts are not “sales” for sales factor purposes.
  8. Taxpayer is a securities dealer, and earns interest income on its securities, and other income from hedging transactions and securities sales. The income from these transactions meets the transactional test and is treated as business income.
    - The gross receipts are “sales” for sales factor purposes.

In the process of drafting this recommendation, the Uniformity Committee noted that the term “sale(s)” carries a different meaning in different provisions of Article IV. In some Article IV provisions, “sale(s)” refers to a type of transaction distinct from other types of transactions like leases, licenses, or rentals. For example, the reference to “*sales of tangible personal property*” in §16 does not include leases of tangible personal property. In other provisions, “sale(s)” refers to receipts rather than transactions, and is intended broadly to include receipts from leases, licenses, and other transactions, in addition to receipts from sales transactions. For example, the definition of “sales” in §1(g) and the reference to the “sales factor” in §9 both refer to the *receipts* from

leases, licenses, rentals, sales, or any other transaction. In §17, the term “sales” is used in *both* senses (e.g., “Sales [meaning receipts from various transactions including leases], other than sales of tangible personal property...”). The Uniformity Committee approved a draft of Compact Article IV that would substitute the term “receipts” for the term “sales” where the broader meaning is intended. (See Attachment F.) These would be purely technical amendments for clarification and compatibility with renaming the term “sales” that is defined in §1(g).

## **2. Numerator Sourcing for Sales of Services and Intangibles**

### **i. Current Language**

Compact Article IV has two rules for sales factor numerator sourcing. The first, in Article IV.16, applies only to receipts from sales of tangible personal property and sources those receipts to the place where the property is “delivered or shipped.” The second, in Article IV.17, applies to receipts from all other transactions – including sales of services and intangibles – and sources those receipts as follows:

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.

Nearly everyone who sees any merit in a UDITPA review recognizes this “cost of performance” (COP) rule as the provision most critically in need of change. One problem is that identifying a taxpayer’s “income producing activity” and determining whether particular types of costs should or should not be included in the cost of performing that activity can be difficult and contentious. Further, the “all or nothing” aspect of assigning receipts to the state with the greatest cost of performance can produce arbitrary results where income-producing activity is taking place fairly evenly in the states.

But even if these administrative difficulties could be overcome, we would still be left with the problem that the COP rule doesn’t do what a sales factor is supposed to do: it doesn’t reflect the taxpayer’s market. Professor John Swain points out that in the past, place of performance may have been a reasonable proxy for market location, but this is no longer the case. Globalization and advances in computer and communications technology now allow many services to be provided remotely.<sup>57</sup> Instead, the COP rule tends to source receipts to the production states where the costs of performance are incurred. Thus, the COP rule duplicates the function of the property and payroll

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<sup>57</sup> John A. Swain, *Reforming the State Corporate Income Tax: A Market State Approach to the Sourcing of Service Receipts* (April 25, 2008). Arizona Legal Studies Discussion Paper No. 08-02; Tulane Law Review, 2008. Available at SSRN: <http://ssrn.com/abstract=1108087>, Available at: [http://works.bepress.com/john\\_swain/1](http://works.bepress.com/john_swain/1) (2008)

factors. This duplication of the property and payroll factors is particularly counter-productive for states that have tried to more heavily weight the sales factor as a means of encouraging economic development.

The UDITPA drafters acknowledged from the beginning that the COP rule was given short shrift.<sup>58</sup> But their focus on UDITPA §16 – sales of tangible personal property – reflects the practical realities of the time. In 1957 most of the economy was mercantile and manufacturing. The major service industries of the day, financial organizations and public utilities, were excluded from UDITPA altogether. Regarding what was left of the service economy, William Pierce - the original primary drafter - wrote in 1957 that he expected frequent resort to the equitable relief provision of § 18.<sup>59</sup>

The concern has only grown over the years, as service sector income has increased much faster than income from other sectors. The service industry alone created more than half of all new jobs nationally between 1992 and 1997.<sup>60</sup> Intangible property rights as a source of income has also intensified. In addition, significant portions of the major industries that were excluded from the rule – financial services and public utilities – have arguably fallen within UDITPA’s scope as they have been deregulated. And many of today’s technology giants derive significant profits not from physical goods, but from royalties on intellectual property (e.g., software used to run other products) and digital goods that can be downloaded (e.g., songs, books, etc.) Thus, a considerably higher percentage of the economy is subject to § 17 today than was the case in 1957.

At the same time that more of the economy’s income is falling under § 17, the movement of states toward heavily weighting the sales factor is magnifying the provision’s significance in determining how income from these growing economic sectors is apportioned. These trends are combining to place increasing emphasis on what was recognized from the beginning as a “default” rule. Shortcomings in §17, which states could live with in the 1960’s, are now presenting a significant risk in terms of growing uncertainty, administrative burden, non-uniformity, and revenue loss. As a noted in a recent New York Times article on state taxes “...technology giants have taken advantage of tax codes written for an industrial age and ill-suited to today’s digital economy.”<sup>61</sup>

A number of states have begun to address these concerns unilaterally. Many more are considering such a move. States are moving away from this UDITPA provision, and – unlike the movement away for each of the other four provisions under review – they are doing so in a non-uniform manner. At least nineteen states now deviate from the COP rule as follows:

- Where Benefit is Received:

California: Cal. Rev. & Tax Code § 25136(b).

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<sup>58</sup>Pierce, William J., “The Uniform Division of Income for State Tax Purposes.” *TAXES*, Tax Magazine; Vol. 35, No. 10, October, 1957; See also, Warren, John S.; “UDITPA – A Historical Perspective.” presentation to the Multistate Tax Commission Annual Meeting; July 28, 2005.

<sup>59</sup>*Id.* p. 780.

<sup>60</sup>See U.S. Census Bureau, 1997 Economic Census: Comparative Statistics, 1987 SIC Basis. Note: updated 2007 census data are being published through 2009.

<sup>61</sup>*How Apple Sidesteps Billions in Taxes*; Charles Duhigg and David Kocieniewski; The New York Times; April 28, 2012.

Iowa: Iowa Admin. Code r. 701 54.2(3), Iowa Admin. Code r. 701 54.6(1)  
Michigan: Mich. Comp. L. §2 08.1305(2); Mich. Compo L. § 20853.  
Ohio: Ohio Rev. Code Ann. § 5733.05(B)(2)(c).  
Utah: Utah Code Ann. § 59-7-319(3)(a).  
Wisconsin: Wis. Stat. Ann. § 7125(9)(dh).

- Where Service is Delivered:

Alabama: Ala. Coe § 40-27-1(IV)(17)

- Where Customer is Located:

Georgia: Ga. Comp. R. & Regs. r. 560-7-7-.03.  
Maryland (services): MD Reg. 03.04.03.08.C(3)(c)  
Oklahoma (services): Okla Admin. Code §710:50-17-71(1)(A)(ii)

- Where Service is Received:

Illinois: 35 ILCS 5/304(a)(3)(B-I), 35 ILCS 5/304(a)(3)(C-5)(iv).  
Maine: Me. Rev. Stat. Ann., tit. 36, § 5211.16.  
Minnesota: Minn. Stat. Ann. § 290.191(5).

- Where Service is Performed:

Connecticut (relative time spent performing service): Conn. Gen. S. Ann. § 12-218.  
New Jersey: NJ. Stat. Ann. § 54:IOA-6(B)(4).  
New York (relative time, value or other reasonable measure): N.Y. Com. Code R. & Regs. tit. 20, § 4-4-3(f).  
Rhode Island (relative time spent performing service): R.I. Gen. L. § 44-11-14(a)(2).  
South Carolina (relative time spent performing service): S.C. Code Ann. § 12-6-2280(C)(2).  
Texas (relative value of services performed): 34 Tex. Admin. Code § 3.557(e)(33).

Many states that have not yet revised their general rule, have nonetheless taken significant steps away from it by adopting a myriad of special apportionment regulations under § 18, carving out large segments of § 17's original scope. The MTC has adopted model special apportionment rules for financial institutions and virtually all of the large common carriage industries, including telecommunications, airlines, railroads, trucking companies, and television and radio broadcasting.<sup>62</sup>

## ii. Proposed Language

The Uniformity Committee recommends the following amendments:

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<sup>62</sup>Available at <http://www.mtc.gov/Uniformity.aspx?id=496>.

- 17(a) Sales, other than sales ~~of tangible personal property described in Section 16~~, are in this State if the taxpayer's market for the sales is in this state. The taxpayer's market for sales is in this state:
- ~~(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.~~
- (1) in the case of sale, rental, lease or license of real property, if and to the extent the property is located in this state;  
(2) in the case of rental, lease or license of tangible personal property, if and to the extent the property is located in this state;  
(3) in the case of sale of a service, if and to the extent the service is delivered to a location in this state; and  
(4) in the case of intangible property,
- (i) that is rented, leased, or licensed, if and to the extent the property is used in this state, provided that intangible property utilized in marketing a good or service to a consumer is "used in this state" if that good or service is purchased by a consumer who is in this state; and  
(ii) that is sold, if and to the extent the property is used in this state, provided that:
- (A) a contract right, government license, or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area is "used in this state" if the geographic area includes all or part of this state;  
(B) receipts from intangible property sales that are contingent on the productivity, use, or disposition of the intangible property shall be treated as receipts from the rental, lease or licensing of such intangible property under subsection (a)(4)(i); and  
(C) all other receipts from a sale of intangible property shall be excluded from the numerator and denominator of the sales factor.
- (b) If the state or states of assignment under subsection (a) cannot be determined, the state or states of assignment shall be reasonably approximated.  
(c) If the taxpayer is not taxable in a state to which a sale is assigned under subsection (a) or (b), or if the state of assignment cannot be determined under subsection (a) or reasonably approximated under subsection (b), such sale shall be excluded from the denominator of the sales factor.  
(d) [The tax administrator may prescribe regulations as necessary or appropriate to carry out the purposes of this section.]

Regulations will be needed for any new market-based sourcing rule, and the Uniformity Committee has begun to compile a list of terms that it expects would need to be defined by regulation if this amendment were to be adopted. The key changes being proposed are:

- Market sourcing - The purpose of this amendment is to move from COP to market sourcing, and under the revised rule that purpose is stated explicitly in the first sentence. There are two reasons for an explicit statement on market sourcing. First, the proposed rule allows for “reasonable approximation” in several instances, and a statement of the overarching intent to market source gives the taxpayer some guidance on what it is supposed to be approximating. Second, by indicating that the purpose is market sourcing, the rule sets a criteria for determining when it might be necessary to use section 18 distortion relief – i.e., when the result does not reflect the taxpayer’s market.

- Proportional, rather than “all or nothing”– Each receipt is sourced to a state “to the extent” the market is in the state. This “to the extent” language allows for the receipt to be attributed among multiple states if the market for the receipt exists in multiple states.

- Specify sourcing for four transaction types – The COP rule applies extremely broadly to receipts from all transactions other than sales of tangible personal property. No single rule is likely to apply well to all the transactions that fall within such a broad category. The amendment breaks this broad category into four major transaction types – services, intangibles, real-estate, and leases of tangible property – and would define market sourcing more specifically for each.

- Real Property receipts sourced to where the property is located – This proposal would simply place the rule of the Commission’s longstanding model regulation into the statute.
- Tangible Personal Property receipts (other than sales) sourced to where the property is located – This rule also moves longstanding Commission model regulation into the statute.
- Service receipts sourced to where the service is delivered – The nineteen states that have moved away from COP have not done so uniformly. But nearly one third of the nineteen source service receipts to where “the benefit of the service is received.” In most cases, the benefit will be received where the service is delivered, so the two rules should achieve the same sourcing result. But there are three possible advantages of the “delivered” rule over the “benefits received” rule. The first is that the “delivered” rule is evaluated more from the perspective of the taxpayer as opposed to the perspective of the taxpayer’s customer. Taxpayers may be more likely to know where their services were delivered than where their customers received the benefit. Second, it may also be easier for an auditor to determine, years later, where a taxpayer delivered a product than where the taxpayer’s customer received a benefit. And third, using the same “delivered” rule for services as is used for tangible personal property avoids having to determine whether the taxpayer’s product is more of a service or a good, which is increasingly a difficult distinction to make (e.g., electric utilities, research reporting services, or digital products).



- Intangible property receipts sourced to where the property is used – This proposal is consistent with the current rule in many states that source receipts from the licensing of intangibles to the location of the payor, or to the state where the intangible is considered to be used by the payor.<sup>63</sup> It also parallels the rule of Compact Art.IV.8(a), which allocates nonbusiness income from copyrights and patents to where the copyright or patent is used by the licensee.<sup>64</sup> Regulations will be needed to further define “use” for most situations. But under the proposal, the statute itself would define “use” for two specific situations.

First, for transactions involving a “marketing intangible,” such as a trademark or a cartoon character licensed for use in marketing a retail product, like a towel or hat, the marketing intangible is deemed to be “used” in a state if that product is purchased by the ultimate consumer in the state. This is a “look-through” rule. The theory of the “look through” rule is that, regardless of where the licensee is located, the taxpayer is able to enter into that license agreement because there is a consumer demand for its intangible in the state of the ultimate consumer. And in many cases, the taxpayer will focus its marketing efforts in that consumer state, not the state of the licensee. Marketing intangibles include trademarks and trade names used to commercially exploit a product or service, customer lists, distribution channels, and unique names, symbols, or pictures with important promotional value. For example:

- Taxpayer licenses the right to manufacture and sell clothing depicting its trademarked characters (marketing intangibles). The manufacturer sells the clothing to consumers in this and one other state. A proportionate share of the gross receipts from the Taxpayer’s licensing transaction is sourced to this state based on the use in this state.
- Taxpayer enters a franchise agreement with a franchisee under which the franchisee is entitled to operate a restaurant utilizing the franchisor’s trademark (marketing intangibles) in this state and one other state. A share of the gross receipts from the portion of the Taxpayer’s franchise agreement that reflects the use of the trademark is sourced to this state based on the trademark’s use in this state.

Second, the sale of an intangible that grants the holder a right to perform an activity in a specific geographic area is deemed to be “used” in that geographic area. For example:

- Taxpayer sells its “gate rights” at an airport in this state. The gross receipts from the sale are sourced to this state.

Because a taxpayer is unlikely to know where an intangible is “used” if it is sold outright, receipts from the *sale*, as opposed to the license, of an intangible are thrown out, with two exceptions. The first exception is for the sale of an intangible that relates to a specific geographic area. The second is made for sales situations where the taxpayer makes a contingent sale and thus does have a continuing relationship with the purchaser.

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<sup>63</sup> BNA State Tax Portfolio 1160-2<sup>nd</sup>, H.2. (April, 2012)

<sup>64</sup> Under Compact Art.IV.6(c), non-business capital gain or loss from the sale of intangible property is sourced to the taxpayer’s commercial domicile.

Essentially, contingency sales are treated as licenses because they resemble licenses. Both exceptions are motivated by the fact that the taxpayer is likely to know where the intangible is “used” even after it is sold. For example:

- Taxpayer licenses a patent for a manufacturing process. The licensee will manufacture its product using that process in this and one other state. A proportionate share of the gross receipts from the licensing transaction is sourced to this state based on the use in this state.
  - Taxpayer sells a patent outright at a fixed price. The purchaser will manufacture its product using that process in this and one other state. The gross receipts from this sale are not included in either the sales factor numerator or denominator of this state.
  - Taxpayer structures a contingency sale, rather than a license, and the purchaser agrees to make monthly payments to the taxpayer based on the purchaser’s volume of production using the patented process. The contingent purchaser will manufacture its product using that process in this and one other state. A proportionate share of the gross receipts from the licensing transaction is sourced to this state based on the use in this state.
- “Reasonable approximation required – If the taxpayer can’t determine with certainty where to source a receipt under the applicable rule, then it must reasonably approximate the sourcing.
  - Throwout – If the taxpayer can’t determine or reasonably approximate the state to which it should source a receipt, or if the taxpayer does not have nexus in the state to which it should source, the receipt is thrown out. The current COP rule does not contain a throwback or throwout provision. This may be for two reasons: first, COP generally arises from property or payroll, and where there is property or payroll there is nexus; and second, PL86-272 does not apply to services and intangibles. Now that the rule is changed to market sourcing, however, nexus is arguably more of an issue. Virtually all state courts have found that a significant market does create nexus, but the matter is still being litigated in the states.<sup>65</sup> Furthermore, under this proposal, receipts from marketing intangibles are sourced based on a “look through” to the location of the ultimate consumer, and Courts have yet to consider whether a taxpayer’s “market” encompasses such a

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<sup>65</sup> KFC v. Iowa Dep’t. of Revenue, 792 N.W. 2d 308 (Iowa 2010), cert. denied, 132 S. Ct. 97 (2011) ; Geoffrey, Inc. v. Comm’r of Revenue, 899 N.E. 2d 87 (2009.), cert. denied, 129 S.Ct. 2853 (2009); Lanco, Inc. v. Dir., Div. of Taxation, 879 A.2d 1234 (App. Div. 2005), aff’d 188 N.J. 380 (2006), cert. denied, 127 S. Ct. 2974 (2007) ; Geoffrey, Inc. v. South Carolina Tax Comm’n, 437 S.E.2d 13 (1993), cert. denied, 114 S. Ct. 550 (1993); A&F Trademark, Inc. v. Tolson, 605 S.E. 2d 187 (2004), cert. denied, 126 S.Ct. 353 (2005); Tax Comm’r of State v. MBNA Am. Bank, N.A. 640 S.E. 2d 226 (2006), cert. denied, 127 S. Ct. 2997 (2007); FIA Card Services, N.A. v. Tax Comm’r of W. Virginia, 127 S. Ct. 2997 (2007); Capital One Bank & Capital One F.S.B. v. Comm’r of Revenue, 899 N.E.2d 76 (2009), cert. denied, 129 S. Ct. 2827 (2009); Comptroller of the Treasury v. SYL, Inc., 825 A. 2d 399 (2003), cert. denied 124 S. Ct. 478 (2003); Sec’y, Dep’t. of Revenue, State of La. v. GAP (Apparel), Inc., 886 So. 2d 459 (LA Ct. App. 2004); Bridges v. Geoffrey, Inc., 984 So. 2d 115 (LA Ct. App. 2008), writ denied sub nom. 978 So. 2d 370; Geoffrey, Inc. v. Oklahoma Tax Comm’n, 132 P. 3d 632 (2005). But see In the Matter of the Income Tax Protest of Scioto Insurance Co., Supreme Court of Oklahoma Case Number 108943 (May 1, 2012) (no due process nexus with second-tier intellectual property holding company whose only contact with state was receipt of royalty payments from an Oklahoma taxpayer – the first-tier royalty recipient – under a contract not made in Oklahoma) and J.C. Penney Nat’l Bank v. Johnson, 19 S.W. 3d 831 (Tenn. Ct. App. 1999) (court applies physical presence nexus rule without deciding whether Commerce Clause compelled such a standard).

“look through” for nexus purposes.<sup>66</sup> So a throwout or throwback may be necessary. As between throwout and throwback, throw back may be preferable since it would be consistent with treatment tangible personal property sales under §16. But for sales or lease of services and intangibles, there is often no clear “origination” to throw back to. So throwout was chosen.

#### **D. Distortion Relief**

##### **1. Current Language**

Compact Art.IV .18 allows for a special apportionment rule where the general rule does not fairly reflect the taxpayer’s activity in the state and its application would thus distort the amount of the taxpayer’s income attributable to the state. The provision currently reads:

Art. IV.18. If the allocation and apportionment provisions of this Article 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:

- (1) separate accounting;
- (2) the exclusion of any one or more of the factors;
- (3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this State; or
- (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

The Executive Committee requested draft amendments clarifying tax administrators’ authority to address distortion through industry-wide and issue-wide special apportionment rules, in addition to the ad hoc relief allowed on a case by case basis. The Commission has interpreted §18 to provide this authority<sup>67</sup> and has adopted several model special apportionment rules pursuant to it.<sup>68</sup>

John Warren, who represented the State of California at ULC during the original drafting of UDITPA, recently remarked:

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<sup>66</sup> See Griffith v. ConAgra Brands (W.V. SC No. 11-0252); But see, KFC v. Iowa Dep’t. of Revenue, 792 N.W. 2d 308 (Iowa 2010), cert. denied, 132 S. Ct. 97 (2011) ;

<sup>67</sup> MTC Reg. IV.18(a) provides: “... In the case of certain industries such as air transportation, rail transportation, ship transportation, trucking, television, radio, motion pictures, various types of professional athletics, and so forth, the foregoing regulations in respect to the apportionment formula may not set forth appropriate procedures for determining the apportionment factors. Nothing in Article IV.18. or in this Regulation IV.18. shall preclude [the tax administrator] from establishing appropriate procedures under Article IV.10. to 17. for determining the apportionment factors for each such industry, but such procedures shall be applied uniformly.”

<sup>68</sup> See, MTC Reg. IV.18.(d). Construction Contractors, July 10, 1980

MTC Reg. IV.18.(e). Airlines, July 14, 1983

MTC Reg. IV.18.(f). Railroads, July 16, 1981

MTC Reg. IV.18.(g). Trucking Companies, July 11, 1986; amended July 27, 1989

MTC Reg. IV.18.(h). Television and Radio Broadcasting, August 31, 1990; amended April 25, 1996

MTC Reg. IV.18.(i). Telecommunications and Ancillary Services, July 31, 2008

MTC Reg. IV.18.(j). Publishing, July 30, 1993

The original drafters probably thought of Section 18 as a tool to be used to avoid gross distortion under the facts of a particular taxpayer. The adopting states and the MTC, however, have chosen to use it in a much broader way. It has become the authority for devising special factors and formulas for whole industries, and this is to be applauded.<sup>69</sup>

The Commission's efforts to modernize Compact Art.IV.17 and other Compact provisions will hopefully minimize the need to use §18 in crafting special rules, and will presumably relieve much of the pressure currently brought to bear on the equitable apportionment provisions. Nonetheless, the economy will certainly continue to change. There will always be a need to fill statutory gaps in tax policy. Ideally, these gaps should be filled uniformly across taxpayers, and not only on an ad-hoc basis. The authority to do so can be clarified.

## 2. Proposed language

The Uniformity Committee recommends the following amendments:

### Art. IV.18

(a) If the allocation and apportionment provisions of this Article 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:

- (1) separate accounting;
- (2) the exclusion of any one or more of the factors;
- (3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this State; or
- (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

(b)

(1) If the allocation and apportionment provisions of this Article do not fairly represent the extent of business activity in this State of taxpayers engaged in a particular industry or in a particular transaction or activity, the tax administrator may, in addition to the authority provided in section (a), establish appropriate rules or regulations for determining alternative allocation and apportionment methods for such taxpayers.

(2) A regulation adopted pursuant to this section shall be applied uniformly, except that with respect to any taxpayer to whom such regulation applies, the taxpayer may petition for, or the tax administrator may require, adjustment pursuant to Section 18(a).

<sup>69</sup> Written comments to the MTC 2005 Annual Meeting; Boise, Idaho

The recommended language in (b)(1) clarifies the tax administrator's authority to require industry-wide and issue-wide special apportionment by regulation. And the new language in (b)(2) preserves authority for ad hoc relief in individual cases where the regulations themselves do not fairly reflect the taxpayer's activity in the state.

**Attachment A**



*Working Together Since 1967 to Preserve Federalism and Tax Fairness*

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September 6, 2006

Mr. Robert A. Stein, Esq.  
Chair, Committee on Scope and Program  
National Conference of Commissioners  
on Uniform State Laws  
211 E. Ontario Street, Suite 1300  
Chicago, IL

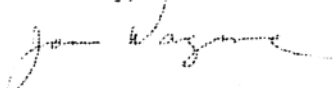
Dear Mr. Stein:

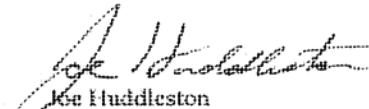
The Multistate Tax Commission has undertaken a project to draft model proposed uniform amendments to Article IV of our Multistate Tax Compact. The Compact became effective in 1967, and Article IV incorporates NCCUSL's 1957 model Uniform Division of Income for Tax Purposes Act nearly word for word. Twenty states have essentially adopted UDITPA through the Compact, and another twenty or so states have adopted UDITPA as a separate act. In the interest of preserving the broadest state uniformity possible, we invite NCCUSL to work with us to simultaneously review and draft model proposed amendments to UDITPA and Article IV of the Compact.

We believe it is essential to act quickly. After 40 years, our Compact states are facing inevitable pressure to change their methods of statutory apportionment. Nearly every aspect of the apportionment rules merit some level of reconsideration. In particular, there is widespread agreement that sales factor sourcing for transactions other than sales of tangible goods (Art. IV, §17 of the Compact and §17 of UDITPA) is the provision most in need of overhaul. A number of states are in various stages of addressing these provisions unilaterally. Our organization is very concerned that stand-alone, state-by-state amendments will quickly result in substantial disuniformity. In the context of income tax apportionment, disuniformity inevitably results in either duplicate taxation or less than full apportionment for multistate taxpayers.

We believe model amendments or a complete rewrite are critical to preserving the original uniformity goals of UDITPA and the Compact. And we would appreciate an opportunity to discuss with you in detail how we might best move forward together with this project.

Sincerely,

  
Joan Wagnon  
Secretary, Kansas Department of Revenue  
Chair, Multistate Tax Commission

  
Joe Huddleston  
Executive Director  
Multistate Tax Commission

**Attachment B**

**RESULTS OF MTC 2008 STATE SURVEY  
ON SCOPE OF UDITPA AMENDMENTS**

<b>Do you agree with the recommendation that scope of review should include:</b>	<b>Yes%</b>	<b>No%</b>
Sales factor numerator sourcing for receipts from transactions other than sales of tangible personal property (UDITPA §17)	100	0
Factor Weighting (UDITPA §9)	84	16
Definition of Business Income (UDITPA §1(a))	100	0
Definition of Gross Receipts (UDITPA §1(g))	100	0
Distortion Relief Provision (UDITPA §18)	100	0

<b>Do you think the recommended scope of review should be expanded to include:</b>	<b>Yes%</b>	<b>No%</b>
Other Specific UDITPA Provisions - Please identify in attached comments	16	84
All UDITPA Provisions	5	95
Nexus Provisions (Not currently addressed in UDITPA)	5	95
Combined Reporting (Not currently explicitly addressed in UDITPA)	5	95
Tax Base Provisions (Not currently addressed in UDITPA)	0	100
Procedural Provisions (Not currently addressed in UDITPA)	0	100
Pass-through Entities (Not currently addressed in UDITPA)	20	80
Other Tax Provisions – please identify provisions in attached comments	0	100

<b>Should the recommended policy criteria for evaluating alternatives be established?</b>	100%	
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## Attachment C



MULTISTATE TAX COMMISSION

*Working Together Since 1967 to Preserve Federalism and Tax Fairness*

### **Model Compact Article IV Amendments**

#### **Five Criteria for Comparing Alternative Apportionment Options**

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##### **1. *Conceptual foundation***

Does the proposal reasonably reflect a sound theoretical concept?

##### **2. *Ease of Administration***

- a. Can the elements of the factor be located geographically?
- b. Will the proposal minimize cost of administration for both taxpayers and the state?
- c. Is the information required readily available to the taxpayer? To the state?

##### **3. *Transparency and Compliance***

- a. Is the proposal simple and workable such that taxpayers can comply?
- b. Does the proposal minimize opportunity for manipulating the apportionment result?

##### **4. *Constitutionality***

- a. Nexus: Will the factors source to states where the taxpayer is doing business and thus has nexus? Will the definition of apportionable income reflect a rational relationship between the item of income subject to apportionment and the business activity conducted, in part, in the taxing state? *See, e.g., Allied Signal v. Dir., Div. of Taxation*, 504 U.S. 765 (1992).
- b. Non-Discrimination: Is the proposal non-discriminatory with respect to both interstate and purely in-state competitors? *See, e.g., General Motors v. Tracy*, 519 U.S. 278 (1997).
- c. Fair Apportionment



- i. Internal Consistency: If applied by every jurisdiction, will the proposal result in no more than 100% of the unitary business income being subject to tax? Does the proposal help assure that income is taxed once and only once - avoiding “nowhere income” and duplicative taxation *See, e.g., Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, 169 (1983).
- ii. External Consistency: Will the proposal reasonably reflect the manner in which income is earned? *See, Container, id.*
- d. Fair Reflection of the Benefits: Will the measure of the tax reasonably reflect the relative extent of the taxpayer’s presence or activity in the state so that the taxpayer shoulders only its fair share of supporting the State’s provision of government services? *See Commonwealth Edison v. Montana*, 453 U.S. 609, 610 (1981).

**5. Equity and Reasonableness**

- a. Will the proposal promote horizontal equity by treating taxpayers in the same situation similarly?
- b. Will the proposal promote vertical equity by distinguishing among taxpayers in a relevant way?
- c. Is the proposal reasonably economically neutral? Will it minimize economic distortions that could arise from, e.g., creating incentives for taxpayers to use one type of production process over another?
- d. Would transition to the proposal have an acceptable fiscal impact to the states and to taxpayers?

## Attachment D

### Multistate Tax Compact Article IV. Division of Income

Showing

- (1) “Apportion...” and “Business” highlighted in yellow, throughout (“Unitary” is not used in UDITPA.)
- (2) “Business Income” changed to “Apportionable Income”
- (3) Uniformity Committee proposed version of §§1(a), 1(g), 9, and 17

**SECTION 1.** As used in this Act, unless the context otherwise requires:

#### **UNIFORMITY COMMITTEE PROPOSED LANGUAGE**

(a) “~~Business~~ Apportionable income” means:

(i) all income that is apportionable under the Constitution of the United States and is not allocated under the laws of this state, including:

(A) income arising from transactions and activity in the regular course of the taxpayer’s trade or business, and includes

(B) income arising from tangible and intangible property if the acquisition, management, employment, development, ~~and~~ or disposition of the property constitute integral parts of is or was related to the operation of the taxpayer’s regular trade or business operations; and

(ii) any income that would be allocable to this state under the Constitution of the United States, but that is apportioned rather than allocated pursuant to the laws of this state.

(b) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

(c) "Compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

(d) "Financial organization" means any bank, trust company, savings bank, [industrial bank, land bank, safe deposit company], private banker, savings and loan association, credit union, [cooperative bank], investment company, or any type of insurance company.

#### **UNIFORMITY COMMITTEE PROPOSED LANGUAGE**

(e) "Non-~~business~~ apportionable income" means all income other than business apportionable income.

(f) "Public utility" means [any business entity which owns or operates for public use any plant, equipment, property, franchise, or license for the transmission communications, transportation of goods or persons, or the production, storage, transmission, sale, delivery, or furnishing of electricity, water, steam, oil, oil products or gas].

**UNIFORMITY COMMITTEE PROPOSED LANGUAGE:**

(g) ~~“Sales” means all gross receipts of the taxpayer not allocated under paragraphs of this Article.~~

“Sales” means gross receipts of the taxpayer that are not allocated under paragraphs of this article, and that are received from transactions and activity in the regular course of the taxpayer’s trade or **business**; except that receipts of a taxpayer other than a securities dealer from hedging transactions and from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities, shall be excluded.

(h) "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof.

**SECTION 2.** Any Taxpayer having income from **business** activity which is taxable both within and without this state, other than activity as a financial organization or public utility or the rendering of purely personal services by an individual, shall allocate and **apportion** his net income as provided in this Act.

**SECTION 3.** For purposes of allocation and **apportionment** of income under this Act, a taxpayer is taxable in another state if (1) in that state he is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing **business**, or a corporate stock tax, or (2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.

**SECTION 4.** Rents and royalties from real or tangible personal property, capital gains, interest, dividends, or patent or copyright royalties, to the extent that they constitute non-**business apportionable** income, shall be allocated as provided in sections 5 through 8 of this Act.

**SECTION 5.**

(a) Net rents and royalties from real property located in this state are allocable to this state.

(b) Net rents and royalties from tangible personal property are allocable to this state:

(1) if and to the extent that the property is utilized in this state, or

(2) in their entirety if the taxpayer's commercial domicile is in this state and the taxpayer is not organized under the laws of or taxable in the state in which the property is utilized.

(c) The extent of utilization of tangible personal property in a state is determined by multiplying the rents and royalties by a fraction, the numerator of which is the number of days of physical location of the property in the state during the rental or royalty period in the taxable

year and the denominator of which is the number of days of physical location of the property everywhere during all rental or periods in the taxable year. If the physical location of the property during the rental or royalty period is unknown or unascertainable by the taxpayer, tangible personal property is utilized in the state in which the property was located at the time the rental or royalty payer obtained possession.

#### **SECTION 6.**

(a) Capital gains and losses from sales of real property located in this state are allocable to this state.

(b) Capital gains and losses from sales of tangible personal property are allocable to this state if

(1) the property had a situs in this state at the time of the sale, or

(2) the taxpayer's commercial domicile is in this state and the taxpayer is not taxable in the state in which the property had a situs.

(c) Capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state.

**SECTION 7.** Interest and dividends are allocable to this state if the taxpayer's commercial domicile is in this state.

#### **SECTION 8.**

(a) Patent and copyright royalties are allocable to this state:

(1) if and to the extent that the patent or copyright is utilized by the payer in this state,  
or

(2) if and to the extent that the patent or copyright is utilized by the payer in a state in which the taxpayer is not taxable and the taxpayer's commercial domicile is in this state.

(b) A patent is utilized in a state to the extent that it is employed in production, fabrication, manufacturing, or other processing in the state or to the extent that a patented product is produced in the state. If the basis of receipts from patent royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the patent is utilized in the state in which the taxpayer's commercial domicile is located.

(c) A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the basis of receipts from copyright royalties does not permit allocation

to states or if the accounting procedures do not reflect states of utilization, the copyright is utilized in the state in which the taxpayer's commercial domicile is located.

**SECTION 9.** All ~~business-apportionable~~ income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

**SECTION 10.** The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented used in this state during the tax period and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the tax period.

**SECTION 11.** Property owned by the taxpayer is valued at its original cost. Property rented by the taxpayer is valued at eight times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from sub-rentals.

**SECTION 12.** The average value of property shall be determined by averaging the values at the beginning and ending of the tax period but the [tax administrator] may require the averaging of monthly values during the tax period of reasonably required to reflect properly the average value of the taxpayer's property.

**SECTION 13.** The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the tax period by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the tax period.

**SECTION 14.** Compensation is paid in this state if:

- (a) the individual's service is performed entirely within the state; or
- (b) the individual's service is performed both within and without the state, but the service performed without the state is incidental to the individual's service within the state; or
- (c) some of the service is performed in the state and (1) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the state, or (2) the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this state.

**SECTION 15.** The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period.

**SECTION 16.** Sales sale of tangible personal property are in this state if:

(a) the property is delivered or shipped to a purchaser, other than the United States government, within this state regardless of the f.o.b. point or other conditions of the sale; or

(b) the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser.

**UNIFORMITY COMMITTEE PROPOSED LANGUAGE:**

**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.~~

- (a) Sales, other than sales described in Section 16, are in this State if the taxpayer's market for the sales is in this state. The taxpayer's market for sales is in this state:
- (1) in the case of sale, rental, lease or license of real property, if and to the extent the property is located in this state;
  - (2) in the case of rental, lease or license of tangible personal property, if and to the extent the property is located in this state;
  - (3) in the case of sale of a service, if and to the extent the service is delivered to a location in this state; and
  - (4) in the case of intangible property,
    - (i) that is rented, leased, or licensed, if and to the extent the property is used in this state, provided that intangible property utilized in marketing a good or service to a consumer is "used in this state" if that good or service is purchased by a consumer who is in this state; and
    - (ii) that is sold, if and to the extent the property is used in this state, provided that:
      - (A) a contract right, government license, or similar intangible property that authorizes the holder to conduct a **business** activity in a specific geographic area is "used in this state" if the geographic area includes all or part of this state;
      - (B) receipts from intangible property sales that are contingent on the productivity, use, or disposition of the intangible property shall be treated as receipts from the rental, lease or licensing of such intangible property under subsection (a)(4)(i); and

- (C) all other receipts from a sale of intangible property shall be excluded from the numerator and denominator of the sales factor.
- (b) If the state or states of assignment under subsection (a) cannot be determined, the state or states of assignment shall be reasonably approximated.
  - (c) If the taxpayer is not taxable in a state to which a sale is assigned under subsection (a) or (b), or if the state of assignment cannot be determined under subsection (a) or reasonably approximated under subsection (b), such sale shall be excluded from the denominator of the sales factor.
  - (d) [The tax administrator may prescribe regulations as necessary or appropriate to carry out the purposes of this section.]

#### **UNIFORMITY COMMITTEE PROPOSED LANGUAGE**

**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.

(b)(1) If the allocation and apportionment provisions of this Article do not fairly represent the extent of business activity in this State of taxpayers engaged in a particular industry or in a particular transaction or activity, the tax administrator may, in addition to the authority provided in section (a), establish appropriate rules or regulations for determining alternative allocation and apportionment methods for such taxpayers.

(b)(2) A regulation adopted pursuant to this section shall be applied uniformly, except that with respect to any taxpayer to whom such regulation applies, the taxpayer may petition for, or the tax administrator may require, adjustment pursuant to Section 18(a).

**Attachment E**

NOTE: Alabama is now single sales

**STATE APPORTIONMENT OF CORPORATE INCOME**

(Formulas for tax year 2012 -- as of January 1, 2012)

ALABAMA *	Double wtd Sales	NEBRASKA	Sales
ALASKA *	3 Factor	NEVADA	No State Income Tax
ARIZONA *	Double wtd Sales/80% Sales, 10% Property & 10% Payroll	NEW HAMPSHIRE	Double wtd Sales
ARKANSAS *	Double wtd Sales	NEW JERSEY	70% Sales, 15% Payroll, & 15% Property (1)
CALIFORNIA *	Sales/Double wtd Sales	NEW MEXICO *	3 Factor
COLORADO *	Sales	NEW YORK	Sales
CONNECTICUT	Double wtd Sales/Sales	NORTH CAROLINA *	Double wtd Sales
DELAWARE	3 Factor	NORTH DAKOTA *	3 Factor
FLORIDA	Double wtd Sales	OHIO	Triple Weighted Sales (3)
GEORGIA	Sales	OKLAHOMA	3 Factor
HAWAII *	3 Factor	OREGON	Sales
IDAHO *	Double wtd Sales	PENNSYLVANIA	90% Sales, 5% Property & 5% Payroll
ILLINOIS *	Sales	RHODE ISLAND	3 Factor
INDIANA	Sales	SOUTH CAROLINA	Sales
IOWA	Sales	SOUTH DAKOTA	No State Income Tax
KANSAS *	3 Factor	TENNESSEE	Double wtd Sales
KENTUCKY *	Double wtd Sales	TEXAS	Sales
LOUISIANA	Sales/3 Factor	UTAH	84% Sales, 8% Payroll, & 8% Property (4)
MAINE *	Sales	VERMONT	Double wtd Sales
MARYLAND	Sales/Double wtd Sales	VIRGINIA	Double wtd Sales
MASSACHUSETTS	Double wtd Sales	WASHINGTON	No State Income Tax
MICHIGAN	Sales	WEST VIRGINIA *	Double wtd Sales
MINNESOTA	93% Sales, 3.5% Property, & 3.5% Payroll (1)	WISCONSIN *	Sales
MISSISSIPPI	Sales/Other (2)	WYOMING	No State Income Tax
MISSOURI *	3 Factor	DIST. OF COLUMBIA	Double wtd Sales
MONTANA *	3 Factor		

Source: Compiled by FTA from state sources.

Notes:

The formulas listed are for general manufacturing businesses. Some industries have a special formula different from the one shown.

\* State has adopted substantial portions of the UDITPA (Uniform Division of Income Tax Purposes Act).

Slash (/) separating two formulas indicates taxpayer option or specified by state rules.

3 Factor = sales, property, and payroll equally weighted.

Double wtd Sales = 3 factors with sales double-weighted

Sales = single sales factor

(1) Minnesota and New Jersey is phasing in a single sales factor which will reach 100% in 2014.

(2) Mississippi provides different apportionment formulas based on specific type of business. A single sales factor formula is required if no specific business formula is specified.

(3) Formula for franchise tax shown. Department publishes specific rules for situs of receipts under the CAT tax.

(4) Utah is phasing in a single sales factor which will reach 100% in 2013.



**Attachment F**



**Draft Compact Art. IV**

*Showing Uniformity Committee proposed amendments, with draft revisions to address:*

- (1) Executive committee's request for clarification of §17(a)(4) and (5), and  
(2) Technical amendments for clarification of "sales"*

*February 10, 2012*

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1. As used in this Article, unless the context otherwise requires:

(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.

(b) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

(c) "Compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

(d) "Financial organization" means any bank, trust company, savings bank, industrial bank, land bank, safe deposit company, private banker, savings and loan association, credit union, cooperative bank, small loan company, sales finance company, investment company, or any type of insurance company.

(e) "Nonbusiness income" means all income other than business income.

(f) "Public utility" means any business entity (1) which owns or operates any plant, equipment, property, franchise, or license for the transmission of communications, transportation of goods or persons, except by pipeline, or the production, transmission, sale, delivery, or furnishing of electricity, water or steam; and (2) whose rates of charges for goods or services have been established or approved by a Federal, State or local government or governmental agency.

(g) ~~"Sales" means all gross receipts of the taxpayer not allocated under paragraphs of this Article.~~

**UNIFORMITY COMMITTEE PROPOSAL, WITH DRAFT EDITS TO ADDRESS "SALE" ISSUE:**

"~~Sales~~Receipts" means gross ~~receipts of amounts received by~~ the taxpayer that are not allocated under paragraphs of this article, and that are received from transactions and activity in the regular course of the taxpayer's trade or business; except that ~~receipts of amounts received by~~ a taxpayer other than a securities dealer from hedging transactions and from the maturity, redemption, ~~sale~~, exchange, loan or other disposition of cash or securities, shall be excluded.

(h) "State" means any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any Territory or Possession of the United States, and any foreign country or political subdivision thereof.

(i) "This State" means the State in which the relevant tax return is filed or, in the case of application of this Article to the apportionment and allocation of income for local tax purposes, the subdivision or local taxing district in which the relevant tax return is filed.

2. Any taxpayer having income from business activity which is taxable both within and without this State, other than activity as a financial organization or public utility or the rendering of purely personal services by an individual, shall allocate and apportion his net income as provided in this Article. If a taxpayer has income from business activity as a public utility but derives the greater percentage of his income from activities subject to this Article, the taxpayer may elect to allocate and apportion his entire net income as provided in this Article.

3. For purposes of allocation and apportionment of income under this Article, a taxpayer is taxable in another State if (1) in that State he is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or (2) that State has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the State does or does not do so.

4. Rents and royalties from real or tangible personal property, capital gains, interest, dividends or patent or copyright royalties, to the extent that they constitute nonbusiness income, shall be allocated as provided in paragraphs 5 through 8 of this Article.

5. (a) Net rents and royalties from real property located in this State are allocable to this State.

(b) Net rents and royalties from tangible personal property are allocable to this State: (1) if and to the extent that the property is utilized in this State, or (2) in their entirety if the taxpayer's commercial domicile is in this State and the taxpayer is not organized under the laws of or taxable in the State in which the property is utilized.

(c) The extent of utilization of tangible personal property in a State is determined by multiplying the rents and royalties by a fraction the numerator of which is the number of days of physical location of the property in the State during the rental or royalty period in the taxable year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the taxable year. If the physical location of the property during the rental or royalty period is unknown or unascertainable by the taxpayer, tangible

personal property is utilized in the State in which the property was located at the time the rental or royalty payer obtained possession.

6. (a) Capital gains and losses from **sales** of real property located in this State are allocable to this State.

(b) Capital gains and losses from **sales** of tangible personal property are allocable to this State if (1) the property had a situs in this State at the time of the **sale**, or (2) the taxpayer's commercial domicile is in this State and the taxpayer is not taxable in the State in which the property had a situs.

(c) Capital gains and losses from **sales** of intangible personal property are allocable to this State if the taxpayer's commercial domicile is in this State.

7. Interest and dividends are allocable to this State if the taxpayer's commercial domicile is in this State.

8. (a) Patent and copyright royalties are allocable to this State: (1) if and to the extent that the patent or copyright is utilized by the payer in this State, or (2) if and to the extent that the patent or copyright is utilized by the payer in a State in which the taxpayer is not taxable and the taxpayer's commercial domicile is in this State.

(b) A patent is utilized in a State to the extent that it is employed in production, fabrication, manufacturing, or other processing in the State or to the extent that a patented product is produced in the State. If the basis of receipts from patent royalties does not permit allocation to States or if the accounting procedures do not reflect States of utilization, the patent is utilized in the State in which the taxpayer's commercial domicile is located.

(c) A copyright is utilized in a State to the extent that printing or other publication originates in the State. If the basis of receipts from copyright royalties does not permit allocation to States or if the accounting procedures do not reflect States of utilization, the copyright is utilized in the State in which the taxpayer's commercial domicile is located.

~~9. All business income shall be apportioned to this State by multiplying the income by a fraction the numerator of which is the property factor plus the payroll factor plus the **sales** factor and the denominator of which is three.~~

**UNIFORMITY COMMITTEE PROPOSAL, WITH DRAFT EDITS TO ADDRESS "SALE" ISSUE:**

All business income shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus two times the **sales receipts** factor, and the denominator of which is four.

10. The property factor is a fraction the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this State during the tax period and the denominator of which is the average value of all of the taxpayer's real and tangible personal property owned or rented and used during the tax period.

11. Property owned by the taxpayer is valued at its original cost. Property rented by the taxpayer is valued at eight times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from subrentals.

12. The average value of property shall be determined by averaging the values at the beginning and ending of the tax period; but the tax administrator may require the averaging of monthly values during the tax period if reasonably required to reflect properly the average value of the taxpayer's property.

13. The payroll factor is a fraction the numerator of which is the total amount paid in this State during the tax period by the taxpayer for compensation and the denominator of which is the total compensation paid everywhere during the tax period.

14. Compensation is paid in this State if:

(a) the individual's service is performed entirely within the State;

(b) the individual's service is performed both within and without the State, but the service performed without the State is incidental to the individual's service within the State; or

(c) some of the service is performed in the State and (1) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the State, or (2) the base of operations or the place from which the service is directed or controlled is not in any State in which some part of the service is performed, but the individual's residence is in this State.

15. The sales-receipts factor is a fraction the numerator of which is the total sales-receipts of the taxpayer in this State during the tax period and the denominator of which is the total sales receipts of the taxpayer everywhere during the tax period.

16. Sales-Receipts from the sale of tangible personal property are in this State if:

(a) the property is delivered or shipped to a purchaser, other than the United States Government, within this State regardless of the f.o.b. point or other conditions of the sale; or

(b) the property is shipped from an office, store, warehouse, factory, or other place of storage in this State and (1) the purchaser is the United States Government or (2) the taxpayer is not taxable in the State of the purchaser.

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.~~

**INCOME & FRANCHISE TAX UNIFORMITY SUBCOMMITTEE PROPOSAL,  
WITH DRAFT EDITS TO ADDRESS “SALE” ISSUE:**

- 17(a) **Sales Receipts**, other than ~~sales receipts~~ described in Section 16, are in this State if the taxpayer’s market for the ~~sales receipts~~ is in this state. The taxpayer’s market for **sales receipts** is in this state:
- (1) in the case of **sale**, rental, lease or license of real property, if and to the extent the property is located in this state;
  - (2) in the case of rental, lease or license of tangible personal property, if and to the extent the property is located in this state;
  - (3) in the case of **sale** of a service, if and to the extent the service is delivered to a location in this state; and
  - (4) in the case of intangible property,
    - (i) that is rented, leased, or licensed, if and to the extent the property is used in this state, provided that intangible property utilized in marketing a good or service to a consumer is “used in this state” if that good or service is purchased by a consumer who is in this state; and
    - (ii) that is **sold**, if and to the extent the property is used in this state, provided that:
      - (A) a contract right, government license, or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area is “used in this state” if the geographic area includes all or part of this state;
      - (B) receipts from intangible property **sales** that are contingent on the productivity, use, or disposition of the intangible property shall be treated as receipts from the rental, lease or licensing of such intangible property under subsection (a)(4)(i); and
      - (C) all other receipts from a **sale** of intangible property shall be excluded from the numerator and denominator of the ~~sales receipts~~ factor.
- (b) If the state or states of assignment under subsection (a) cannot be determined, the state or states of assignment shall be reasonably approximated.
- (c) If the taxpayer is not taxable in a state to which a ~~sale receipt~~ is assigned under subsection (a) or (b), or if the state of assignment cannot be determined under subsection (a) or reasonably approximated under subsection (b), such ~~sale receipt~~ shall be excluded from the denominator of the ~~sales receipts~~ factor.
- (d) [The tax administrator may prescribe regulations as necessary or appropriate to carry out the purposes of this section.]

18. If the allocation and apportionment provisions of this Article 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.