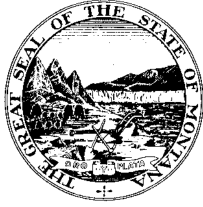

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# Revenue and Transportation Interim Committee

## 64th Montana Legislature

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TO: Revenue and Transportation Interim Committee

FROM: Megan Moore, Research Analyst

DATE: March 9, 2016

RE: Information Requests for Taxation of International Corporations Study

This memorandum provides responses to requests made at the last meeting for additional information for the study of taxation of international corporations doing business in Montana. The topics covered include whether there have been attempts at uniform reporting in states with mandatory combined reporting, whether the single sales factor has been challenged in court, and whether more or less than 100% of income is being taxed with the shift away from three-factor apportionment.

Uniform Reporting in Mandatory Combined Reporting States

There is considerable variation in aspects of the corporate income tax systems adopted by the states including apportionment formulas, definitions of terms (such as "sale," "business income," "gross receipts," etc.), and rules on sourcing of sales. With such variation, there do not seem to be current attempts to unify reporting requirements.

However, the Multistate Tax Commission is an organization created in 1967 by the Multistate Tax Compact to work "on behalf of states and taxpayers to administer, equitably and efficiently, tax laws that apply to multistate and multinational enterprises."[1] The Commission works in the areas of corporate income tax and sales tax.

Fifteen states, including Montana, are compact members and have adopted the Multistate Tax Compact as a state law. In addition, seven states are sovereignty members that support the purposes of the Multistate Tax Compact and regularly participate in Commission activities and 26 states are associate and project members that consult and cooperate on programs and projects.[2]

The National Conference of Commissioners on Uniform State Laws drafted the Uniform Division of Income for Tax Purposes Act (UDITPA) in 1957, which included an equally weighted three-factor apportionment formula. Few states initially adopted UDITPA but the Multistate Tax Compact was

[1] "The Commission," *Multistate Tax Commission*, available from http://www.mtc.gov/The-Commission, accessed March 7, 2016.

[2] "Member States," *Multistate Tax Commission*, available from http://www.mtc.gov/The-Commission/Member-States, accessed March 7, 2016.

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created in the 1960s amid threats of Congress setting uniform standards. Article IV of the Compact included UDITPA. Enough states adopted UDITPA, the Compact, or Multistate Tax Commission regulations to create basic uniformity in corporate income tax systems.[3]

As states have moved away from three-factor apportionment, some have withdrawn from the Multistate Tax Compact and others have repealed the portion of the Compact containing the three-factor apportionment formula. The Compact no longer specifies use of an equally weighted three-factor apportionment formula but recommends use of a double-weighted sales factor formula.[4]

The Multistate Tax Commission is charged by the Compact with "facilitating the proper determination of state and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes" and "promoting uniformity and compatibility in significant components of tax systems."[5] The Commission is active in promoting uniformity and its list of current projects include model definition of "receipts" regulations, model market-sourcing regulations, trusts uniformity, and a partnership information project.[6] Whether the Multistate Tax Commission is successful in furthering uniformity in corporate income tax ultimately depends on state participation and adoption of model laws developed by the Commission.

Single-Sales Factor: Court Cases and Over or Under Apportionment of Income

Attached to this memorandum is a portion of a Deloitte report titled, "Alternative Apportionment: Seeking a Fairly Apportioned Tax Base in a World of Increasing Reliance on the Sales Factor."[7] The report provides concise responses to the questions about court cases involving use of a single-sales factor and whether more or less than 100% of income is taxed with the move from the three-factor apportionment formula.

The article provides an example of more than 100% of income being taxed when two states differ in which sales are included in the sales factor numerator. The article also provides a summary of U.S. Supreme Court cases affirming single-factor apportionment.

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[3]Wolters Kluwer, "State Apportionment of Business Income," September 2014.

[4]Wolters Kluwer, "State Apportionment of Business Income," September 2014.

[5]"The Commission," *Multistate Tax Commission*, available from http://www.mtc.gov/The-Commission, accessed March 7, 2016.

[6]"Current Uniformity Projects," *Multistate Tax Commission*, available from http://www.mtc.gov/Uniformity/Current-Uniformity-Projects, accessed March 8, 2016.

[7]Alex Meleney and Frederick H. Thomas, "Alternative Apportionment: Seeking a Fairly Apportioned Tax Base in a World of Increasing Reliance on the Sales Factor," Dec. 10, 2010.

under the states' apportionment formulas.[64] There appear to be few if any cases addressing the issue under claims for an alternative apportionment method.

However, one interesting case involving the delivery of information into a state without the sale of tangible personal property involves a very old economy product—the yellow pages. In *BellSouth Advertising & Publishing Corp. v. Tennessee Comr.*,[65] the taxpayer was a publisher of yellow pages phone books. The taxpayer sent salesmen into Tennessee to solicit advertisers in the yellow pages phone book directories, but the entire process of publishing and printing the various Tennessee yellow pages was conducted entirely out of state. The phone books were then distributed to phone users in Tennessee at no charge. As a result, there was no sale of tangible personal property, and the taxpayer sought to source its revenue as a sale of advertising services under the traditional income-producing activity standard that was based on the location of the greatest portion of the taxpayer's costs of performance. As these costs were outside Tennessee where the printing and publishing occurred, the taxpayer had no sales in Tennessee. The Tennessee court noted that over a five-year period, the taxpayer had delivered more than 23 million directories in Tennessee and cited history from the initial adoption of UDITPA that noted that the standard apportionment rules might not operate fairly for publishers, to conclude that apportioning none of the taxpayer's substantial advertising revenue to Tennessee resulted in an unfair apportionment.[66]

Another case for alternative apportionment involves extraordinary sales of property where a large amount of gross receipts attributable to the location of the property can overwhelm receipts from ordinary operations and skew the sales factor to one state. Arguably, the income from such sales is apportionable business income and inclusion of the gross receipts from the sale in the sales factor is appropriate.[67] The Multistate Tax Commission Allocation and Apportionment Regulations (the MTC Regulations)—which serve as model regulations for states that have adopted UDITPA—in Reg. §IV.18.(c).(1), addresses this problem by providing that:

> (1) Where substantial amounts of gross receipts arise from an incidental or occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business, those gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory or plant will be excluded.

A large number of states have adopted this regulation or a regulation similar to it. However, fixed assets do not include intangible assets, and many state formulas would appear to require the inclusion of gross receipts from sales of intangibles in the sales factor.[68] Upon the sale of the assets of a going business, the sold assets are likely to include sales of intangibles as well as fixed assets. It would seem appropriate to exclude the receipts from the sale of the intangible assets from the sales factor as well as the receipts from the sale of the fixed assets. This issue was addressed by the California Franchise Tax Board in Legal Ruling 97-1, which held:

> The exclusion from the sales factor pursuant to 18 CCR §25137(c)(1)(A) of substantial amounts of gross receipts from an incidental or occasional sale of a fixed asset is based on the rationale that such gross receipts do not fairly reflect the taxpayer's day-to-day business activity and therefore cause excessive income to be apportioned to the state where the occasional sale took place. This is especially so if the growth of built-in appreciation occurs over a substantial period of time, because taking the gross receipts into account in the year of a recognition event does not reflect the gradual effects of appreciation over several years.
>
> The same rationale can be applied to gross receipts from an incidental or occasional sale of intangible property held or used in the regular course of taxpayer's trade or business. There is no logical basis for distinguishing between fixed assets and intangibles. Accordingly, under authority of §25137 [California's alternative apportionment statute], gross receipts from an incidental or occasional sale of intangible property held or used in the regular course of taxpayer's trade or business will be excluded from the sales factor, if substantial.

## Using Alternative Apportionment to Overcome Conflicting State Apportionment Formulas

One of the most common complaints of taxpayers is that more than 100 percent of their taxable income is apportioned to the states, or that more than 100 percent of one of the factors, usually the sales factor, is appor-

[64] *See American Business Information, Inc. v. Tennessee Dept. of Rev.*, No. M2008-0129-COA-R3-CV (Tenn. Ct. App. Aug. 26, 2009).

[65] *BellSouth Advertising & Publishing Corp. v. Tennessee Comr.*, 308 S.W.3d 350 (Tenn. Ct. App. 2009).

[66] *BellSouth Advertising & Publishing Corp. v. Tennessee Comr. of Rev.* 308 S.W.3d 350, 366 (Tenn. Ct. App. 2009).

[67] To the extent the gain represents depreciation recapture, the depreciation has presumably been deducted from apportionable income.

[68] Uniform Division of Income for Tax Purposes Act, in Reg. §IV.18.(c).(3) addresses the issue of receipts from intangible property under the statute's alternative apportionment authority but does not directly address the distortion that can be caused by extraordinary sales:

> (3) Where the income producing activity in respect to business income from intangible personal property can be readily identified, the income is included in the denominator of the sales factor and, if the income producing activity occurs in this state, in the numerator of the sales factor as well. For example, usually the income producing activity can be readily identified in respect to interest income received on deferred payments on sales of tangible property (Regulation IV.15.(a)(1)(A)) and income from the sale, licensing or other use of intangible personal property (Regulation IV.17.(2)(D)).
>
> Where business income from intangible property cannot readily be attributed to any particular income producing activity of the taxpayer, the income cannot be assigned to the numerator of the sales factor for any state and shall be excluded from the denominator of the sales factor. For example, where business income in the form of dividends received on stock, royalties received on patents or copyrights, or interest received on bonds, debentures or government securities results from the mere holding of the intangible personal property by the taxpayer, the dividends and interest shall be excluded from the denominator of the sales factor.

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tioned to the states. The most common example of this involves the sales factor when a taxpayer selling services is operating in some states that source sales using the traditional income producing activity/cost of performance test and in other states that use a so-called ''market sourcing'' method that sources sales to the location of the customer or where the services are received. A taxpayer that is providing services to a customer in state A that uses a market sourcing approach but does most of the actual work related to those services in state B that uses the traditional test, may find the sales included in the numerator of both states. From a taxpayer's perspective, such a situation appears ripe for alternative apportionment.

Unfortunately, just the opposite is the case. Although a taxpayer in such a situation may get a sympathetic ruling from its ''home state'' where it has substantial operations, it is doubtful that the taxpayer has a right to alternative apportionment under either constitutional principles or under state alternative apportionment statutes. Each state has a right to impose its own apportionment formula so long as the formula meets constitutional standards. The issue of double taxation is addressed under the internal consistency test that examines whether double taxation will result if every state adopted the apportionment method used by the taxing state. There is no requirement that the states conform to a consistent apportionment method. Indeed, in the above example, is it the state using market sourcing or the state using the traditional method of sourcing sales that needs to relent to avoid double taxation?

**One of the most common complaints of taxpayers is that more than 100 percent of their taxable income is apportioned to the states.**

The U.S. Supreme Court addressed this issue in *Moorman Mfg. Co. v. Bair*.[69] In that case, as discussed in more detail below, the taxpayer challenged Iowa's use of a single-sales factor formula under the Due Process and Commerce Clauses of the U.S. Constitution. Because most other states used a three-factor formula consisting of property, payroll, and sales factors and the taxpayer's property and payroll were substantially located outside Iowa, the result was that more than 100 percent of the taxpayer's income was apportioned to the states and subject to tax. According to the taxpayer, this was caused by Iowa's failure to have a property and payroll factor that diluted taxpayer's Iowa apportionment. The court found no constitutional issue with that result:

> Even assuming some overlap, we could not accept appellant's argument that Iowa, rather than Illinois, was necessarily at fault in a constitutional sense. It is, of course, true that if Iowa had used Illinois' three-factor formula, a risk of duplication in the figures computed by the two States might have been avoided. But the same would be true had Illinois used the Iowa formula. . . .
>
> . . .
>
> The prevention of duplicative taxation, therefore, would require national uniform rules for the division of income. Although the adoption of a uniform code would undeniably advance the policies that underlie the Commerce Clause, it would require a policy decision based on political and economic considerations that vary from State to State.
>
> . . .
>
> It is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income. It is to that body, and not this Court, that the Constitution has committed such policy decisions.[70]

## ALTERNATIVE APPORTIONMENT AND THE SINGLE-SALES FACTOR

### Constitutionality of Single Factor Apportionment

The U.S. Supreme Court has held that a single factor apportionment formula is presumptively valid. In *Underwood Typewriter Co. v. Chamberlain*,[71] the court sustained the constitutionality of a Connecticut statute that required the taxpayer to apportion its net income based on a single property factor. The taxpayer was engaged in the business of manufacturing and selling typewriters, which it manufactured in Connecticut and then sold and serviced at branch offices throughout the United States. Under Connecticut's statutory formula, 47 percent of the taxpayer's income was attributed to the state, despite the fact that only 3 percent of its profits were received there. The court noted that the profits of the taxpayer ''were largely earned in a series of transactions beginning with manufacture in Connecticut and ending with sale in other States.''[72] Under these circumstances, the court concluded that the formula ''reached, and was meant to reach, only the profits earned within the State,'' and that the taxpayer had failed to establish that the ''method of apportionment . . . was inherently arbitrary, or that its application . . . produced an unreasonable result.''[73]

In addition to upholding the use of a single property factor formula in *Underwood*, the U.S. Supreme Court has specifically sustained the use of a single-sales factor formula. The court first addressed the validity of a single-sales factor formula in *General Motors Corp. v. District of Columbia*,[74] but did not address whether such a formula passed constitutional muster.[75] At issue

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[69] *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978).

[70] *Moorman*, 437 U.S. at 280.

[71] *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920).

[72] *Id.* at 120.

[73] *Id.* at 121. The U.S. Supreme Court again sustained the constitutionality of a single property factor in *Bass, Ratcliff & Gretton Ltd. v. State Tax Comn.*, 266 U.S. 271 (1924).

[74] *General Motors Corp. v. District of Columbia*, 380 U.S. 553 (1965).

[75] An earlier case, *Ford Motor Co. v. Beauchamp*, 308 U.S. 331 (1939), challenged the results under a single-sales factor

in *General Motors* was the validity of a single-sales factor regulation promulgated by the District of Columbia. While the relevant statute granted the district broad discretion to devise regulations for determining the amount of income ''fairly attributable'' to the District, in the case of a taxpayer doing business ''both within and without the District,'' the statute required that net income ''be deemed to be income from sources within and without the District.''[76] The court noted that the regulation failed to satisfy this statutory requirement under certain circumstances, such as in the case of a taxpayer with manufacturing facilities outside the district selling all of its products in the district.[77] In this example, the entire net income of a taxpayer doing business ''both within and without the District'' would be attributed to the district in violation of the statutory requirement that such a taxpayer's income ''be deemed to be income from sources within and without the District.'' The court therefore concluded that the single-sales factor regulation was not authorized by the statute and reversed the court of appeals without reaching the constitutional questions presented.[78]

While the court in *General Motors* resolved the case on nonconstitutional grounds and specifically disclaimed taking any position ''on the constitutionality of a state income tax based on the sales factor alone,'' the decision nevertheless contains some interesting dicta:

> [T]he result reached in this case is consistent with the concern which the Court has shown that state taxes imposed on net income from interstate commerce be fairly apportioned. In upholding taxes imposed on corporate income by Connecticut [in *Underwood*] and New York [in *Bass*] and apportioned in accordance with the geographical distribution of a corporation's property, this Court *carefully* inquired into the reasonableness of the apportionment formulae used.
>
> While the Court has refrained from attempting to define any single appropriate method of apportionment, it has sought to ensure that the methods used display a modicum of reasonable relation to corporate activities in the State. The Court has approved formulae based on the geographic distribution of corporate property and those based on the standard three-factor formula. *See, e.g.*, *Underwood Typewriter Co. v. Chamberlain, supra; Butler Bros. v. McColgan*, 315 U.S. 501. The 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. By contrast, the geographic distribution of a corporation's sales is, by itself, of dubious significance in indicating the locus of either factor . . . . In construing the District Code to prohibit the use of a sales-factor formula, we sacrifice none of the values which our scrutiny of state apportionment measures has sought to protect.[79]

Thirteen years after *General Motors*, the court in *Moorman* held, in a 6-3 decision, that a single-sales factor apportionment formula passed constitutional scrutiny.[80] The taxpayer in *Moorman* manufactured animal feed in Illinois and sold a portion of its product—approximately 20 percent—to customers located in Iowa. The taxpayer maintained warehouses and a sales force in Iowa.[81] Citing *General Motors*, the taxpayer argued that its Illinois operations were responsible for at least some portion of the income generated by its Iowa sales, and that by subjecting this income to tax in Iowa, the statutory formula resulted in extraterritorial taxation in violation of the Due Process Clause.[82]

The court described as ''speculative'' the taxpayer's contention that its Illinois operations were responsible for some of the profits generated by its Iowa sales, noting that ''the record does not contain any separate accounting analysis showing what portion of appellant's profits was attributable to sales, to manufacturing, or to any other phase of the company's operations.''[83] However, even had the taxpayer established that its Illinois manufacturing activities contributed to the profitability of its Iowa sales, the court concluded that the taxpayer was incorrect in claiming ''that the Constitution invalidates an apportionment formula whenever it *may* result in taxation of some income that did not have its source in the taxing State . . . .''[84] In holding against the taxpayer, the court noted that while the taxpayer was given an opportunity to demonstrate that the single-factor formula produced an arbitrary result in its case, the record contained no such showing.[85]

## Application of Alternative Apportionment To the Single-Sales Factor

While *Moorman* establishes that a single-sales factor formula will withstand challenges based on facial con-

formula rather than the formula itself. In that case, Texas imposed franchise tax on the privilege of doing business in the state. The measure of the tax was the value of the capital stock, surplus, and undivided profits apportioned to the state using a single gross receipts factor. The formula resulted in an apportioned value of $23 million while the client showed that the actual value of its property in Texas was only $3 million. The taxpayer claimed that the Texas tax was reaching out-of-state values. The court rejected this argument, noting that the tax was not a property tax but a tax on the value of the franchise to do business in the state that was measured by capital value apportioned to the state. The value of that Texas franchise could be enhanced by property outside of Texas as evidenced by the relative amount of gross receipts in Texas.

[76] *General Motors Corp. v. District of Columbia*, 380 U.S. 553, 554 (1965).

[77] *Id.* at 557.

[78] *Id.* at 558-59.

[79] *Id.* at 561 (emphasis added).

[80] *Moorman*, 437 U.S. at 267.

[81] *Id.* at 269.

[82] *Id.* at 271-272.

[83] *Id.* at 272.

[84] *Id.* (emphasis added).

[85] *Id.* at 275. The dissenting opinion focused almost exclusively on the operation of a single-sales factor formula as discriminating against interstate commerce by failing to recognize contributors to earning income other than sales and favoring taxpayers who have property and employees in the state relative to the traditional three-factor formula. Justice Blackmun in dissent observed: ''Single-factor formulas are relics of the early days of state income taxation. The three-factor formulas were inevitable improvements and, while not perfect, reflect more accurately the realities of the business and tax world.'' 437 U.S. at 282. (Footnotes omitted.) Justice Powell in dissent argued: ''Iowa's use of single-factor sales-apportionment formula—though facially neutral—operates as a tariff on goods manufactured in other States and as a subsidy to Iowa manufacturers selling their goods outside of Iowa.'' 437 U.S. at 283.

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