

State Corporate Income Apportionment: Key Fundamentals and Legislative Trends

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State Corporate Income Apportionment: Key Fundamentals and Legislative Trends

Understanding State Approaches to Factor Weighting, Service Revenue,
Joyce v. Finnigan, Gillette and Other Apportionment Concepts

MAY 15, 2014

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STATE CORPORATE INCOME APPORTIONMENT

May 15, 2014

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BUSINESS VS NON-BUSINESS INCOME

Only In-State Income is Subject to Tax

- (1) Corporations with “In-State” Source Income are taxable.
- (2) Due process clause and commerce clause require nexus between taxing state and the multi-state business.

- **Physical presence** is sufficient nexus (e.g. traveling salesman)
- What about **intangible nexus or economic nexus**?
 - O.K. for income tax but not sales/use tax.

Intangible Nexus – Good for income tax. See *Geoffrey Inc. v. S.C. Tax Comm’n*, 437 S.E.2d 13 (S.C. 1993) and *K-Mart Corp. v. Taxation and Revenue Dep’t*, 131 P.3d 22 (N.M. 2005).

Economic Nexus – Good for income tax. See *W.Va. v. MBNA American Bank*, 640 S.E.2d 226 (W. Va. 2006).

Only In-State Income is Subject to Tax

(3) **Public Law 86-272** prohibits states from taxing out-of-state businesses when only in-state activity is solicitation of **sales of tangible personal property**.

Does P.L. 86-272 apply to **sales of services or intangibles**?
No.

(4) Tax test for nexus is not the same as qualification test.

Determining a Multi-State Corporation's In-State Income

(1) **Separate Accounting**

- Separate geographical accounting.

(2) **Formula Apportionment**

- States frequently use the 3-Factor Formula contained in the **Uniform Division of Income for Tax Purposes Act (“UDITPA”)**, or a derivative, such as super weighted sales factor or single sales factor.

(3) **Specific Allocation**

- Income is traced to its source.

UDITPA Three Factor Formula

$$\frac{\frac{\text{In-State property}}{\text{Total Property}} + \frac{\text{In-State payroll}}{\text{Total Payroll}} + \frac{\text{In-State sales}}{\text{Total Sales}}}{3}$$

x

Apportionable
(Business)
Income

=

Income
taxable by
the State

UDITPA's Purpose to Avoid Non-Uniform Apportionment

UDITPA's purpose is to provide a formulary method to ensure that a multistate taxpayer is not taxed in the aggregate on more than its net income.

Taxpayers Subject to UDITPA

UDITPA applies to **any taxpayer that has income from business activity which is taxable both within and without the state.**

Taxpayers Subject to UDITPA

The Uniform Act excludes public utilities and financial institutions.

- Regulations establish industry specific apportionment methods.

How UDITPA is Structured to Accomplish Its Purpose

UDITPA divides income into “**business income**” and “**nonbusiness income.**”

Specific Allocation of “Nonbusiness Income”

“Nonbusiness income” means all income other than business income.

General Rule--**Allocate Nonbusiness Income To A Specific State**

Specific Allocation of “Nonbusiness Income”

- Net Rents and Royalties from Real Property – State Where Property is Located
- Capital Gains and Losses - State Where Property is Located
- Interest and Dividends - Domiciliary State
- Patent and Copyright Royalties - State Where Property is Located

Apportionment of Business Income

“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. (emphasis added).

Apportionment of Business Income

Rule-- Business Income is apportioned among all the states in which the taxpayer does business using the 3 Factor Formula.

Business v. Nonbusiness Income

Business Income: One Test or Two?

1. Transactional Test: did the transaction giving rise to the gain occur in the regular course of the taxpayer's trade or business? [**Phrase 1** in definition]

Business v. Nonbusiness Income

2. Functional Test: was income-producing property integrated into, or used in, business operations? [**Phrase 2** in definition]

- “Liquidation Exception” recognized by many courts when a business is liquidated or goes out of business.
- Is the Functional Test a separate test? Or is it a sub-part of the Transactional Test (see underlining in definition -- “and includes”)? In other words are there two tests or one.

Business Income Cases

Transactional Test Used

Alabama Dept. of Rev. v. Uniroyal Tire Co., Inc., 779 So.2d 227 (Ala. 2000) (“and”)

- Court of Appeals held that gain on sale of partnership (which manufactured tires) is business income. **Court used functional test.**
- The Alabama Supreme Court **reversed** holding that Alabama’s definition of business income contains **only a transactional test.**

Business Income Cases

Transactional Test Used

In re Kimberly Clark Corp. v. Alabama Dep't of Revenue, 69 So. 3d 144 (Ala. 2010).

- Lower court found business income **under the transactional test** when a paper company sold a paper mill and related timberland in Alabama because the company had bought and sold businesses in the past, making the sale a normal part of its ordinary business.
- The Alabama Supreme Court reversed, holding that the sale did not satisfy the transactional test even though it had acquired and sold some businesses during the audit period because the sale was extraordinary in nature. **The court applied a transactional test only.**

Business Income Cases

Transactional Test Used

Other cases adopting only a transactional test include:

- *Phillips Petroleum Co. v. Iowa Dep't of Revenue & Fin.*, 511 N.W.2d 608 (Iowa 1993).
- *Gen. Care Corp. v. Olsen*, 705 S.W.2d 642 (Tenn. 1986).
- *W. Natural Gas Co. v. McDonald*, 446 P.2d 781 (Kan. 1968).
- *In re Chief Indus., Inc.*, 875 P.2d 278 (Kan. 1994).

Note that several states where courts adopted only a transactional test revised their statutory definition of business income to include the functional test.

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Business Income Cases

Functional Test Used

Texaco—Cities Serv. Pipeline Co. v. McGaw, 695 N.E.2d 481 (Illinois 1998) (“and”)

- Gain from the sale of pipeline in Illinois is business income. **Court used the functional test.**

Business Income Cases

Functional Test Used

Polaroid Corp. v. Offerman, 507 S.E.2d 284 (N.C. 1998)
 (“and/or”)

- Court awarded damages for patent infringement and loss of royalties is business income. **North Carolina definition of business income included a functional test.**

Hoechst Celanese v. Cal. Franchise Tax Bd., 22 P.3d 324 (Cal. 2001). (“and”)

- **Surplus from pension plan reversion to corporation treated as business income under functional test, relying on *Polaroid*.**

Business Income Cases

Functional Test Used

May Department Stores Company v. Indiana Department of State Revenue, 749 N.E.2d 651 (Ind. Tax Ct. 2001).

- When a company sold its subsidiary, the Court found non-business income because the sale failed both the transactional and functional tests. As an issue of first impression, the Court held that **Indiana recognizes both the transactional and functional tests.**

Business Income Cases

Functional Test Used

Gannett Satellite Info. Network, Inc. v. Mont. Dep't of Revenue, 201 P.3d 132 (Mont. 2009).

- Most recent state supreme court decision to adopt the functional test.
- Found the UDITPA definition of “business income” to be **ambiguous** as to the existence of one test or two, but nonetheless adopted a functional test in reliance on UDITPA’s legislative history and UDITPA’s goal of promoting uniformity amongst the states.
- Relied heavily upon *Hoechst*.

Business Income Cases

Functional Test Used

Harris Corp. v. Ariz. Dep't of Revenue, 312 P.3d 1143 (Ariz. App. 2013).

- Recent Arizona Court of Appeals decision adopting the functional test.
- Ignoring the maxim that ambiguous statutes must be construed in favor of taxpayer, the court purported to derive a functional test from the plain language of the business income definition.
- Followed California's approach in *Hoechst*.

Business Income Cases

Functional Test Used

Other courts to adopt a Functional Test include:

- *Kroger Co. v. Dep't of Revenue*, 673 N.E.2d 710 (Ill. 1996).
- *District of Columbia v. Pierce Associates*, 462 A.2d 1129 (D.C. 1983).
- *First Data Corporation v. Ariz. Dep't of Revenue*, 313 P.3d 548 (Ariz. App. 2013) (companion case to *Harris*).

Business Income Cases

Liquidation Exception to Functional Test

Lenox, Inc. v. Tolson, 548 S.E.2d 513 (N.C. 2001). (“and/or”).

- Income from the liquidation sale of jewelry division (Art Carved) determined to be non-business income **under functional test.**
- The court ruled that liquidation transactions “are in a category by themselves . . . [W]hen the transaction involves a **complete or partial liquidation** and cessation of a company’s particular line of business, and the proceeds are distributed to shareholders rather than **reinvested** in the company, **any gain or loss generated from the transaction is nonbusiness income under the functional test.**”
 - The liquidation transaction was not an integral part of the taxpayer’s regular trade or business.

Business Income Cases

Liquidation Exception to Functional Test

Lenox, Inc. v. Tolson, 548 S.E.2d 513 (N.C. 2001). (“and/or”).

- Overruled *Polaroid* on definition of functional test. Functional test required that the “property constitute an integral part of the corporation’s regular trade or business.”
- The extraordinary nature or infrequency of the transaction bears on functional test.
- Important Factor: Not Reinvested.

Business Income Cases

Liquidation Exception to Functional Test

McVean & Barlow, Inc. v. New Mexico Bureau of Revenue,
543 P. 2d 489 (Ct. App. 1975).

- Income from an asset sale and partial liquidation of a business was non-business income because the sale and liquidation was not an integral part of the taxpayer's regular trade or business operations.
- Not Reinvested.

Business Income Cases

Liquidation Exception to Functional Test

Laurel Pipe Line Co. v. Commonwealth of Pennsylvania, 642 A.2d 472 (Pa. 1994).

- The court found non-business income on a partial liquidation where the company ceased business in that geographic area and the proceeds of the sale were distributed to the shareholders.
- Not Reinvested.

Business Income Cases

Liquidation Exception to Functional Test

Blessing/White, Inc. v. Zehnder 768 N.E.2d 332 (App. Ct. Ill. 2002).

- Income from a liquidation, where the corporation ceases operations and distributes all the proceeds from the sale to its shareholders is non-business income as an exception to the functional test.
- Not Reinvested.

Business Income Cases

Liquidation Exception to Functional Test

Nat'l Holding, Inc. v. Zehnder, 369 Ill. App. 3d 977 (Ct. App. 2007).

- Proceeds from an asset sale which liquidated two subsidiaries of a parent corporation generated non-business income. **Court found an exception to the functional test when the proceeds from the liquidation were not reinvested into the ongoing business of the company.**

- Not Reinvested.

Business Income Cases

Liquidation Exception to Functional Test

The Mead Corp. v. Illinois Dep't of Revenue, 861 N.E.2d 1131 (App. Ct. Ill. 2007).

- The court found apportionable business income where a taxpayer liquidated a section of its business but reinvested the proceeds into its ongoing business, thus satisfying the functional test for business income.
- U.S. Supreme Court reversed the Illinois Court (2008), holding that the business division sold must be unitary with the seller to give rise to business income.

Business Income Cases

Liquidation Exception to Functional Test - Partnership

Shakkour v. Hamer, 859 N.E.2d 49 (App. Ct. Ill. 2006).

- **Court found non-business income** when a partnership sold an intangible asset and distributed the proceeds to the partners **under the liquidation exception to the functional test.**
- **The Court also found Illinois could not then tax a non-resident partner on the distribution if the money received by the partnership was non-business income.**

Business Income Cases

Liquidation Exception to Functional Test S-Corporation

Kemppel v. Zaino, 746 N.E.2d 1073 (Ohio 2001).

- Court found non-business income under both the transactional and functional tests, where an S corporation liquidated, dissolved and distributed the proceeds to shareholders.

Business Income Cases

Liquidation Exception Rejected by California

Jim Beam Brands v. Cal. Fran. Tax Bd., 34 Cal. Rptr. 3d 874 (Cal. App. 2005).

- **Going Out of Business (Liquidation) Exception to Functional Test REJECTED by California.**
- Found business income under functional test.
- The Court distinguished its ruling from other cases by stating that in California the focus of the Functional Test is on the nature of the income producing property, while other cases focused on the nature of the income producing transaction.
 - Does the Court's interpretation square with the definition of business income?

Business Income Cases

Liquidation Exception Rejected by Arizona

Harris Corp. v. Arizona Department of Revenue, 312 P.3d 1143 (Ariz. App. 2013).

- The Arizona Court of Appeals issued the first decision following California's rejection of the Liquidation Exception to the functional test.
- Relied heavily on *Jim Beam*.
- Reasoned that adopting the liquidation exception would result in a lack of symmetry.

“Assets would be depreciated and expenses deducted, reducing business income prior to disposition of the assets, but upon sale any gain would become nonbusiness income under a liquidation exception. Consequently, a single state might capture all the income while the states that had previously allowed expenses on an apportioned basis would shoulder the deductions.”

I.R.C. § 338(h)(10) Cases

Stock Sale Treated as Asset Sale for Income Tax Purposes

- Most reviewing courts have treated a 338(h)(10) deemed asset sale as falling under liquidation exception to functional test.
- The gain on a “deemed” asset sale is not reinvested but distributed to shareholder parent.

I.R.C. § 338(h)(10) Cases

Canteen Corp. v. Commonwealth of Pennsylvania, 818 A.2d 594 (Pa. Comm. Ct. 2003).

- Court found non-business income when a corporation sold the stock of a subsidiary and made the election under I.R.C. Sec. 338(h)(10). Court reasoned that gain from a fictional asset liquidation pursuant to the election should be treated the same as an actual liquidation.

I.R.C. § 338(h)(10) Cases

McKesson Water Prods. Co. v. Div. of Taxation, 23 N.J. Tax 449 (2007), *aff'd* 974 A.2d 443 (N.J. Super. App. Div. 2009).

- Court applied the functional test and found non-operational income where a parent company sold the stock of a subsidiary and made the election under I.R.C. Sec. 338(h)(10).

I.R.C. § 338(h)(10) Cases

Osram Sylvania, Inc. v. Commonwealth of Pennsylvania, No. 310 F.R. 1998, Pa. Tax Rptr. (CCH) ¶203-090 (Pa. Comm. Ct. 2003); affirmed by Penn. Supreme Court, 863 A.2d 1140 (Pa. 2004).

- Court found non-business income when a parent corporation sold its subsidiary and made the election under I.R.C. Sec. 338(h)(10). The Court upheld *Canteen Corp.*

I.R.C. § 338(h)(10) Cases

Am. States Ins. Co. v. Hamer, 816 N.E.2d 659 (Ill. App. Ct. 2004).

- Gain from a stock sale, deemed to be an asset sale under I.R.C. Sec. 338(h)(10), generated non-business income after the court found that the functional test was not satisfied in the case of a liquidation and cessation of business.

I.R.C. § 338(h)(10) Cases

ABB C-E Nuclear Power Inc. v. Director of Revenue, 215 S.W.3d 85 (Mo. 2007).

- ABB was a wholly owned subsidiary, whose parent corporation sold it through a stock sale to a third party. The buyer and seller made the election under I.R.C. Sec. 338(h)(10). **Court found that ABB's income was non-business income.**

I.R.C. § 338(h)(10) Cases

Chambers v. Utah State Tax Commission, Utah Tax Rptr. (CCH) ¶400-501, (Utah D. Ct. 2007).

- Court found non-business income when S corporation shareholders sold their stock in the corporation and made the election under I.R.C. Sec. 338(h)(10).

I.R.C. § 338(h)(10) Cases

Business Income Found

First Data Corporation v. Ariz. Dep't of Revenue, 313 P.3d 548 (Ariz. App. 2013).

- The Arizona Court of Appeals had rejected the Liquidation Exception in *Harris*, and also rejected it here in the context of a § 338(h)(10) election.

Business Income Example

- California corporation has plant in Nevada.
- Sells for **\$10 million gain**.
- Taxpayer's California apportionment percentage is **60%** and Nevada is **40%**.

Business Income Example

- If Business Income:
 - **\$6 million** apportioned to California and taxed.
 - **\$4 million** apportioned to Nevada - **no tax**.
- If Non-Business Income:
 - All gain allocated to Nevada - **no tax**.
 - Nothing allocated to California.

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Apportionment Fundamentals
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05/15/2014
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Apportionment Fundamentals – Apportioning State Income

• Typical State Taxable Income Calculation

$$\begin{aligned}
 & \text{Federal Taxable Income} \\
 & \pm \text{ State Adjustments} \\
 & - \text{ Nonbusiness Income} \\
 & = \text{ **Apportionable State Income** } \\
 & \times \text{ Apportionment Percentage (From 3-factor Formula)} \\
 & = \text{ **Apportioned Business Income** } \\
 & + \text{ Nonbusiness Income Allocated to State} \\
 & = \text{ **State Taxable Income** } \\
 & \times \text{ Statutory Tax Rate} \\
 & = \text{ **Gross State Tax** } \\
 & - \text{ State Tax Credits} \\
 & = \text{ **Net State Tax** }
 \end{aligned}$$



Apportionment Fundamentals – Apportioning State Income

- **U.S. Supreme Court precedent has interpreted the Commerce Clause to require fair apportionment.**
 - Apportionment is a method of dividing the business income of taxpayer among the states in which the taxpayer does business.
 - What is fair apportionment?
 - When do taxpayers have a right to apportion? If so, when?
 - Apportionment formula must reasonably reflect how income is generated.



Apportionment Fundamentals – Apportioning State Income

• Multistate Uniform Laws & Rules

– Uniform Division of Income for Tax Purposes Act (UDITPA)

- Adopted in 1957 by the National Conference of Commissioners on Uniform State Laws to address the “need for a uniform method of division of income for tax purposes among the several taxing jurisdictions.”
- Article IV of the MTC adopts UDITPA for purposes of determine business and non-business income as well as allocation and apportionment.

– Multistate Tax Compact (MTC)

- Drafted in 1966 and became effective in 1967 after seven states adopted it.
- Established The purpose of the MTC is to properly determine state and local tax liability of multistate taxpayers, including equitable apportionment by:
 - » *Promoting uniformity and compatibility in significant components of tax systems.*
 - » *Facilitating taxpayer convenience and compliance in tax administration.*
 - » *Avoiding duplicative taxation.*



Apportionment Fundamentals – Apportionment Formula

• Standard UDITPA Apportionment Formula

- All business income is apportioned by multiplying the income by a fraction – the numerator is the property factor plus the payroll factor plus the sales factor divided by the denominator which is three.
 - **Property Factor:** The numerator is property within the state and the denominator is property everywhere.
 - **Payroll Factor:** The numerator is payroll within the state and the denominator is payroll everywhere.
 - **Sales Factor:** The numerator is sales within the state and the denominator is sales everywhere.
 - **Total Apportionment Factor:** Add the property factor, payroll factor, and sales factor, then divide the sum by three.



Apportionment Fundamentals – Apportionment Formula

• Apportioning Income to the States

$$\text{Property Factor} = \frac{\text{In-State Property}}{\text{Everywhere Property}}$$

$$\text{Payroll Factor} = \frac{\text{In-State Payroll}}{\text{Everywhere Payroll}}$$

$$\text{Sales Factor} = \frac{\text{In-State Sales}}{\text{Everywhere Sales}}$$

$$\text{Apportionment Factor} = (\text{Property Factor} + \text{Payroll Factor} + \text{Sales Factor})/3$$



Apportionment Fundamentals – Apportionment Formula

• Trending the Standard Formula

- Apportionment achieves the objectives of states by allowing them to tax business income derived from the state.
 - The income attributed to a state by that state’s apportionment formula must be rationally related to the values connected with the taxing state.
- Apportionment also achieves the objectives of taxpayers by helping alleviate the risk of double taxation.
- Only a handful of states still use the traditional formula, because it punishes investment in the state by measuring property and payroll in the state.
 - Apportionment formulas with weighted sales factors.
 - Single-sales factor apportionment.



Apportionment Formula – Property Factor

• Property Factor under UDITPA

- Property is included in the Property Factor if it is owned or rented, and used by the taxpayer during the tax period.
- The property must be used or be capable of being used in the taxpayer's regular course of trade or business, and it must produce business income (intangible property generally is not included).
- The MTC includes property in the property factor when it is actually used or available for use during the tax period.



Apportionment Formula – Property Factor

• Property Factor defined by UDITPA

- Owned and leased real and tangible personal property are included in the factor.
- “Real and tangible personal property” is defined by the MTC to include land, buildings, machinery, stores of goods, equipment, and other real or tangible personal property.
 - Intangibles and currency are generally not included.
- Owned property is valued at its original cost unless original cost is not known.
 - If original cost not known, fair market value at the time of acquisition is used.
 - The factor is determined by averaging beginning and end of year values.
- Leased and rented property is valued at eight times its net annual rental rate.
 - Imputed/Deemed Rent – Include fair market value of property used by the taxpayer for which rent is not paid or paid at a nominal rate.



Apportionment Formula – Property Factor

• Movable Property MTC Reg. IV.10(d)

- MTC approach is to distribute movable property on a pro-rata basis.
 - The value of mobile or movable property such as construction equipment, trucks, or leased electronic equipment located within and without a state during the tax period is determined based on the total time within the state during the tax period.
 - An automobile assigned to a traveling employee is included in the numerator of the factor of the state to which the employee’s compensation is assigned under the payroll factor or in the numerator of the state in which the automobile is licensed.



Apportionment Formula – Property Factor

• In-transit Property MTC Reg. IV.10(d)

- MTC approach is to source in-transit property to its state of destination.
 - “Property in transit between locations of the taxpayer to which it belongs shall be considered to be at the destination for purposes of the property factor.” Cal. Code Regs. Tit. 18 § 25129(d).
 - NJ Throwout: Inventory in transit from one state to another is not included in the numerator or denominator of the property factor. N.J. Admin. Code § 18:7-8.4(c)(3).
 - Maryland required inclusion of the value of automobiles on the high seas in the Maryland numerator, despite the fact that in-transit inventory was not addressed in the property factor statute. *Mercedes Benz of N. Am., Inc. v. Comptroller of Treasury*, Dkt. No. 2813, (MD Tax Ct. Oct. 7, 1988).



Apportionment Formula – Property Factor

• Outer-Jurisdictional Property MTC Reg. IV.18(h)(4)(ii)A

- MTC approach excludes outer-jurisdictional property from the property factor.
 - Outer-jurisdictional property includes satellites and undersea transmission cables that are owned or rented by the taxpayer but not physically located in a state.
- New Hampshire includes outer-jurisdictional property in the property factor based on the number of uplinks and downlinks in New Hampshire over the number of transmissions everywhere. N.H. Reg. 304.08.



Apportionment Formula – Property Factor

• Special Considerations

– Construction in Progress

- The MTC does not include property under construction in the property factor, generally.
- Massachusetts includes construction in progress in the property factor. *Commissioner of Revenue v. New England Power Co.*, 562 N.E.2d 543 (Mass. 1991).

– Idle Property

- The MTC includes idle property if it is intended for later business use.
- Idle property is only removed when permanent withdrawal is established by an identifiable event such as conversion to production of nonbusiness income, sale, or lapse of time – normally, five years.

– Service v. Lease

- Must determine whether bundled charges for use of space are charges for rent or service.



Apportionment Formula – Payroll Factor

• Payroll Factor

- Includes amounts paid as compensation by the taxpayer in the regular course of its trade or business.
 - Compensation includes taxable wages, salaries, commissions, etc.
 - Compensation does not include any amount paid to independent contractors.
 - Some states exclude executive compensation in the payroll factor.
- Payroll related to the production of non-business income is excluded.



Apportionment Formula – Payroll Factor

• Payroll Sourcing Rules

- The numerator of the payroll factor includes compensation paid to employees for services rendered within the state.
 - If an employee works both within and without the state, his or her wages are sourced according to the Model Unemployment Compensation Act (MUCA).
 - » *State in which the employee’s services are wholly or substantially performed, if services performed outside of the state are incidental or rendered in connection with isolated transactions.*
 - » *The state in which the employee’s base of operations is located, if some part of the services are performed in that state.*
 - » *The state from which the employee is directed or controlled, if some part of the services are performed in that state.*
 - » *The state in which the employee resides.*



Apportionment Formula – Payroll Factor

• Who is included in payroll?

- State auditors use Federal Form 940 to tie payroll figures since payroll generally follows unemployment compensation rules.
- Review common-law employees versus book employees.
 - Common law employee: Performs services for a company who controls what will be done and how it will be done.
- Exclusions
 - Payroll attributable to non-business income.
 - Independent contractors.
 - Non-jurisdictional payroll.



Apportionment Formula – Payroll Factor

• Other Definitions of Compensation

- Alabama does not exclude independent contractors, because the Alabama law states that the payroll factor is measured by compensation paid for services in the state versus compensation paid everywhere. *C&D Chemical Products, Inc. v. Alabama Dept. of Rev.*, No. 00-288 (Ala. Admin. Law. Div. Feb. 9, 2001).
- Kentucky ruled that compensation paid to an affiliate by a taxpayer for services rendered by the affiliate’s employees to the taxpayer were includable as Kentucky compensation. *Cincinnati, New Orleans & Texas Pacific Railway v. Kentucky Dept. of Rev.*, 684 S.W.2d 303 (Ky. Ct. App. 1984).
- Louisiana excludes compensation paid by a common paymaster to affiliates for salaries, wages, and other compensation from the Louisiana payroll numerator. La. Rev. Stat. Ann § 47:286.95(J).



Apportionment Formula – Sales Factor

• Sales Factor defined by UDITPA

- The sales factor is a fraction, the numerator of which is the total sales in the state and the denominator is the total sales everywhere.
- UDITPA refers to “total sales” but defines “sales” as “all gross receipts of the taxpayer not allocated.”
- MTC regulations specify that “sales” includes “all gross receipts derived by the taxpayer from transactions and activity in the regular course of the trade or business.”



Apportionment Formula – Sales Factor

• Sales Generally

- Sales are characterized as sales of tangible personal property, sales of services, or sales of intangibles.
 - Changing the character of the sale can change the way the sale is sourced.
- Sales are generally determined net of returns, allowances, and discounts.
- Only sales that generate business income are includable.



Apportionment Formula – Sales Factor

• Sales Factor Exclusions

–MTC regulations exclude:

- Substantial amounts of gross receipts from the occasional sale of fixed assets used in the taxpayer's business.
- Insubstantial amounts that do not materially affect the factors.

–State-specific exclusions:

- Receipts other than receipts from the principal business activity.
- Receipts from the sale of certain assets.
- Receipts from income not included in the tax base.



Apportionment Formula – Sales Factor

• Sourcing Sales of Tangible Personal Property

- Sales of TPP are attributed to the destination where TPP is delivered.
 - Ultimate Destination – Although initial delivery and passage of title may occur at one location, the subsequent shipment to the final destination determines the location of the receipt.
 - Sales to U.S. Government may be sourced to state of destination or origin.
- UDITPA – Sales of TPP are in the state if the property is delivered or shipped to a purchaser, other than the U.S. government, within this state regardless of F.O.B. point.
 - Per MTC regulations, does not matter if the property is ordered from another location.
 - Addresses shipments delivered by common carrier.
 - Does not matter if purchaser subsequently transfers the property to another state
 - Drop shipments are sourced to where the ultimate recipient of the property is situated.



Apportionment Formula – Sales Factor

• Dock Sales

- Dock sales occur when the purchaser acquires the goods at the seller’s place of business rather than the seller shipping the goods via common carrier or delivering the goods with its own vehicles.
- How do you source sales that are “delivered or shipped to a purchaser...within this state”?
 - Some states source the goods to the ultimate destination of the TPP, while other states source the receipt to the state of the “dock” where the goods were acquired.
 - Delaware’s Supreme Court ruled that the state where title transfers, i.e. the “dock,” is where the receipt should be sourced.
- The issue is whether to view a receipt as being attributable to the location of the sale or the location where the goods will ultimately be used.



Apportionment Formula – Sales Factor

• Sourcing Sales of Services

- Services are generally sourced using one of two methods – cost of performance or a market approach.
- UDITPA sources sales of other than TPP to a state if:
 - The income-producing activity is performed in this state, or
 - The income-producing activity is performed both in and outside the state, and a greater proportion of the income-producing activity is performed in the state than in any other state based on cost of performance.
- Cost of Performance may be source as all-or-nothing based on the majority of costs of the service occur in one state or COP may be sourced proportionally.
- The Market Approach looks at the recipient of the services to source the receipt.



Apportionment Formula – Sales Factor

• Income-Producing Activities

- The MTC regulations provide that income-producing activity means “the transaction and activity directly engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gains and profits.” MTC Reg. IV.17.(2).
- Examples:
 - Arizona – Soliciting customers, investigating credit history, and negotiating contracts is an income-producing activity.
 - California & Wisconsin – Solicitation activities are not income-producing activities.
 - Massachusetts – a financial organization’s administrative functions constituted income-producing activities.
 - California – a financial organization’s broker services were income-producing activities, but not its administrative functions.



Apportionment Formula – Sales Factor

• Sourcing Sales of Intangibles

- Intangibles are generally sourced using cost of performance methodologies.
 - Trending towards market sourcing of intangibles.
- The MTC excludes income derived from merely holding intangibles from the numerator and denominator of the sales factor since no income-producing activity can be identified.
- Non-UDITPA states generally source intangibles to the taxpayer's commercial domicile.
- Software licenses are treated similarly to the license of a copyright:
 - Sourced using cost of performance, e.g. California.
 - Sourcing software to the state based on its use in the state, e.g. Florida.
 - Sourcing based on state-specific provisions, e.g. Illinois.



Apportionment Formula – Sales Factor

• Sourcing Sales of Intangibles

- Sourcing investments is unique since inclusion of a taxpayer’s treasury functions can distort income attributable to a state.
- MTC regulations only include the net gain from sales of liquid assets in connection with the treasury functions of a taxpayer in the sales factor of a state. MTC Reg.IV.18(c)(4)(A).
 - Treasury functions are defined as the management of liquid assets for the purpose of satisfying cash flow needs of a taxpayer.
 - Taxpayer’s engaged in the buying and selling of marketable instruments are not performing treasury functions.
 - Hawaii, Idaho, and Utah following the MTC method.



Apportionment Formula – Sales Factor

• Sourcing Sales of Intangibles

- Capital gains are usually considered part of business income, but not all receipts from capital transactions are included in the sales factor.
 - The sale of a significant asset, such as a manufacturing plant, may distort the overall apportionment of income by giving undue weight to a particular state.
- The MTC excludes substantial amounts from the occasional sale of a fixed asset used in the regular course of a taxpayer’s trade or business. MTC Reg. IV.18.(c)(1).
 - California defines “substantial” for purposes of excluding occasional sales or sales of assets as sales resulting in a 5% or greater change in the taxpayer’s sales factor denominator.
 - New York excludes receipts from the sales of capital assets as being non-business income.



Apportionment Formula – Sales Factor

• Throwback Sales

- UDITPA provides that sales of TPP are sourced to a state if property is shipped from the state and the taxpayer is not taxable in the state.
- Taxable in another state means that a state has the right to impose a net income tax, even if it does not actually impose such a tax.
 - The right to tax is measured by the nexus standards of the state seeking throwback.
- The Double Throwback rule applies when three states are involved.
 - If the taxpayer is neither taxable in the destination state, nor the state of origin, the double throwback rule would “throw back” the sales to the third state in which a taxpayer maintained some contact.
 - » *Third state processes billing, contains a sales office, performs other functions associated with the sale.*



Apportionment Formula – Sales Factor

• Throwout Sales

- For sales of TPP, some states have adopted a “throwout” rule to resolve the issue of sales made to jurisdictions that do not have the power to tax the seller.
 - Throwout seeks to apportion only those receipts which are taxable.
- The Throwout rules acts to remove receipts from both the numerator and denominator of a state’s sales factor that were sourced to a state in which the receipts were not taxable.
 - Nexus standards of the Throwout state should be applied to jurisdictions in which the receipts are not taxed in order to determine whether the receipt should be thrown out.



Apportionment Formula – “Nowhere Income”

• Creating “Nowhere Income”

- Sourcing Services – Performing services whose costs are primarily in market states but whose benefit is rendered in cost of performance states.
- Throwback Planning – Establishing locations in states with no throwback rules and selling into states with throwback rules.
- Dock Sale Planning – “Nowhere sales” created by receiving “dock” sales in a state of ultimate destination while the customer ultimately takes the goods to a state that sources based upon the “dock” sale methodology.



Apportionment Formula – Special Industry Apportionment

• Considerations Related to Special Industry Apportionment

- Financial Institutions – Receipts sourced to location of borrower & property includes intangible assets like loans and receivables.
- Construction – Include construction in progress.
- Professional Sports – Source by duty-days, i.e. proportion based on games played.
- Motion Pictures – Source by audience data.
- Transportation – Source by in-state mileage, passenger mileage, etc.
- Insurance – Source by premium dollars written.
- Airlines – Airplane and flight crew payroll may be apportioned based on number of departures from the state.
- Communications – Source by cable-miles, circulation, satellite uplink and downlink stations, or location of the customer.



Apportionment Formula – Trending Towards Weighted Sales Factor

• Weighted Sales Factors

- States are moving away from the equally-weighted three factor methodology to encourage investment in the state.
 - Reducing the property and payroll factors encourages investment in the state since a taxpayer is not punished for locating property and payroll in the state.
 - Some states simply double-weight the sales factor, i.e. multiply the sales factor by two and divide the factors by four.
 - States moving to a single sales factor often apply a graduated weight to the sales factor, slowly weighting the factor more heavily until a single sales factor is attained.



Apportionment Formula – Trending Towards Weighted Sales Factor

• Minnesota's Transition to Single Sales Factor

- Minnesota is among the many states that have transitioned to a single sales factor formula by applying a graduated sales factor:
 - MN 2008: Property 9.5%, Payroll 9.5%, Sales 81%.
 - MN 2009: Property 8%, Payroll 8%, Sales 84%.
 - MN 2010: Property 6.5%, Payroll 6.5%, Sales 87%.
 - MN 2011: Property 5%, Payroll 5%, Sales 90%.
 - MN 2012: Property 3.5%, Payroll 3.5%, Sales 93%.
 - MN 2013: Property 2%, Payroll 2%, Sales 96%.
 - MN 2014: 100% Sales



Apportionment Formula – Alternative Apportionment

• Applying Alternative to Apportionment

- States may allow or a department may require a taxpayer to use an alternative apportionment methodology.
 - UDITPA § 18 states that a 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:
 - » *Separate Accounting,*
 - » *Exclusion of one or more factors,*
 - » *Inclusion of one or more additional factors, or*
 - » *Employment of any other method that will equitably allocate and apportion a taxpayer's income.*
- Alternative apportionment is used to prevent distortion of the taxpayer's income and/or to clearly reflect income derived from the state.



Apportionment Formula – Combined/Consolidated Return Issues

• Combination

- Combined returns typically include unitary members of the combined group on either a worldwide or water's edge basis.
- Inter-company transactions within the group are eliminated for apportionment purposes in many states.
- Partnership factor flow-up.
- *Joyce/Finnigan* application.



Apportionment Formula – Combined/Consolidated Return Issues

• Appeal of Joyce (Cal. SBE 1966)

- SBE held that a company's receipts from sales of TPP, shipped to California by a seller that was not taxable in California because of P.L. 86-272 but was part of a unitary business conducted in California, could not be included in the California sales factor numerator.
- *Joyce* treats each combined member as a separate entity for apportionment purposes. Unless an entity has nexus with a state on its own, its sales are not included in the numerator of the state sales factor.
- Throwback sales are included in the numerator of separate entities who do not have nexus in states where other combined members may have nexus.



Apportionment Formula – Combined/Consolidated Return Issues

• *Appeal of Finnigan (Cal. SBE 1990)*

- SBE overruled *Joyce* and held that when a combined group member has sales to another state in which the combined group member is not taxable, but in which other unitary combined group members are taxable, the combined group member's sales to that state are not subject to throwback.
- *Finnigan* treats all combined group members as a single entity for apportionment purposes.
- All sales of each combined group member are sourced to the state and included in the numerator regardless of individual nexus, but if one member of the group is subject to tax in the state.

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RECENT APPORTIONMENT DEVELOPMENTS

The *Gillette* Case

- *Gillette Co. v. Franchise Tax Bd.*, 207 Cal. App. 4th 1369 (1st Dist. 2012), on rehearing, 209 Cal. App. 4th 938, petition for review granted 291 P.3d 327 (2013).
- Many states are members of the Multistate Tax Commission's Multistate Tax Compact.

The *Gillette* Case

- The Multistate Tax Compact states:
 - “Any taxpayer . . . Whose income is subject to apportionment and allocation for tax purposes pursuant to the laws of a party State . . . may elect to apportion and allocated his income in the manner provided by the laws of such State . . . without reference to this compact, **or may elect to apportion and allocated in accordance with Article IV** [the equally weighted 3-factor formula].
 - Multistate Tax Compact art. III(1), available at www.mtc.gov.

The *Gillette* Case

- Prior to 1993, California followed the 3-factor UDITPA apportionment formula.
- In 1993, California modified its apportionment formula to double-weight the sales factor.
- In *Gillette*, the taxpayer cited the Compact and asserted the right to apportion its business income using the standard 3-factor formula, despite California's adoption of the double-weighted sales factor.

The *Gillette* Case

- California Court of Appeals Held:
 - The Compact was binding on California and Taxpayers could elect to use the equally weighted 3-factor formula:
 - “Because the Compact is both a statute and a binding agreement among sovereign signatory states, having entered into it, California could not, by subsequent legislation [the adoption of a modified apportionment formula], unilaterally alter or amend its terms. Indeed, as an interstate compact the Compact is superior to prior and subsequent the statutory law of member states.
 - As a result, the Compact “trumped” California’s adoption of a double-weighted apportionment formula.

The *Gillette* Case

- California's response:
 - Withdrew from the Multistate Tax Compact.
 - The FTB appealed the case to the California Supreme Court, which granted review; the case is pending.
- Responses from other states:
 - States including Minnesota, Oregon, South Dakota, Utah and the District of Columbia also withdrew from the Multistate Tax Compact.
 - Utah, Oregon and the District of Columbia subsequently re-enacted the Compact but removed the election language.

The *Gillette* Case

- Decisions from Other States = Texas
 - Decisions No. 108,223, 108, 284 and 108, 285, (Texas Comptroller of Public Accounts May 2, 2013).
 - Denied taxpayer's refund claims based on the 3-factor apportionment formula because Texas has adopted a single factor apportionment formula.
 - The Comptroller concluded that no weight should be given to *Gillette* because it is under review by the California Supreme Court and has no precedential value under California law.

The *Gillette* Case

- Decisions from Other States - Michigan:
 - *International Business Machines Corp. v. Dep't of Treasury*, No. 306618 (Mich. Ct. App. Nov. 20, 2012).
 - The court acknowledged that there was a conflict between the Compact and Michigan's Business Tax Act (requiring a single sales factor apportionment formula).
 - The court concluded that the more recent and more specific Business Tax Act prevailed over the Compact election.
 - Adopting a conflicting statute that could not be reconciled with prior law implicitly repealed the prior law.
 - Unlike the court in *Gillette*, the court here did not consider the Compact to be a binding contract amongst the signatory states (the Michigan statute does not “specif[y] that the Compact is a binding contract”).

The *Gillette* Case

- Decisions from Other States - Michigan:
 - *Anheuser-Busch, Inc. v. Dep't of Treasury*, No. 11-85-MT (Mich. Ct. Claims June 6, 2013).
 - Reached the opposite conclusion of *International Business Machines*.
 - Held that the Multistate Tax Compact was a binding contract that could not be repealed by a subsequent law changing the normal apportionment formula.
 - Permitted the taxpayer to elect apportionment using the Compact's 3-factor formula for the income tax portion of the Michigan business tax.

The *Gillette* Case

- For additional information on the *Gillette* case, see Jerome R. Hellerstein et. al. *State Taxation* ¶ 9.01[1] (3d ed. Supp. 2014)

Other Recent Developments

- *Minact, Inc. v. Director of Revenue*, 2014 WL 1499538 (Mo. April 15, 2014).
 - Employer set up a “rabbi trust” to fund a non-qualified deferred compensation plan for key employees.
 - Employer treated the income from the trust as non-business income and allocated it to its home state of Mississippi.
 - The Director reclassified the income as business income on audit.
 - **Missouri Supreme Court held that the trust income was business income under the functional test.**
 - The trust provided an incentive to attract and retain top executives so that the company could sustain business operations. Therefore, the gain was attributable to the “acquisition, management, and disposition of property” that constitutes an integral part of the taxpayer’s regular business.

Other Recent Developments

- *Tektronix, Inc. v. Dep't of Revenue*, 316 P.3d 276 (Ore. 2013).
- Taxpayer engaged in the business of developing and selling test measurement and monitoring equipment.
- In 1999, the taxpayer sold its printer division for \$925 million, of which \$590 million related to goodwill.
- Taxpayer excluded the \$590 million from its sales factor, resulting in a lower Oregon tax liability.
- Oregon Department of Revenue included the \$590 million in the taxpayer's sales factor and assessed additional tax.

Other Recent Developments

- *Tektronix, Inc. v. Dep't of Revenue*, 316 P.3d 276 (Ore. 2013).
- “Sales” for purposes of the sales factor exclude gross receipts from the sales of intangible assets “unless those receipts are derived from the taxpayer’s primary business activity.” O.R.S. § 314.665(6)(a).
- **Court held that the taxpayer properly excluded goodwill from the sales factor.**
- Although the printer division itself was central to the taxpayer’s primary business, **the Taxpayer’s primary business was not to sell off business divisions** and the exception to O.R.S. § 314.665(6)(a) did not apply.

Other Recent Developments

- *Equifax, Inc. v. Dep't of Revenue*, 125 So.3d 26 (Miss. 2013).
 - Taxpayer was a service business engaged in the business of consumer credit reporting.
 - Taxpayer applied the standard apportionment method authorized for service businesses under Mississippi regulations and determined that it had no taxable income in the state.
 - On audit, the Department argued that the taxpayer should have used an alternate apportionment formula because the standard formula did not fairly reflect the extent of its business in Mississippi.

Other Recent Developments

- *Equifax, Inc. v. Dep't of Revenue*, 125 So.3d 26 (Miss. 2013).
- Reviewing largely procedural issues, the Mississippi Supreme Court **upheld the assessment**.
 - Use of an alternate apportionment method was not the promulgations of a rule in violation of the Mississippi Administrative Procedures Act.
 - Taxpayer (and not the taxing authority) had the burden of proof.
 - Taxpayer failed to show that the imposition of penalties was unlawful.

Other Recent Developments

- *Crystal Communications, Inc. v. Dep't of Revenue*, 297 P.3d 1256 (Ore. 2013); *CenturyTel., Inc. v. Dep't of Revenue*, 297 P.3d 1264 (Ore. 2013).
- Oregon taxes public utilities outside the modified UDITPA framework applicable to other businesses.
- Oregon tax statutes authorize apportionment but do not specify what apportionment mechanism should be used.
- The Oregon Department of Revenue adopted apportionment regulations for public utilities that cross-reference Oregon's UDITPA framework and adopted two separate definitions of "business income" – one in the UDITPA statute and one contained in an administrative regulation. .

Other Recent Developments

- *Crystal Communications, Inc. v. Dep't of Revenue*, 297 P.3d 1256 (Ore. 2013); *CenturyTel., Inc. v. Dep't of Revenue*, 297 P.3d 1264 (Ore. 2013).
 - The Department relied upon the regulation's definition of business income and taxed the gain from liquidation sales as business income.
 - The taxpayer argued that the regulation was invalid because it conflicted with the statutory definition of business income contained in Oregon's version of UDITPA.
 - I.e. the liquidation exception.

Other Recent Developments

- *Crystal Communications, Inc. v. Dep't of Revenue*, 297 P.3d 1256 (Ore. 2013); *CenturyTel., Inc. v. Dep't of Revenue*, 297 P.3d 1264 (Ore. 2013).
 - Held: Gain from the liquidation was taxable as business income.
 - Public utilities are not taxed under Oregon's version of UDITPA.
 - The framework for taxing public utilities cross references both the statutory and regulatory definitions of "business income" and either one may apply.
 - "[W]e need not and do not decide whether ORS 314.610(1), the statute that defines 'business income' for purposes of UDITPA, includes gain realized from the sale of an asset during the course of liquidating a business."

Other Recent Developments

- **Mississippi H.B. 799, Laws 2014.**
 - The Commissioner of Revenue may (or the taxpayer may petition the Commissioner to) use an alternate apportionment formula .
 - The party requesting the alternate apportionment formula has the burden of proof by a preponderance of the evidence that the standard apportionment formula does not fairly reflect the taxpayer's activities.
 - The Commissioner cannot impose penalties on a deficiency relating to its requiring of a taxpayer to use an alternate apportionment formula unless the apportionment method used by the taxpayer lacks a reasonable basis or is not in accordance with existing statutes or regulations.
 - Appears to be a response to *Equifax*.

Other Recent Developments

- **New York S.B. 6359 (2014-2015 Budget)**
 - Enacts several corporate tax reforms.
 - Adds N.Y. Tax Law § 210-A, which generally source receipts based on the location of the customer.

Other Recent Developments

- **South Dakota – H.B. 1201, Laws 2014.**
 - Amends apportionment rules for state bank franchise tax.
 - The denominator for the property, payroll and sales factors is included to include the total of each factor “everywhere” instead of just “in all the states of the United States, the District of Columbia, and any territory or political subdivision.”



THANK YOU

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