# Demystifying the States' Apportionment of Corporate Income & the Ramifications of Alternative Apportionment

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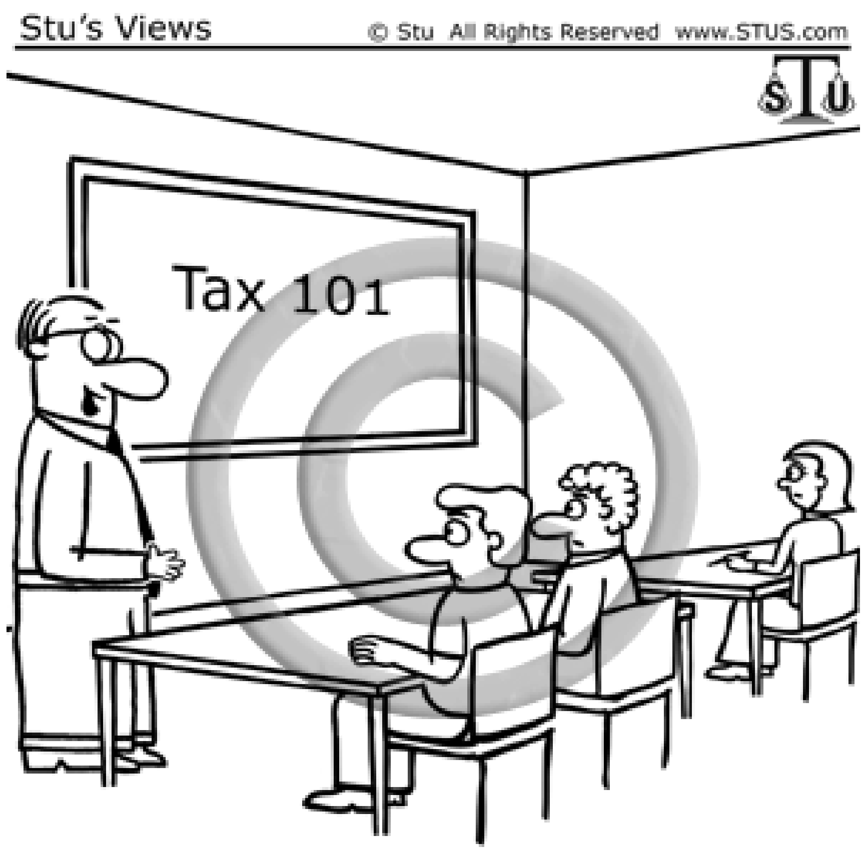
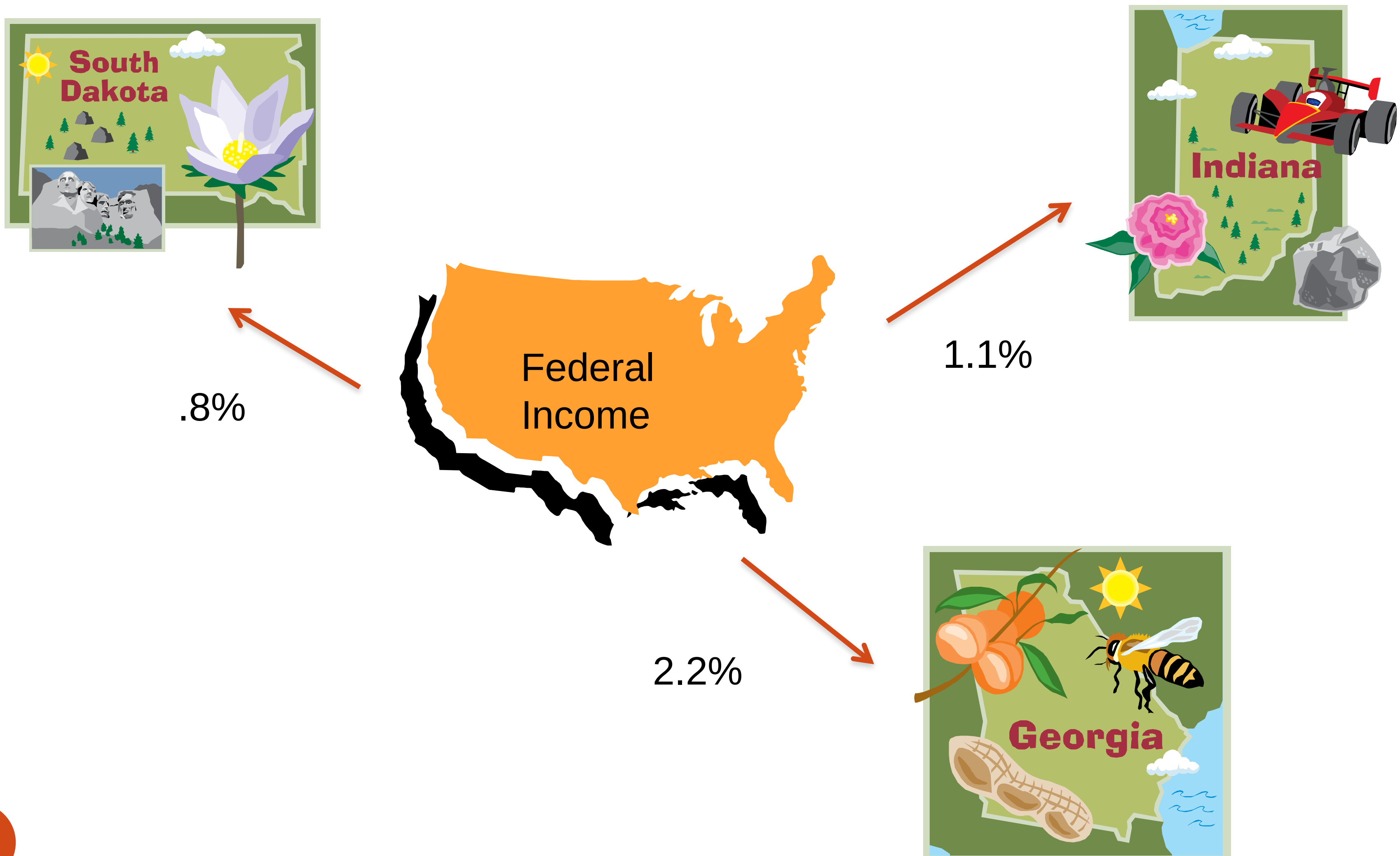
# COMPLEXITY – ALL BAD?




The Internal Revenue Code is absurdly complex or, as we lawyers say, a goldmine.

# APPORTIONMENT BASICS
## “Rough Approximation”



# CONSTITUTIONAL RESTRAINTS

- States may tax “fair share” of profits earned from activity conduced within their borders using apportionment
  - *Underwood Typewriter*, 254 U.S. 113 (1920)
- “Linchpin of apportionability in the field of state income taxation is the unitary business principle”
  - *Mobil Oil*, 445 U.S. 425 (1980)
- Burden cannot be excessive, unreasonable and arbitrary
  - *Hans Rees*’, 283 U.S. 123 (1931)
  - *Norfolk & Western Railway*, 390 U.S. 317 (1968)

# CONSTITUTIONAL RESTRAINTS

- Modern test used by Court found in *Complete Auto*, 430 U.S. 274 (1977) – a sales tax case
- State's ability to impose a tax requires that:
  - The activity taxed has substantial nexus with the state
  - The tax is fairly apportioned – *Jefferson Lines*, 514 U.S. 175 (1995)
    - Internal Consistency
      - If every state imposed the same tax, the activity would not be subject to duplicative taxation
    - External Consistency
      - Does tax reach beyond economic activity fairly attributable to the taxing state
  - The tax does not discriminate against interstate commerce
  - The tax is fairly related to services provided by the state

# APPORTIONMENT BASICS

## TRADITIONAL STATE APPORTIONMENT FORMULA
## Three Factors

| Property | Payroll | Sales |
|---|---|---|
| In State Property | In State Payroll | In State Sales |
| All Property | All Payroll | All Sales |

# STANDARD FACTORS

- Sales Factor
  - "Sourced" to a particular state
  - Generally includes all business gross receipts
  - Sale of tangibles
    - Sourced to delivery location
  - Sales of services and intangibles are either:
    - Sourced to place performed ("COP")
      - Preponderance (100% or 0%)
      - Proportionate (% performed in state)
    - or delivery ("market") in some states

# STANDARD FACTORS

- PROPERTY FACTOR
  - Value of property located in state
    - Rent normally 8X annual rent payment

- PAYROLL FACTOR
  - “Wages” paid in state

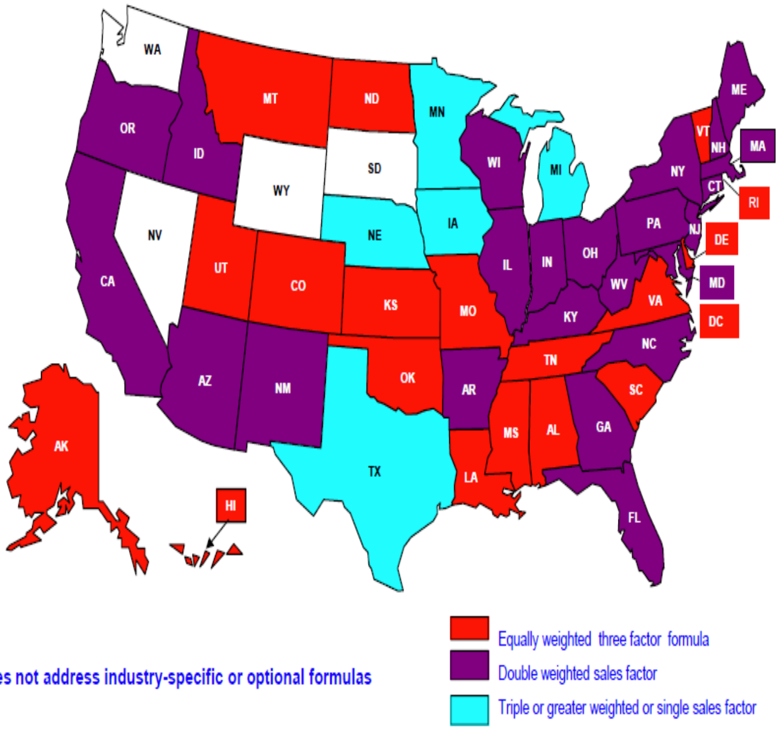
# APPORTIONMENT TRENDS

| 1957 | 1990 | 2000 | 2012 |
| --- | --- | --- | --- |
| **Intentional Uniformity** | **Inconsistency** | | **Inadvertent Uniformity** |
| UDITPA 3-factor formula | Sales factor weighting and non-TPP sourcing | | Single-sales factor and market-based sourcing |

- Modernization
  - Formula, sourcing changes reflect shifts in economy
  - Incentives to in-state business
- Continued push of factors out to the marketplace
  - Single-sales factor
  - Market-based sourcing for sales of intangible and services

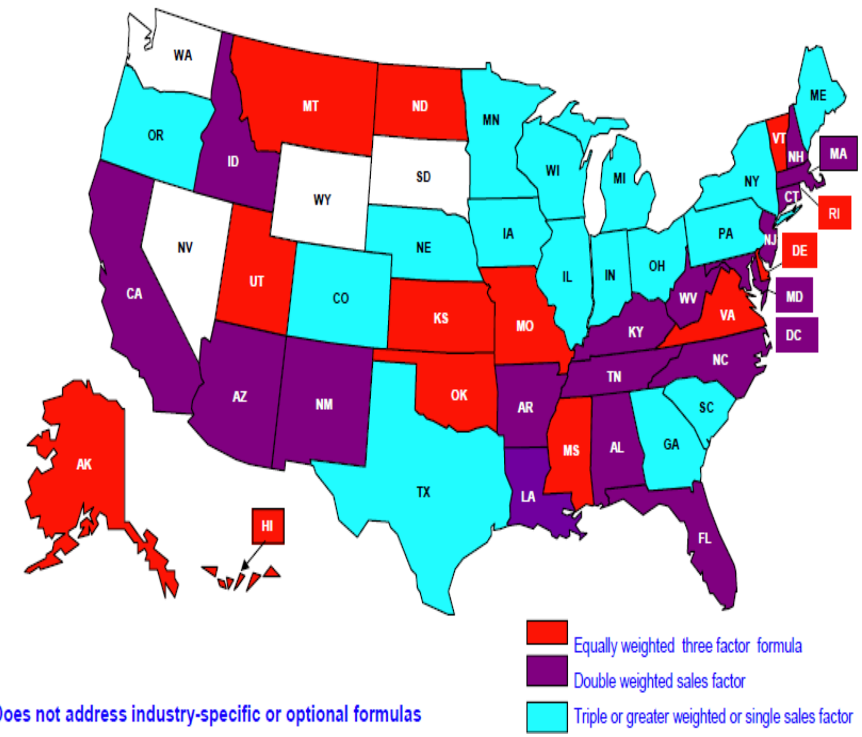
# SHIFT TO HEAVIER SALES FACTOR WEIGHTING

*Apportionment Formulas* - 1998*




*Does not address industry-specific or optional formulas

*Apportionment Formulas* - 2012*




*Does not address industry-specific or optional formulas

# ALTERNATIVE APPORTIONMENT

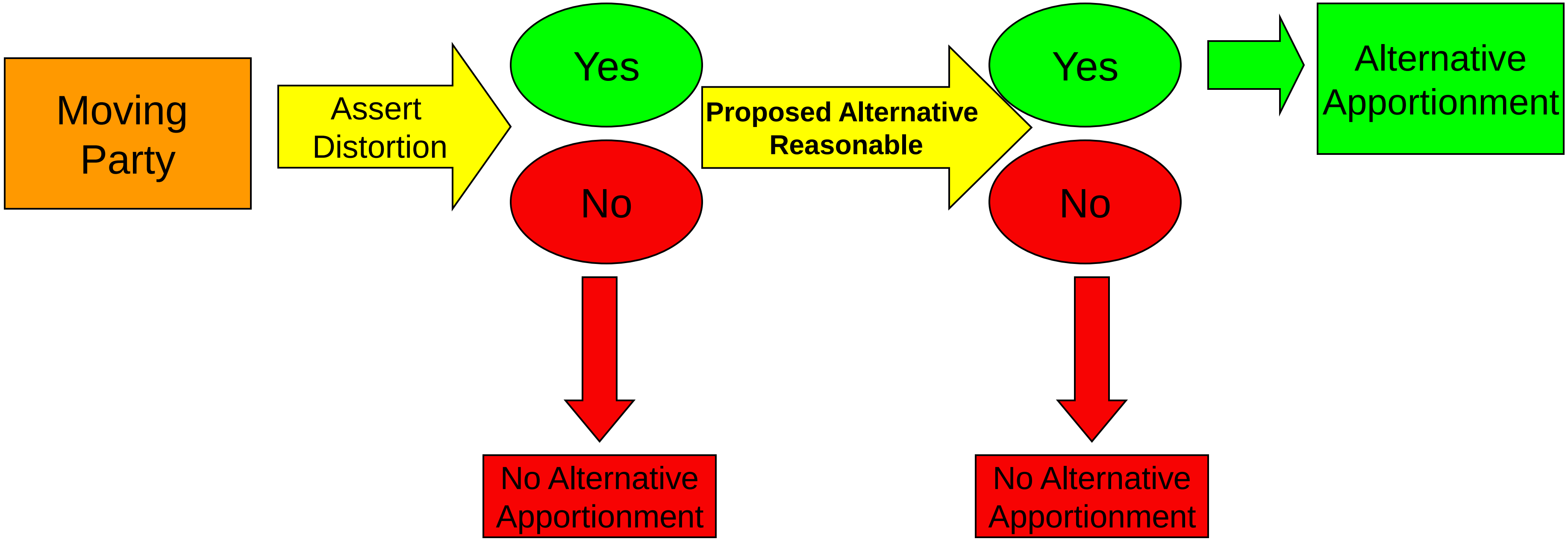
- UDIPTA section 18
  - Provides for the use of alternative apportionment "[i]f the allocation and apportionment provisions of this Act <u>do not fairly represent the extent of the taxpayer's business activity in the state</u>."
- Double-Edged Sword
  - Available to both the taxpayer and the state
    - Most state tax authorities have some statutory discretion to require a taxpayer to use an alternative apportionment formula.
  - Taxpayers may request alternative apportionment formula.

# ALTERNATIVE APPORTIONMENT

- Allows for the use of one or more alternative methods if the standard apportionment provisions "do not fairly represent" the taxpayer's business activity in the state
  - Alternatives methods include:
    - Separate accounting,
    - Exclusion/inclusion of one or more factors, or
    - "Employment of any other method to effectuate an equitable allocation and apportionment" of taxpayer's income
- Special election/procedure in some states
- When to apply
  - Prospective
  - Refund claims
  - Audit adjustments

# ALTERNATIVE APPORTIONMENT STANDARD

## Alternative Apportionment Procedure



# ALTERNATIVE APPORTIONMENT CONTROVERSIES

- **Industry-Wide Application through Regulations**
  - Airlines - Miles flown
  - Advertising - Audience
- **Widespread Application Without Regulations**
  - How important is "unusualness"
  - Intangible Holding Companies
  - MTC rejected suggestion that regulations must be adopted
- **MTC Regulation**
  - **Original:** "…only in specific cases where unusual fact situations (which usually will be unique and non-recurring) produce incongruous results..."
  - **As Amended:** "…only in limited and specific cases where the apportionment and allocation provisions contained in Article IV produce incongruous results..."

## ALTERNATIVE APPORTIONMENT CONTROVERSIES

- **Burden of Proof**
  - Did Tax Commissioner ***abuse her discretion*** in granting/refusing equitable apportionment?
  - Or is the burden something else?
  - De Novo review?

- **MTC Amended Rule**
  - Burden on party invoking alternative apportionment
  - Exception where taxpayer used different method 2 out past 5 years

# ALTERNATIVE APPORTIONMENT CONTROVERSIES

- **Imposition of penalties for using statutory method**
  - MTC Amendment prevents

- **Retroactive revocation**
  - MTC Amendment prevents

- **Distortion**
  - How can you measure whether the standard apportionment provisions produce a “fair” representation of the extent of the taxpayer’s business attributable to a state?
    - More or less tax?
  - Should degree matter?
  - Prevent under or over taxation?

# ALTERNATIVE APPORTIONMENT CONTROVERSIES

**California Standard for Distortion: *Microsoft***

- **Qualitative Analysis:**
  - The qualitative analysis examines the type of business conducted by the taxpayer in comparison to any activity that may create distortion.

- **Quantitative Distortion:**

  Quantitative distortion may be demonstrated by various methods, including:
  - Separate accounting, comparison of profit margins, comparison of apportionment percentages, comparison of income and gross receipts from various activities, etc.
  - Profit margin from a taxpayer's primary business is several orders of magnitude different from the profit margin on the treasury function.
  - Court in Microsoft found distortion where operational profit margin far exceeded treasury profit margin. Operational margin 167x greater than treasury profit margin

# ALTERNATIVE APPORTIONMENT CONTROVERSIES

- **Appropriate for use in Economic Development?**
  - Should it be statutory or by administrative policy/decision making?
- **Adjustments to sales factor**
  - Ohio, gross receipts tax state, modifies sourcing for sales made to a qualified distribution center
  - Other states also make modifications
- **Adjustments to property & payroll factors**
  - Some states exclude property and/or payroll for property and/or employees located in a development district

# MEDIA GENERAL COMMS. INC., S.C. S.CT. 2010

- Department of Revenue agreed with taxpayer that the state’s apportionment was not fairly reflecting the taxpayer’s activity in the state, but held combined reporting was not allowed as a method of alternative apportionment to fix the distortion
- Court held combined reporting could be used as an alternative apportionment method

# CARMAX AUTO SUPERSTORES OF REVENUE PENDING AT S.C. S. CT.

- Both parties agree on who carries the burden when invoking alternative apportionment – it is on the party seeking its use
  - Should the burden be by the preponderance of evidence or higher clear and convincing standard?

- One of the disputed questions is over whether that burden requires a showing that there was no other reasonable method that could be used to apportion the income
  - Is it possible to analyze all potential methods to apportion income?

- Another major question deals with whether it is appropriate for the SC DOR to exclude the use of the standard apportionment formula using the income of the unitary group, rather than just select income and receipts from intangibles and financing
  - In other words, was it appropriate to use separate accounting?
  - Court held oral arguments on March 19, 2014, awaiting its decision

# EQUIFAX

- Equifax is a GA corporation engaged in consumer credit reporting services; these services were provided electronically to Mississippi businesses

- Equifax apportioned its income to MS used IPA / COP method for refund claims - DOR determined that Equifax should have used an alternative market-based sourcing formula

- Mississippi Supreme Court overruled Ct of Appeals, holding that <u>Taxpayer</u> bears burden of proof when Department of Revenue asserts alternative methodology (here market-based sourcing methodology)
  - Court's review of Department's imposition of alternative methodology is limited to whether that decision was supported by substantial evidence or that it was arbitrary and capricious
  - Result that taxpayer may find it much more difficult to challenge Department's assertion of alternative methodology

# EQUIFAX – MISSISSIPPI LEGISLATIVE RESPONSE

**Legislative Response to *Equifax (HB 799)(Eff. 1/1/2015)***

- Places burden of proof on party invoking alternative apportionment method to prove by a *preponderance of evidence* that: □Statutory method does not fairly represent activity in state; *and*
- Selected method more fairly represents that activity than any other reasonable method available
- Requires that alternative apportionment be invoked only in “limited and unique, nonrecurring circumstances”
- Prohibits DOR from invoking forced combination until regulations have been promulgated
- No penalties from forced combination unless DOR finds no reasonable basis or nontax business purpose.

# ALTERNATIVE APPORTIONMENT BURDENS AND PENALTIES

- Equifax generated strong reaction from taxpayer community
  - Reaction directed toward court's placement of burden on taxpayer and Department's imposition of penalties upheld by court
  - U.S. Supreme Court denied review of Due Process Clause issues on June 30th
- Indiana is the only other state with a decision from the state's highest court holding that the DOR does not carry the burden when it invokes alternative apportionment. *See Rent-A-Center East*.

# QUESTIONS

**We hope we eliminated this perception!**