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# Current Trends in Alternative Apportionment

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## UDITPA Section 18

Advanced State and Local Tax Institute  
August 6-7, 2012

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# Your Panel

## ■ Panelists

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# Overview

- Background
  - Dividing the Corporate Income Tax Base
  - UDITPA
- Alternative Apportionment
  - Invoking Alternative Apportionment
    - Distortion
    - Reasonable Alternative
    - Who has the burden of proof?
- Practical Considerations

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# Background: Dividing the Corporate Income Tax Base

- States have significant leeway in adopting an apportionment formula to apportion taxpayers' business income for purposes of imposing their income taxes
- The apportionment method selected by a state cannot be **arbitrary** and must not produce **unreasonable** results. *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920)

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# Background: Dividing the Corporate Income Tax Base

- However, in *Hans Rees' Sons v. State of North Carolina*, 283 U.S. 123 (1931), the U.S. Supreme Court found that an apportionment formula did act arbitrarily when applied to the taxpayer's facts
  - Department apportioned 80% of taxpayer's income to North Carolina and taxpayer offered proof that approximately only 21% of its income was attributable to its business activity in North Carolina
  - "It is sufficient to say that, in any aspect of the evidence, and upon the assumption made by the state court with respect to the facts shown, the statutory method, as applied to the appellant's business for the years in question operated unreasonably and arbitrarily, in attributing to North Carolina a percentage of income out of all appropriate proportion to the business transacted by the appellant in that state."

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## Background: Dividing the Corporate Income Tax Base

- Many states early on adopted a 3 factor apportionment formula using the following equally weighted factors:
  - Property factor
  - Payroll factor
  - Sales factor

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# Background: UDITPA

- The Uniform Division of Income for Tax Purposes Act (“UDITPA”) adopted the same 3 factor formula
  - **July 1957** -- Approved by the National Conference of Commissioners of Uniform State Laws and the American Bar Association
  - **UDITPA Section 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.”

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# Background: UDITPA

- Because the standard apportionment formula may produce unreasonable results, UDITPA Section 18 provides an alternative apportionment method
  - Acts as a pressure valve for when the standard apportionment formula provides **arbitrary** and **unreasonable** results.



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# Background: UDITPA

- UDITPA Section 18 provides:
  - 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:
    - **Separate accounting;**
    - The **exclusion** of any one or more the factors;
    - The **inclusion** of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
    - The **employment of any other method** to effectuate an equitable allocation and apportionment of the taxpayer's income

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# Alternative Apportionment

- Alternative apportionment was originally intended by drafters of UDITPA to apply only in unusual circumstances:
  - William Pierce (Prof. Univ. of Michigan, chairman of UDITPA committee, writing about Section 18 in *Taxes: The Tax Magazine*, Vol.35, No. 10 (Oct. 1957) pg. 748):

“Of course, departures from the basic [apportionment] formula should be avoided except where reasonableness requires. Nonetheless, some alternative method must be available to handle the constitutional problem [arbitrary and unreasonable apportionment] as well as the unusual cases, because no statutory pattern could ever resolve satisfactorily the problems for the multitude of taxpayers with individual business characteristics”

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# Alternative Apportionment

- Multistate Tax Commission's Regulation IV.18(a) provides:
  - Article IV.18 permits a departure from the allocation and apportionment provisions of Article IV only in limited and specific cases where the apportionment and allocation provisions contained in Article IV produce incongruous results
- However, states have increasingly applied alternative apportionment methods where the statutory apportionment rules result in less income apportioned to the state than the state believes is fair

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# Invoking Alternative Apportionment

- Many states have either adopted UDITPA Section 18 or similar language granting them the authority to use an alternative apportionment method
- When a state or taxpayer wants to use an alternative apportionment method, the party seeking alternative apportionment bears the **burden of proof** in showing:
  - Distortion exists; and
  - That a proposed alternative method is reasonable

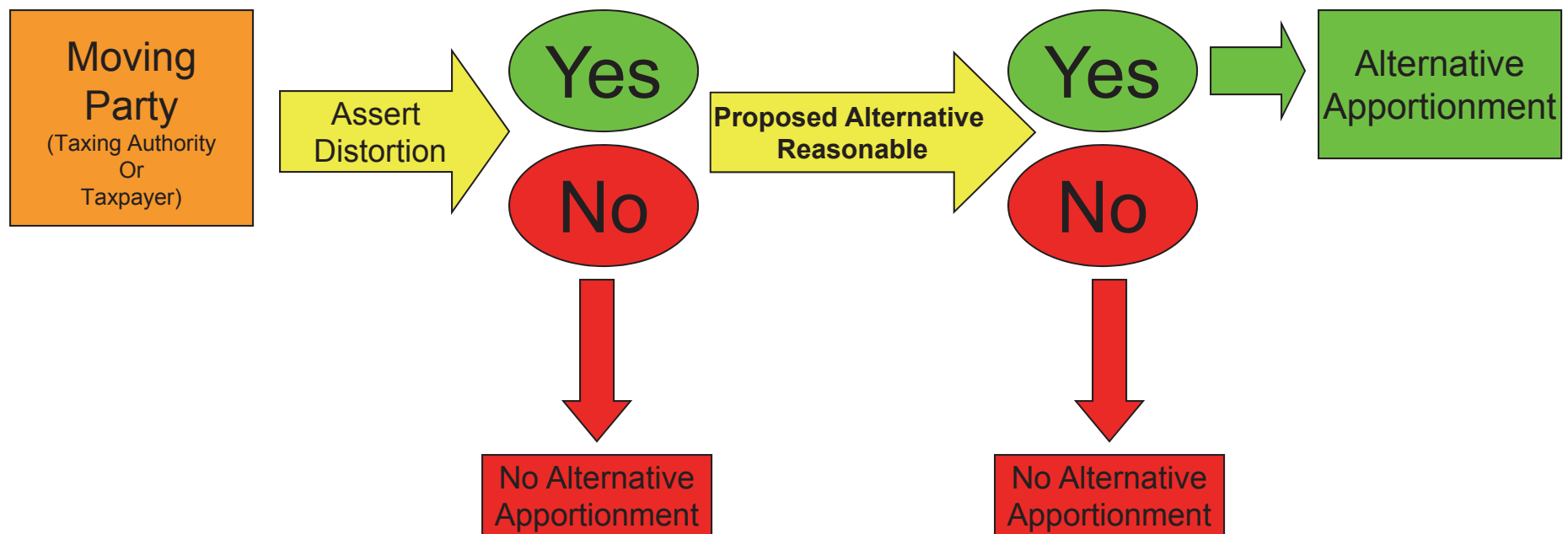
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# Invoking Alternative Apportionment

- Example: In *Microsoft Corp. v. Franchise Tax Board*, 139 P.3d 1169, 1178 (Cal. 2006) (emphasis added) the California Supreme Court stated:
  - As the party invoking section 25137 [California's version of Section 18], the [Franchise Tax] Board has the burden of proving by clear and convincing evidence that (1) the approximation provided by the standard formula is not a fair representation, and (2) its proposed alternative is reasonable.

# Invoking Alternative Apportionment

## Alternative Apportionment Procedure



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# Invoking Alternative Apportionment: Burden of Proof

- What standard of proof must be met for a taxpayer or state to prove distortion?
  - Clear and Convincing Evidence
  - Preponderance of the Evidence
  - Clear and Cogent Evidence
  - Prima Facie Evidence

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# Invoking Alternative Apportionment: Burden of Proof

- ❑ Clear and Convincing Evidence
  - Somewhere between preponderance of evidence and beyond a reasonable doubt
    - ❑ Example: California – *Microsoft v. Franchise Tax Board*, 139 P.3d 1169 (Cal. 2006).
- ❑ Preponderance of the Evidence
  - ❑ Example: Oregon - *Twentieth Century-Fox*, at 234
- ❑ Clear and Cogent Evidence
  - ❑ Example: New York
    - Must demonstrate by clear and cogent evidence that the standard apportionment formula does not properly reflect a taxpayer's presence. *British Land (Maryland) Inc. v. N.Y. Tax App. Trib.*, 85 N.Y.2d 139, 147-48 (N.Y. Ct. App. 1995).
- ❑ Prima Facie Evidence



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# Invoking Alternative Apportionment: Burden of Proof

- Application of Burden of Proof:
- *Equifax, Inc. v. Mississippi Dep't of Revenue*, 2012 WL 1506006 (Miss. App. 5/1/2012)
  - Court held the state [party invoking alternative apportionment] bears burden to prove two things:
    - The statutory formula does not fairly represent the taxpayer's business activity in the state; and
    - The state's proffered alternative method is "reasonable"
  - After reversing trial court for improperly imposing burden on the taxpayer, court remanded case for determination on merits
  - In dicta, court opined that state's *ad hoc* application of alternative apportionment did not constitute rulemaking subject to Mississippi's Administrative Procedures Act

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**WHAT IS “NOT A FAIR  
REFLECTION OF INCOME?”**

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# Invoking Alternative Apportionment: Distortion

- Most states have found that the constitutional “gross distortion” requirement is not necessary to justify alternative apportionment – some lesser standard usually applies
- Consistent with Section 18, many states require only a showing that the statutory formula does not fairly reflect the extent of the taxpayer’s activities in the state

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# Invoking Alternative Apportionment: Distortion

- What level of distortion must be shown in order for a taxpayer or state to be entitled to alternative apportionment?
- Constitutional “Gross Distortion”
  - *Twentieth Century-Fox Films v. Dep’t of Revenue*, 700 P.2d 1035 (Ore. 1985).
    - **Oregon** Supreme Court reviewed whether the Department proved that the statutory three-factor apportionment formula did not fairly represent the extent of taxpayer’s business activity in this state, thus permitting the Department to employ a different method
    - Court held that alternative apportionment is only applicable to remedy unconstitutional situations or where the UDITPA formula does not fairly represent the business activity of the taxpayer
  - **Florida and Illinois** – Regulations provide if the statutory formula will lead to “grossly distorted” results in a particular case, a fair and accurate alternative method is appropriate. Fla. Admin. Code Ann. § 12C-1.0152; 86 Ill. Admin. Code § 100.3390(c)

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# Invoking Alternative Apportionment: Distortion

- Illinois regulations provide:
  - A departure from the required apportionment method is allowed only where such methods do not accurately and fairly reflect business activity in Illinois. An alternative apportionment method may not be invoked, either by the Director or by a taxpayer, merely because it reaches a different apportionment percentage than the required statutory formula. However, if the application of the statutory formula will lead to a grossly distorted result in a particular case, a fair and accurate alternative method is appropriate. 86 Ill. Adm. Code § 100.3390(c)
  
- Illinois General Information Letter No. IT 11-0010-GIL (June 20, 2011)
  - An investment company that invested substantially all of its net assets in a portfolio of master limited partnerships requested that the apportionment factors of the underlying partnerships be used as an alternative apportionment method for its gain from sales of partnership interests
  - Department determined there is nothing inherently distortive or unfair in sourcing gross receipts from sales of partnership interests based on the activities of the partner in managing its investment in the partnership

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# Invoking Alternative Apportionment: Distortion

- Fla. Tech. Asst. Adv. No. 08C1-006 (July 25, 2008)
  - Illustrates the difficulty in obtaining alternative apportionment
  - Taxpayer requested alternative apportionment formula because it pays an income tax on over 150% of its federal consolidated income
  - Department denied request and noted that the fact taxpayer was filing on different bases contributed to why the taxpayer paid tax on more than 100%
    - The taxpayer reaped the benefit of including affiliated group in apportionment factors

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# Invoking Alternative Apportionment: Distortion

- California uses a qualitative and quantitative analysis to determine if distortion exists
  - Qualitatively Different
    - 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
    - Courts in *Microsoft* and *Square D* found distortion where operational profit margin far exceeded treasury profit margin
      - *Microsoft* – Operational margin 167x greater than treasury profit margin
      - *Square D* – Operational margin 74x greater than treasury profit margin

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# Invoking Alternative Apportionment: Distortion

- *Appeal of Home Depot, California SBE-298683 (Dec. 18, 2008)*
  - The FTB denied a refund claim on the grounds that the inclusion of treasury function gross receipts in the taxpayer's California sales factor denominator would not fairly represent Home Depot's activities in the state
  - The SBE determined that the FTB failed to carry its burden of proving by clear and convincing evidence that inclusion of these gross receipts resulted in distortion under prior SBE decisions and the California Supreme Court's decision in *Microsoft*
  - Home Depot successfully argued that any distortion was too insignificant to permit relief under alternative apportionment as the gross receipts from the sale of its marketable securities was just 6.6 percent of the unitary business' total gross receipts
    - Operational margin 18x greater than treasury profit margin not distortive



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# Invoking Alternative Apportionment: Distortion

- *Bellsouth Adv. & Pub. Co. (BAPCO) v. Chumley*, 308 S.W.3d 350 (Tenn. Ct. App. 2009), appeal denied (Mar. 1, 2010)
  - Court held that the Commissioner could apply alternative apportionment formula
  - Taxpayer sourced receipts in accordance with statute using cost of performance (COP) (i.e., receipts sourced to Tennessee if a majority of taxpayer's income-producing activity occurs in Tennessee)
  - Commissioner invoked an alternative apportionment formula and required the taxpayer to use market sourcing rules
  - Court held that the Commissioner established that the statutory formula did not adequately represent the taxpayer's business activity in the state, based solely on the fact that Bellsouth generated substantial revenue from the distribution of advertising within the state
  - Court granted Commissioner wide latitude to disregard the statutory formula in any case in which the Commissioner believes Tennessee should be entitled to greater tax revenue, as opposed to extraordinary and unique circumstances

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# Invoking Alternative Apportionment: Distortion

- While BAPCO's “all or nothing” argument is appealing, in that the Commissioner can virtually ignore the statutorily required cost of performance formula when the results are unfavorable to the Department, the fact remains that Tenn. Code Ann. §§ 67–4–2014(a) and 67–4–2112(a) were enacted by the legislature to provide the Commissioner with the authority to permit or require a departure from the standard apportionment formula when application of the formula does not fairly represent the extent of the taxpayer's business activity in Tennessee and the Commissioner is given the authority to use any method to source receipts for purposes of the receipts factor or factors of the apportionment formula numerator or numerators

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# WHAT IS A “REASONABLE ALTERNATIVE?”

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# Invoking Alternative Apportionment: Reasonable Alternative

- If the taxpayer or the Department of Revenue successfully argues that distortion exists in the application of the statutory apportionment formula, it must then show that there is a reasonable alternative
- UDITPA § 18 – Alternatives
  - **Separate accounting;**
  - The **exclusion** of any one or more of the factors;
  - The **inclusion** of one or more additional factors which will fairly represent the taxpayer's business activity in this state;  
or
  - The **employment of any other method to effectuate** an equitable allocation and apportionment of the taxpayer's income

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# Invoking Alternative Apportionment: Reasonable Alternative

- *Buffets Holdings, Inc. v. Cal. Franchise Tax Bd.*, No. 08-10141 (MFW), 2011 WL 3607825 (Bankr. D. Del. Aug. 15, 2011)
  - Bankruptcy court ruled that the California FTB used an appropriate alternative method to apportion the share of debtors' unitary business income that was taxable to California when calculating its claims, by excluding all gross receipts from the debtor's treasury investments from the apportionment formula
  - The treasury department's activities generated an average of 77% of debtors' gross receipts but only an average of 5.4% of their income
  - Relying on Qualitative and Quantitative test from *Microsoft*, the Bankruptcy Court held that the FTB established by clear and convincing evidence that the inclusion of the treasury gross receipts did not fairly represent the extent of the business activity in California
  - The bankruptcy court determined that the FTB met its burden of proving by clear and convincing evidence that the debtors' treasury functions "were qualitatively different from [their] principal business and that the overall quantitative difference in applying the standard formula supported the application of the alternative apportionment method."

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# Invoking Alternative Apportionment: Reasonable Alternative

- California uses alternative apportionment to combat inclusion of treasury receipts in the sales factor
  - *Microsoft Corp. v. Franchise Tax Bd.*, 139 P.3d 1169 (Cal. 2006)
    - California Supreme Court found that although gross receipts from treasury function were to be included in the sales factor per California statutes, that inclusion of Microsoft's gross receipts from its treasury function in its sales factor was distortive
    - "Microsoft's short-term investments produced less than 2 percent of the company's income, but 73 percent of its gross receipts."
  - *General Motors Corp. v. Franchise Tax Bd.*, 139 P.3d 1183 (Cal. 2006)
  - *General Mills v. Franchise Tax Bd.*, 172 Cal.App.4th 1535 (Cal. App. 2009), on remand, Case No. CGC05-439929 (San Fran. Super. Ct., Nov. 1, 2010)

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# Invoking Alternative Apportionment: Reasonable Alternative

- Alternative Formula is Not Reasonable
  - *Montgomery Ward LLC v. Cal. Franchise Tax Bd.*, Docket No. GIC 802767 (Cal. Super. Ct., San Diego Cnty, Dec. 10, 2007)
    - Taxpayer included treasury gross receipts in the denominator of the sales factor.
    - The court refused to allow the FTB to apply an alternative method based on the inclusion of net investment receipts, because treasury income constituted a significant portion of unitary income. Treasury income constituted 14.23% of unitary income.
    - Court held that FTB failed to meet its burden of proof for both prongs—the standard formula is not a fair representation of the taxpayer’s business activity and its proposed alternative is reasonable.
  - Note: net investment income from the treasury function has been found to produce reasonable and unreasonable result based on specific facts

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# Invoking Alternative Apportionment: Reasonable Alternative

- *Carmax Auto Superstores West Coast, Inc. v. S.C. Dep't of Revenue* (Docket No. 09-ALJ-17-0160-CC, Apr. 22, 2010)
  - Carmax's used motor vehicle sales operations are operated through two entities, Carmax East (with locations in South Carolina) and Carmax West (no South Carolina locations)
  - South Carolina DOR used alternative apportionment that effectively imposed separate accounting on Carmax West's income by the DOR only using Carmax West's royalty and financing receipts in South Carolina to those same receipts derived everywhere (i.e., the DOR excluded all other sales in Carmax West's denominator)



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# Invoking Alternative Apportionment: Reasonable Alternative

- The DOR also imposed a \$200,000+ negligence penalty on \$439,526 in assessed tax liability. Fortunately, the administrative law court dismissed the negligence penalty noting that “the Taxpayer filed in accordance with the statutory method as well as the tax return forms and instructions.”
- Carmax West argued that if a business is unitary, the alternative apportionment provisions should not apply. However, the court affirmed the alternative apportionment determination. The taxpayer is appealing this decision
  - Note: the taxpayer attempted to apply a different statutory apportionment formula in response to the auditor’s separate accounting alternative

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# Invoking Alternative Apportionment: Reasonable Alternative

- *CarMax Auto Superstores West Coast, Inc. v. S.C. Dep't of Revenue*, Op. No. 4953 (S.C. Ct. App. Mar. 14, 2012)
  - The court concluded that the Department bears the burden to prove both that the statutory formula does not fairly represent CarMax West's business activity in South Carolina, and that the Department's "alternative accounting method is reasonable and more fairly represents CarMax West's business activity in South Carolina."
  - The court remanded the case to the ALC.

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# Invoking Alternative Apportionment: Reasonable Alternative

- Taxpayers, however, should consider asserting alternative apportionment where appropriate
  - *Media General, Inc. et al. v. S.C. Dep't of Revenue*, 694 S.E.2d 525 (S. Car. 2010)
    - “The Department need not automatically use the method requested by the taxpayer as it has the discretion to select an alternative method that fairly measures the taxpayer's income in South Carolina.”
    - Upheld taxpayer’s assertion of alternative apportionment using combined filing method where state stipulated to fact that separate filing resulted in distortion.

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# Invoking Alternative Apportionment: Reasonable Alternative

- Some states have used disingenuous applications of existing law rather than alternative apportionment
  - *Ameritech Publishing, Inc. v. Wis. Dep't of Revenue*, 327 Wis.2d 798 (Wis. App. 2010) (unpublished), cert. denied, 793 N.W.2d 71 (Wis. 2010)
    - Receipts from telephone directory advertising services appearing in WI directories sourced to WI, achieving result similar to market sourcing, despite fact that statute applied COP approach and majority of costs were incurred out-of-state
  - Compare TN *Bellsouth Advertising* case above

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# **ALTERNATIVE APPORTIONMENT – PRACTICAL CONSIDERATIONS**

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# Practical Considerations

- Anticipating states' assertion of equitable apportionment, asserting alternative methods offensively
- Documentation (contemporaneous) is key
- Market sourcing changes will lead to tax return positions
- Identifying the applicable burden of proof

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# Practical Considerations

- The majority of states require the taxpayer to petition or request an alternative apportionment formula in advance
  - **California** – Requires prior approval from the FTB before filing a return using an alternative apportionment formula. Cal. Franchise Tax Bd. Notice No. 2004-5 (Aug. 6, 2004)
  - **Idaho** – A written request to use an alternative apportionment formula must be filed with the Tax Commission at least thirty (30) days prior to the due date for filing the return

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# Practical Considerations

- ***New York City*** recently changed its procedure for requesting alternative apportionment for the general corporation tax and unincorporated business tax
  - Taxpayers must now submit a written request, separate and apart from the entity's tax return describing the alternative method desired
  - "This is a change from the procedure that was in place in past years in which an alternative method could be requested by checking a box on the return and submitting information with the return." Requests for Permission to Use an Alternative Allocation Method (issued Feb. 3, 2012)



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# Practical Considerations

- Other States Require Pre-Approval and/or Alternative Apportionment be in the Form of Refund
  - **Illinois** – Must petition 120 days before return is due. If not within 120 days, taxpayer must file using statutory method and attach amended return applying alternative method

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# Practical Considerations

- Other States Require Pre-Approval and/or Alternative Apportionment be in the Form of Refund
  - ***New Mexico*** – Extensive pre-filing requirements.
    - Taxpayer must :
      - Submit written petition,
      - File return applying statutory formula (including amount of tax due under this method), and
      - Submit an amended return applying the requested method. In an appropriate case (the petition will be considered a claim for refund)

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# Practical Considerations

- Other States Require Pre-Approval and/or Alternative Apportionment be in the Form of Refund
  - **Michigan** –
    - **New corporate income tax** (effective January 1, 2012), if the taxpayer wants to use an alternative apportionment method, the taxpayer must petition the Department of Treasury. Mich. Comp. Laws Ann. § 206.667(1)
    - The filing of a return or an amended return is not considered a petition. Mich. Comp. Laws Ann. § 206.667(3)

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# Practical Considerations

- Other States Require Pre-Approval and/or Alternative Apportionment be in the Form of Refund
  - **Michigan** –
    - Similar provision existed under the **Michigan business tax**
    - *Sidney Frank Importing Co., Inc. v. Michigan Dep't of Treas.*, MTT Docket No. 383623 (Mich. Tax Trib. Oct. 5, 2011)
      - Michigan Tax Tribunal found that taxpayer failed to comply with requirement that it petition Department of Treasury before it could seek to use alternative apportionment method, therefore it waived its right to apportionment relief

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# Practical Considerations

- Violation of State Administrative Procedures Act?
- The broad application of Alternative Apportionment may violate state administrative procedures acts that limit a state agency's ability to rely on *ad hoc* adjudication when the adoption of a rule is more appropriate
- Query, is there a tension between applying alternative apportionment to a particular taxpayer due to its unique facts and circumstances?

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# Questions?

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