

## Trends and Developments in Alternative Apportionment of State Income

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In this edition of A Pinch of SALT, the authors report on the latest cases and regulatory efforts regarding alternative apportionment. They also update readers on the Multistate Tax Commission's amended model section 18, designed to provide fairness to taxpayers.

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In 1957 the National Conference of Commissioners on Uniform State Laws<sup>1</sup> (NCCUSL) adopted the Uniform Division of Income for Tax Purposes Act to set forth a uniform model approach for allocation and apportionment of multistate income. That original model statute used a three-factor apportionment formula that consisted of equally weighted sales, property, and payroll factors. The NCCUSL also anticipated the need for a relief provision that would allow for an alternative apportionment method when the statutory method failed to produce a result that fairly represented the extent of a taxpayer's business activity in a particular state. The NCCUSL accordingly included section 18 of UDITPA, which provides that if the allocation and apportionment provisions of UDITPA do not fairly represent the extent of a taxpayer's business activity in a state, the taxpayer may petition for — or the tax administrator may require — a different apportionment method to effectuate an equitable allocation and apportionment of the taxpayer's income. Most states have adopted some version of section 18.<sup>2</sup>

While alternative apportionment is an important relief mechanism to avoid unjust taxation, it is often used to justify the ad hoc administration of tax. Alternative apportionment should be equally available to taxpayers and administrators. Some recent cases, rulings, and an effort by the Multistate Tax Commission to rewrite its model regulations show a tilting of the playing

<sup>1</sup>The NCCUSL, also known as the Uniform Law Commission, is an organization comprising attorneys from every state with the stated purpose of "promoting uniformity in the law among the several States on subjects as to which uniformity is desirable and practicable." See NCCUSL Constitution, Article I.

<sup>2</sup>Many states have adopted the entirety of UDITPA as Article IV of the Multistate Tax Compact.

field by allowing greater access to alternative apportionment relief for the states and more limited access to state taxpayers.

This article will address recent cases, rulings, and developments among the states regarding alternative apportionment. That background provides important context for the many proposed regulations, including those considered in Massachusetts, Illinois, Oregon, Hawaii, and Alabama. Finally, the MTC's recent proposed regulations for UDITPA section 18 will be discussed. Many of those recent rules, far from facilitating the reasonable resolution of controversies, primarily provide tools to states to invoke alternative apportionment on assessment while denying taxpayers that same ability. The tax community should be wary of many of those changes because they generally serve to undermine the fundamentally important, and constitutionally required, flexibility provided by alternative apportionment.

## I. Recent Case Law Regarding Alternative Apportionment

### A. *Vodafone Americas Holdings Inc. v. Roberts*

On June 23, 2014, the Court of Appeals of Tennessee upheld the Tennessee commissioner of revenue's variance letter requiring the taxpayer in *Vodafone* to use market-based sourcing rather than the statutory cost-of-performance method.<sup>3</sup> In that case, the taxpayer challenged the Department of Revenue's denial of its refund claim on the basis that it was entitled to use the statutory cost-of-performance method in calculating its Tennessee sales factor numerator. After three years of litigation over the refund claim denial, the DOR commissioner issued the alternative apportionment "variation letter" requiring market-based sourcing.<sup>4</sup> Despite the variance letter's extremely late issuance, the court of appeals held that the letter sufficiently established that alternative apportionment was necessary.

<sup>3</sup>*Vodafone Americas Holdings Inc. v. Roberts*, No. M2013-00947-COA-R3-CV (Tenn. Ct. App. 2014).

<sup>4</sup>Tennessee has substantially adopted UDITPA section 18, allowing for "variances to standard determination of apportionment." Tenn. Code Ann. section 67-4-2014.

The basis for this decision was primarily that (1) while the taxpayer had a significant market in the state, it had very little cost of performance in the state, and (2) the telecommunications industry is sufficiently unique as a whole to justify deviation from Tennessee's statutory formula.

Because the Tennessee Supreme Court accepts only a small percentage of state tax petitions for review, many in the state and local tax community took the Tennessee Supreme Court's decision to hear the appeal as a positive sign that the court of appeals decision might be reversed.<sup>5</sup> The Tennessee Cable Telecommunications Association filed an amicus brief in which it explained that the court of appeals opinion "would expand the Commissioner's authority to impose a variance well beyond the taxpayer at issue . . . to the entire wireless telecommunications industry and potentially to numerous other industries and business sectors."<sup>6</sup> The supreme court, however, upheld the court of appeals decision.<sup>7</sup>

Notably, the Tennessee Supreme Court did not address the propriety of the very late issuance of the variance. Instead, the decision effectively concluded that because the taxpayer's income tax liability would be substantially larger under a market-based sourcing approach, the cost-of-performance approach did not reasonably reflect the taxpayer's business in the state. In reaching this conclusion, the court stated:

In the present case, during the Relevant Period, Vodafone's receipts for telecommunications services for Tennessee customers totaled over \$1.3 billion. If Vodafone were permitted to apply the COP method as it advocates in its refund request, this would drop its sales factor to slightly more than \$150 million, thereby excluding some 89

<sup>5</sup>See, for example, Peter L. Faber, "Inequitable Apportionment: A Bad Precedent in Tennessee," *State Tax Notes*, Apr. 25, 2016, p. 277.

<sup>6</sup>Brief of Amicus Curiae Tennessee Cable Telecommunications Association, *Vodafone Americas Holdings Inc. v. Roberts*, No. 07-1860-IV (Tenn. 2016). Attorneys from Sutherland Asbill & Brennan LLP, now Eversheds Sutherland (US) LLP, were involved in the drafting and filing of the Tennessee Cable Telecommunications Association brief.

<sup>7</sup>*Vodafone Americas Holdings Inc. v. Roberts*, M2013-00947-SC-R11-CV (Tenn. 2016).

percent of Vodafone's total Tennessee sales receipts. Thus, billions of dollars in Vodafone's revenue from Tennessee customers would become invisible for tax purposes under the standard franchise and excise tax apportionment formula.<sup>8</sup>

As the taxpayer and many others argued, however, the fact that less tax was owed should not have been the dispositive consideration of whether alternative apportionment was appropriate.<sup>9</sup>

At no point did either the commissioner or the Tennessee Supreme Court explain why the cost-of-performance method did not accurately measure the taxpayer's business activities in Tennessee. Instead, the commissioner summarily concluded that the cost-of-performance method resulted in too low of an income tax liability, and the supreme court upheld that treatment on the basis that the commissioner should be afforded significant deference in determining whether alternative apportionment was necessary. Indeed, the court concluded that in order for the taxpayer to prevail in the case, it "must prove that the variance imposed by the Commissioner constitutes an abuse of his discretion . . . in evaluating whether Vodafone has met its burden, we are required to defer to the legislature's policy decision to delegate discretionary variance authority to the Commissioner."<sup>10</sup> Hence, the court's ruling seems to invert the application of alternative apportionment: that is, rather than the

commissioner bearing the burden regarding the appropriateness of deviating from the statutory alternative method, the court required the taxpayer to show that the deviation was an abuse of discretion.

The *Vodafone* decision also raises significant separation of powers and due process concerns. It has historically been the case that the party advocating for alternative apportionment bears the burden of establishing that the statutory method does not adequately reflect how a business earns income in a state.<sup>11</sup> While the Tennessee Supreme Court paid lip service to the notion that the taxpayer in that case presented an "unusual fact situation" and that the cost-of-performance method produced "incongruous results," this analysis was entirely deterministic and relied only on the distinction between the results under cost-of-performance versus market-based sourcing. Absent from the analysis was that the legislature previously made the policy decision to measure income by the location of income-producing activity rather than the size of a market. The court's refusal to qualitatively explain why the cost-of-performance method was inappropriate thus undermined the prerogative of the legislature in adopting the cost-of-performance sourcing method. Moreover, the commissioner's adoption of the variance after litigation had been initiated undermined the taxpayer's right to consistent and transparent treatment by the DOR.

<sup>8</sup> *Id.*

<sup>9</sup> See Brief of Amicus Curiae Tennessee Cable Telecommunications Association, citing *Union Pacific Corp. v. Idaho State Tax Commission*, 83 P.3d 116, 120 (Idaho 2004) ("the mere fact that the alternative form of computation produces a higher business activity attributable to [the state] is not in and of itself a sufficient reason for deviating from the legislatively mandated formula"); *Donovan Construction Co. v. Michigan Department of Treasury*, 337 N.W.2d 297, 300 (Mich. Ct. App. 1983) (the mere fact that proposed method resulted in substantially greater tax liability than did statutory method was insufficient to justify variance); and *St. Johnsbury Trucking Co. Inc. v. State*, 385 A.2d 215, 217 (N.H. 1978) (holding that simply showing use of alternative formula produces a higher (or lower) result is an insufficient basis for setting aside the standard formula on equitable grounds). See also *Amoco Production Co. v. Arnold*, 518 P.2d 453, 464-66 (Kan. 1974); and *Donald M. Drake Co. v. Department of Revenue*, 500 P.2d 1041, 1042-1044 (Or. 1972).

<sup>10</sup> *Vodafone*, M2013-00927-R11 CV at 46.

<sup>11</sup> *Union Pacific*, 83 P.3d at 116 ("The party asserting alternative apportionment bears the burden of showing that alternative apportionment is appropriate"); *Microsoft Corp. v. Franchise Tax Board*, 139 P.3d 1169 (2006) ("As the party invoking [alternative apportionment] the 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"); and *St. Johnsbury Trucking*, 385 A.2d at 215 ("the party who wants to use an alternative formula accordingly has the burden of showing that the alternative is appropriate").

State	Must Request Alternative Apportionment With Original Return	Must Pay Full Tax Using Statutory Method	Different Burden on State and Taxpayer	Alternative Formula Valid Until	Deemed Denied After
Massachusetts	X	X	X	3 years	9 months
Illinois	X	X <sup>a</sup>			
Oregon		X		Revoked	
Hawaii			X		
Alabama		X			90 days
South Carolina		X		Change in material law or facts	
<sup>a</sup> The taxpayer must pay tax using the statutory method only if the taxpayer does not request alternative apportionment within 120 days of the deadline for filing its return.					

### **B. *Rent-A-Center West Inc. v. Department of Revenue***

Fortunately, in *Rent-A-Center West*,<sup>12</sup> the South Carolina Court of Appeals took an approach that reflects the purposes of alternative apportionment and denied the South Carolina DOR's attempt to deviate from the statutory formula. Relying on two recent cases, *Carmax I* and *Carmax II*,<sup>13</sup> the court of appeals noted that the proponent of an alternative apportionment formula bears the burden of proving that alternative apportionment is necessary based on a preponderance of the evidence. In *Rent-A-Center West*, the taxpayer was engaged in a unitary business that involved both retail selling and licensing of intangibles. However, no retail sales occurred in South Carolina. The department argued that including the retail sales in the denominator of the apportionment factor distorted the taxpayer's business in the state because only the royalty payments on the licensing of intangibles were in the numerator of the factor. The court concluded that the apportionment method was working exactly as intended; because a very small amount of the taxpayer's business came from royalties, it

made sense that those receipts should include only a small amount of its apportionment in South Carolina. The department's "bald assertions" that including retail receipts in the denominator would distort the taxpayer's income earned in the state thus did not satisfy the department's burden of proving the threshold question whether the statutory formula represented the taxpayer's business in South Carolina.<sup>14</sup>

### **C. *Corporate Executive Board v. Virginia Department of Taxation***

Interestingly, a decision at the Circuit Court of Arlington County, Virginia, addressed a very similar issue to the one presented in *Vodafone*.<sup>15</sup> In that case, the taxpayer sought to deviate from the state's cost-of-performance apportionment method in favor of a single-sales-factor, market-based sourcing approach. The taxpayer, Corporate Executive Board (CEB), was thus essentially seeking an identical variance to that required by the commissioner in *Vodafone* on the basis that it did not have significant sales to Virginia customers and its tax liability should not have been calculated in Virginia based on its more extensive income-producing activities performed

<sup>12</sup> *Rent-A-Center West Inc. v. Department of Revenue*, 792 S.E.2d 260 (S.C. Ct. App. 2016).

<sup>13</sup> *Carmax Auto Superstores West Coast Inc. v. Department of Revenue*, 725 S.E.2d 711 (S.C. Ct. App. 2012); and *Carmax Auto Superstores West Coast Inc. v. Department of Revenue*, 767 S.E.2d 195 (2014).

<sup>14</sup> *Rent-A-Center West Inc.*, 792 S.E.2d at 332-333.

<sup>15</sup> *Corporate Executive Board v. Virginia Department of Taxation*, No. CL 13-3104 (Va. Cir. Ct. 2016).



in the state. In assessing the taxpayer's request for a variance, the court made the following observation:

A challenge to the constitutionality of the Statutory Method carries a showing by clear and cogent evidence; a challenge to the equity of that method requires a showing by the preponderance of the evidence; and whether CEB's proposed method was better calculated to assign CEB's income also requires proof by a preponderance of the evidence.

However, the court added that the "Statutory Method was inequitable if it produced a result of double taxation that was attributable to Virginia rather than to another unique method used in some other state. . . . The record is void of evidence for the Court to find that, were inequity to exist, it was attributable to Virginia rather than to another unique method used in some other states."<sup>16</sup>

While the *CEB* court was correct in stating that a party challenging the statutory method should be held to a preponderance of the evidence standard, the language in the decision suggests that this showing requires proof that double taxation would result from application of the standard formula. Of course, the proof required should not be whether the application of apportionment results in double taxation or a violation of the Constitution; rather, the party moving for alternative apportionment need only show that the statutory formula does not result in taxing income that is reasonably attributable to business or other sources in Virginia.<sup>17</sup> Nonetheless, the court concluded that the record was void of evidence for it to find any inequity. This analysis is at odds with the *Vodafone* decision, in which the court reached its conclusion based on the extent of the liability resulting from the different approaches.

## D. Arkansas and Indiana Department of Revenue Rulings

Tennessee is not alone in granting tax administrators significant discretion in determining whether alternative apportionment is appropriate. In a June 2016 ruling, the Arkansas Department of Finance and Administration Office of Hearings and Appeals also applied an "abuse of discretion" standard in finding that the Department of Finance and Administration's use of market-based sourcing rather than the statutory method was appropriate.<sup>18</sup> The department did not undertake an analysis and did not make a specific finding that the statutory formula was inappropriate. With no discussion or analysis, the administrative law judge concluded that because the taxpayer made numerous sales into the state, the department did not abuse its discretion in requiring market-based sourcing.

However, the Indiana DOR agreed with a taxpayer that the department could not use its alternative apportionment authority to disregard a transfer pricing study prepared for the taxpayer.<sup>19</sup> In that case, the department attempted to adjust the taxpayer's gross operating margin on the ground that the original method of reporting did not fairly reflect the taxpayer's income earned in Indiana. The department thus adjusted the gross operating margin under its alternative apportionment authority. Although the department's letter of findings stated that it was the taxpayer's responsibility to establish that the department's tax assessment was incorrect,<sup>20</sup> it ultimately held that the taxpayer's transfer pricing study adequately documented the gross operating margin and that

<sup>18</sup> State of Arkansas Department of Finance and Administration Office of Hearings & Appeals, Nos. 16-267, 16-269, and 16-269 (June 21, 2016). Notably, in the Arkansas decision, the department never issued a variance letter. Instead, it merely denied a refund claim, which the administrative law judge interpreted as a variance.

<sup>19</sup> Indiana Department of Revenue, Letter of Findings No. 02-20150117 (Sept. 13, 2016).

<sup>20</sup> Notably, despite its holding, the department appears to have applied the incorrect standard here. This requirement again puts the burden on the taxpayer to show that alternative apportionment is not warranted. However, in the context of alternative apportionment, the moving party, whether the taxpayer or the tax administrator, bears the burden. Thus, while the department ultimately concluded that the taxpayer satisfied its burden, the correct approach would have required the department to prove alternative apportionment was appropriate.

<sup>16</sup> *Id.*

<sup>17</sup> Va. Code Ann. section 58.1-421.

the department could not merely disregard the transfer pricing study. Consequently, the taxpayer's protest of the department's claim denial was upheld.

### **E. *Target Brands Inc. v. Department of Revenue***

In another recent case, the District Court of Denver ruled in *Target Brands Inc. v. Department of Revenue*<sup>21</sup> that while the statutory apportionment formula did not adequately reflect how a Minnesota intangible holding company earned income in the state, the department did not present a reasonable alternative. In that case, the taxpayer had substantial property and payroll outside Colorado, but neither its property nor payroll was located in Colorado. Moreover, because the state used an income-producing activity test in calculating the sales factor in the state, no sales would be attributed to the state, thus resulting in the taxpayer's owing no income tax to Colorado. In that respect, the court stated:

As far back as 1985, California adopted a regulation that broadly instructed licensors to use a market-based sales factor. The MTC, as well, modified its model sales factor regulation in 2014 to incorporate market sourcing of receipts from intangibles. The Department has adopted industry-wide regulations for other industries, such as broadcasters, that embrace market sourcing. . . . However, the Department never promulgated a comparable regulation for IP licensors.

The Court is disinclined to permit the Department to accomplish indirectly what neither it nor the General Assembly could have done, but did not do, directly and expressly. . . . Nevertheless, for the reasons previously expressed, the Court concludes that it was not inappropriate for the Department to invoke Section 18 here. Section 18, in essence, is a safety valve to address unusual circumstances. Its purpose would be negated if it could not be applied when the Department arguably was slow to recognize that the possibility of such circumstances existed.<sup>22</sup>

<sup>21</sup> Case 2015CV33831 (Colo. Dist. Ct. 2017).

<sup>22</sup> *Id.* at paras. 69, 70.

However, the department's proposed alternative apportionment formula involved eliminating all three of the taxpayer's apportionment factors (property, payroll, and sales). In their place, the department used a single new factor to apportion the taxpayer's income: the sales factor of its parent, which had sales in the state. The court concluded, however, that the record was "replete with evidence of the material contributions made by [the taxpayer's] employees and property toward creating, enhancing, and preserving the income the department seeks to tax."<sup>23</sup> Thus, any alternative apportionment formula would necessarily require the taxpayer's payroll and property factors to be in the calculation of its income attributable to Colorado. The court did not state whether using the taxpayer's parent's sales factor was reasonable.

### **F. *Petition of Staples Inc., Appealing the Decision of the Maryland Tax Court***

Finally, the Circuit Court for Anne Arundel County, Maryland, upheld the comptroller's decision to deviate from the state's statutory apportionment formula, stating that the taxpayer "carried the burden of proving, by clear and cogent evidence, that the Comptroller's non-statutory formula produced a tax liability out of all appropriate proportion to the business transacted in Maryland, or led to a 'grossly distorted result.'"<sup>24</sup> In that case, the comptroller deviated from the statutory three-factor apportionment formula.<sup>25</sup> Maryland law provides that "to reflect clearly the income allocable to Maryland, the Comptroller may alter, if circumstances warrant," the statutory apportionment formula.<sup>26</sup> Rather than require the comptroller to demonstrate that the circumstances warranted a deviation from the statutory formula,

<sup>23</sup> *Id.* at para. 73.

<sup>24</sup> *Petition of Staples Inc. and Staples the Office Superstore LLC*, Case No. C-02-CV-15-0020009 (Cir. Ct. Ann. Arundel, Dec. 30, 2016).

<sup>25</sup> See Md. Code Ann. section 10-402 of the Tax — General Article (TG). Notably, the comptroller's use of alternative apportionment here was similar to the alternative approach taken in *Gore Enterprise Holdings Inc. v. Comptroller*, 437 Md. 492 (2014), which the court of appeals upheld.

<sup>26</sup> TG 10-402(d).

however, the court referred to *Moorman Manufacturing Co. v. Bair*<sup>27</sup> for the proposition that “states have wide latitude in the selection of apportionment formulas and that a formula produced assessment will only be disturbed when the taxpayer has proved by ‘clear and cogent evidence’ that the income attributed to the State is in fact ‘out of all appropriate proportion to the business transacted . . . in that State’ or has ‘led to a grossly distorted result.’”<sup>28</sup> Because the taxpayer did not demonstrate that the use of the alternative apportionment formula clearly produced a “disproportionate, distorted, arbitrary, or unreasonable tax liability,” the court upheld the comptroller’s alternative apportionment formula.<sup>29</sup>

In *Moorman*, the U.S. Supreme Court upheld Iowa’s use of a single-sales-factor apportionment formula. However, that single sales factor was prescribed by statute. The taxpayer in *Moorman* brought a challenge, claiming that the formula led to a grossly distorted result in its income tax liability and that the formula discriminated against interstate commerce, among other claims.<sup>30</sup> The Court concluded that Iowa had wide latitude in the selection of its apportionment formula.<sup>31</sup> However, the *Moorman* Court did not address whether the Iowa DOR had wide latitude in deviating from the statutory apportionment formula.

As the Tennessee Supreme Court did in *Vodafone*, the Circuit Court for Anne Arundel County inverted the burdens for which a party should have been required to demonstrate distortion of the apportionment factor. Indeed, the circuit court’s decision appears to stand for the proposition that the comptroller may deviate from the statutory apportionment formula at any time, subject to limitation only when its alternative apportionment produces a distorted result. Of course, that raises serious questions regarding the purpose of the statutory formula. If

the comptroller is not required to show that the circumstances warranted deviation from the statutory formula, as the state statute appears to require, the comptroller will apparently be free to adopt varied apportionment formulas in an ad hoc and nontransparent fashion. As with *Vodafone*, the *Staples* decision raises serious separation of powers considerations, given that the Maryland General Assembly has adopted a statutory apportionment formula and created a procedure for deviating from the statutory formula when it produces a distortive result.

## II. Recent State Regulatory Efforts to Address Alternative Apportionment

Perhaps as a result of the intensifying litigation surrounding alternative apportionment, states have begun adopting regulations that require the uneven treatment of taxpayers and tax administrators in the context of alternative apportionment. In the last year, Massachusetts, Illinois, Oregon, Hawaii, Alabama, and South Carolina have adopted rules on alternative apportionment. As demonstrated in the table, the recent adopted and proposed regulations almost uniformly make it easier for states to use alternative apportionment while erecting obstacles for taxpayers.

### A. Massachusetts

Massachusetts adopted numerous amendments to its alternative apportionment regulations that are among the most onerous for taxpayers. Under the existing regulations, the taxpayer must request alternative apportionment when it files its tax return and file its return (and pay tax) using the statutory method.<sup>32</sup> If the commissioner grants a taxpayer’s petition, the taxpayer must then file a refund claim for its overpayment of tax.<sup>33</sup>

The Massachusetts regulations also place a disparate burden on taxpayers applying for alternative apportionment. The taxpayer must show by “clear and cogent evidence” that the statutory method does not fairly reflect the

<sup>27</sup> *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978).

<sup>28</sup> *Petition of Staples*, at \*6.

<sup>29</sup> *Id.* at \*7.

<sup>30</sup> *Moorman*, 437 U.S. at 274-276.

<sup>31</sup> *Id.* at 274.

<sup>32</sup> Mass. Gen. Laws ch. 63, section 42; 830 Mass. Code Regs. 63.42.1(3)(a).

<sup>33</sup> 830 Mass. Code Regs. 63.42.1(3)(b)2.

taxpayer's in-state business activities.<sup>34</sup> On the other hand, the commissioner may use his or her "judgment" in deciding whether to grant the application, and the regulation does not provide any specific standard to which the commissioner's "judgment" must adhere.<sup>35</sup> If the commissioner does not act on an application for alternative apportionment within nine months, the application is deemed denied.<sup>36</sup>

Under the proposed Massachusetts regulations, a taxpayer can use an alternative apportionment formula for up to three years.<sup>37</sup> Also, in the context of a combined report, the proposed regulations would direct the commissioner to look at the overall combined group's apportioned income in determining whether the individual member of the combined group is entitled to alternative apportionment.<sup>38</sup> That kind of approach, however, ignores the actual business activity conducted by the taxpayer in the state. Unfortunately, the Massachusetts regulations may provide a blueprint for states seeking to undermine the rights of taxpayers in reaching a fair apportionment method.

## B. Illinois

In December 2016 the Illinois DOR proposed to amend its alternative apportionment regulation. A taxpayer seeking alternative apportionment for years ending on or after December 31, 2008, would have to show that the statutory formula results in taxation that is out of all proportion to the "market for the taxpayer's goods, services or other sources of business income in" Illinois.<sup>39</sup> Thus, to obtain alternative apportionment, a party must show that the statutory method either "results in the taxation of extraterritorial

values" or "unreasonably and arbitrarily" attributes income to Illinois that is out of proportion with the taxpayer's business transacted in the state.<sup>40</sup> Either showing is a high bar compared with the standard set forth by Illinois statute, which requires that a party show that the statutory formula does not "fairly represent the extent of a person's business activity in" Illinois.<sup>41</sup>

Most concerning is that under the proposed amendments, a taxpayer may not raise alternative apportionment in a protest or petition regarding a notice of deficiency unless either the taxpayer has requested that the auditor allow the use of alternative apportionment and was denied or "the audit disallows an alternative method of apportionment used by the taxpayer on its return."<sup>42</sup> Under the current regulations, a taxpayer is prevented from raising alternative apportionment in an administrative protest or petition to the Illinois Independent Tax Tribunal only when the alternative apportionment petition could have been submitted proactively, or, as the regulations explain, when "the petition for an alternative apportionment formula is not necessitated by the proposed adjustments made to the taxpayer's return during the course of the audit."<sup>43</sup> Thus, the proposed regulations attempt to eliminate a taxpayer's ability to invoke alternative apportionment when the only reason for alternative apportionment may be adjustments made by the department on audit that could not have been anticipated on the taxpayer's original return, let alone 120 days before the due date of the tax return, when an alternative apportionment petition must be filed.

<sup>34</sup> 830 Mass. Code Regs. 63.42.1(7)(c).

<sup>35</sup> 830 Mass. Code Regs. 63.42.1(7).

<sup>36</sup> 830 Mass. Code Regs. 63.42.1(7)(e).

<sup>37</sup> Proposed 830 Mass. Code Regs. 63.42.1(5)(c).

<sup>38</sup> Proposed 830 Mass. Code Regs. 63.42.1(8).

<sup>39</sup> Proposed Ill. Admin. Code tit. 86, section 100.3390(a). The existing regulations allow for alternative apportionment only if the statutory formula does not fairly represent the extent of the taxpayer's business activity in Illinois.

<sup>40</sup> Proposed Ill. Admin. Code tit. 86, section 100.3390(c). The existing regulations are conjunctive instead of disjunctive and require the party seeking alternative apportionment to show that the statutory method both "results in the taxation of extraterritorial values" and "unreasonably and arbitrarily" attributes income to Illinois that is out of proportion with the taxpayer's business transacted in the state. This distinction is important because the previous standard virtually required a showing of unconstitutional distortion in order to obtain alternative apportionment.

<sup>41</sup> 35 ILCS 5/304(f).

<sup>42</sup> Ill. Admin. Code tit. 86, section 100.3390(e)(3).

<sup>43</sup> *Id.*



## C. Hawaii

In April 2016 Hawaii added a new regulation and amended its existing regulations regarding alternative apportionment.<sup>44</sup> Under the new regulations, the taxpayer's petition for alternative apportionment must "include data clearly showing" that the statutory formula "does not result in a reasonable attribution of net income to Hawaii because of the peculiar nature of the taxpayer's business and that the taxpayer's proposed method more clearly reflects income attributable to Hawaii."<sup>45</sup> However, the new regulations do not require the same "clear showing" by the state and allow the director of the Department of Taxation to require a taxpayer to use an alternative apportionment method if the director "determines" that the statutory method is distortive.<sup>46</sup> Notably, Hawaii's new regulations require the taxpayer petitioning for alternative apportionment to inform the director of the extent to which the taxpayer's proposed method of apportionment is being used in other states.<sup>47</sup>

## D. Alabama

In November 2016 Alabama adopted extensive regulations regarding alternative apportionment, including several special rules governing specific industries.<sup>48</sup> Under the Alabama regulations, taxpayers may not use an unapproved alternative formula on an original return.<sup>49</sup> Only after the department has approved a petition can the taxpayer file an original return or an amended return using the alternative formula.<sup>50</sup> If a taxpayer's petition is denied or deemed denied,<sup>51</sup> the taxpayer should file an

amended return using the alternative formula.<sup>52</sup> Notably, the Alabama regulations do not describe the burden of proof by which a taxpayer must prove that the statutory method does "not fairly represent the extent of the taxpayer's business activity in Alabama."

## E. South Carolina

In June 2015 the South Carolina issued two revenue rulings regarding alternative apportionment instead of adopting new administrative regulations.<sup>53</sup> Rev. Rul. 15-5 provides that the burden is on the party seeking an alternative formula to prove by a preponderance of the evidence that "(1) the statutory formula does not fairly represent the taxpayer's business activity in South Carolina and (2) its alternative accounting method is reasonable."<sup>54</sup> Taxpayers must use the statutory method of apportionment until the department grants permission to use an alternative formula.<sup>55</sup>

Rev. Rul. 15-2 elaborates on the procedure for requesting alternative apportionment including that a request for alternative apportionment may be filed at any time.<sup>56</sup> It requires, among other things, an explanation of why the statutory method should not be used; a projection of the taxpayer's net income attributable to South Carolina in the tax year the new allocation/apportionment method would commence and for three years thereafter; and a statement on whether the taxpayer has made requests to any other states to use an alternative apportionment method and the result of those requests.<sup>57</sup> Taxpayers in South Carolina must use the alternative formula until permission is revoked by the department.<sup>58</sup>

<sup>44</sup> Hawaii Department of Taxation, Amendments to Chapter 18-235, Hawaii Administrative Rules (Apr. 2, 2016). The alternative apportionment statute generally mirrors the MTC's model regs. Haw. Rev. Stat. section 235-38.

<sup>45</sup> Haw. Code R. section 18-235-5-05(b)(1).

<sup>46</sup> Haw. Code R. section 18-235-5-05(a).

<sup>47</sup> Haw. Code R. section 18-235-5-05(b)(2).

<sup>48</sup> Alabama Department Revenue, Administrative Rules. The special industries rules include airlines, construction, publishing, railroads, TV and radio broadcasting, and telecommunications service providers. Ala. Code sections 810-27-1-.18.01 through .18.07.

<sup>49</sup> Ala. Code section 8 10-27-1-.18(2)(d)2.

<sup>50</sup> Ala. Code section 8 10-27-1-.18(2)(c).

<sup>51</sup> A proposed alternative apportionment method is deemed denied if not approved within 90 days. Ala. Code section 8 10-27-1-.18(2)(d).

<sup>52</sup> Ala. Code section 8 10-27-1-.18(2)(d)1.

<sup>53</sup> S.C. Department Revenue, Rev. Rul. No. 15-5 (June 12, 2015); and S.C. Department Revenue, Rev. Rul. No. 15-2 (June 12, 2015).

<sup>54</sup> Rev. Rul. 15-5 (citing *Carmax Auto Superstores West Coast*, 767 S.E.2d at 195).

<sup>55</sup> Rev. Rul. 15-2.

<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

<sup>58</sup> *Id.*

### III. The MTC's Amended Model Section 18

In light of the litigation and regulatory activity regarding alternative apportionment, in 2014 and 2015, the MTC adopted recommended amendments to UDITPA section 18 that on their face provide some fairness to taxpayers. However, the amendments are only recommendations, and states are free to adopt whatever rules and regulations they prefer, as is evident from the clear lack of uniformity described above.

The MTC's model section 18 amendments require that the party petitioning for alternative apportionment relief prove, by a standard of proof to be chosen and expressly set forth in the amended section 18 language by the adopting state, both (i) that the existing statutory allocation and apportionment provisions do not fairly represent the extent of the taxpayer's activity in the state, and (ii) that the alternative method proffered by the petitioning party is reasonable. The recommended amendments also provide that the same burden of proof will apply to taxpayers and state tax administrators equally, theoretically putting taxpayers and tax administrators on equal footing. However, the model regulation provides a burden of proof exception applicable to tax administrators that is triggered when the taxpayer used an allocation or apportionment method in two of the prior five years that differs from the method used in the other years. In those instances, the tax administrator may impose a different apportionment method without being required to meet the standard of proof adopted by the state.

The amendments also provide that if a taxpayer has received written permission from the tax administrator to use a reasonable alternative apportionment method, that permission cannot be revoked regarding transactions and activities that have already taken place unless there has been a material change in, or material misrepresentation of, the facts provided by the taxpayer on which the tax administrator reasonably relied when granting the permission. Further, in a rebuke of the 2013 Mississippi case *Equifax Inc. v. State Tax Commission*,<sup>59</sup> if a tax administrator requires

application of an alternative apportionment method to a taxpayer, the recommended amendments provide that the tax administrator cannot impose any civil or criminal penalty on the taxpayer stemming from the taxpayer's reasonable reliance solely on the standard allocation and apportionment provisions. Because penalties were also imposed in *Vodafone*, that change could greatly reduce the inequity in many states' approaches to alternative apportionment.

Finally, the recommended amendments grant express authority to tax administrators to uniformly apply alternative apportionment methods to particular industries with business activity in the subject state that is deemed unfairly represented by the standard allocation and apportionment provisions. The taxpayer may still petition for, or the tax administrator may require, adjustment of those industrywide alternative apportionment methods under section 18(a).

Following the MTC's adoption of those recommended amendments to section 18, the commission formed a working group to devise and draft model regulations to interpret and implement the section 18 amendments. The working group comprises primarily state tax administrators and MTC representatives, though taxpayer and public comments and participation are encouraged.

For most of 2016 and into 2017, the working group has focused on drafting a model regulation to address perceived sales factor distortion when a taxpayer has taxable income in a given state but less than 3.33 percent "receipts" derived from transactions and activities in the taxpayer's regular course of business that are not otherwise allocable under Article IV (that is, not derived from the lease, license, or sale of tangible personal property, real property, intangible property, or services). The working group's foundational concern driving that regulation stems from a worry that such "special purpose entity" taxpayers (for example, pure holding companies, dividend recipients, etc.) may have apportionable base income but no apportionment factors in single-sales-factor states.<sup>60</sup>

<sup>59</sup> 125 So.3d 36 (Miss. 2013).

<sup>60</sup> Section 18 Working Group status memorandum to MTC Uniformity Committee (Dec. 8, 2016).

The draft model regulation prescribes the following rules for assigning particular gross receipts:

- (1) dividends from related parties are to be assigned using the apportionment factors of the dividend payer or its related parties generating the underlying earnings;
- (2) capital gains (but not capital losses) from the disposition of stock or other intangible property rights representing ownership in an entity that is or was functionally connected to the taxpayer's unitary business activities are to be assigned according to the entity's average apportionment factors from the preceding year;
- (3) financial institution receipts are to be assigned to the extent called for by the state's financial institution receipts factor rules;
- (4) accounts receivable not otherwise assigned under the previous rule shall be assigned to the extent such amounts are collected from borrowers in the state; and
- (5) net amounts of investment activity receipts not assigned by the previous rules are to be assigned to the extent covered by the state's financial institution receipts factor rules, or otherwise to the state in which such investments are managed.

The first alternative sourcing rule to the above primary sourcing rules in multiple-factor states is to source income according to property and payroll factors, and the first default sourcing rule in single-sales-factor states is to source according to combined or consolidated group factors (in states using those methods) or based on the receipts factor of the preponderant owner of the business entity, if identifiable (in separate-filing states). Most recently, the working group has been grappling with whether to include a throwout rule in the model regulation that would eliminate receipts that would be assigned to a jurisdiction where the taxpayer is not taxable. In light of the rapid pace at which states are adopting their own regulations affecting taxpayers' rights to alternative apportionment, it will be important to monitor whether the MTC's model rules help to create uniformity and fairness for taxpayers.

## IV. Conclusion

For many years, alternative apportionment has been used by states and taxpayers alike in order to ensure that state income taxes cover an amount of income that is fairly attributable to a given state. However, alternative apportionment has often been applied unevenly so as to enable tax administrators to easily deviate from the statutory formula while providing a more significant hurdle for taxpayers seeking a similar deviation. While some recent cases have shown that taxpayers can be successful in pushing back against state attempts to use alternative apportionment, states have also recently begun to adopt regulations that will significantly undermine the ability of taxpayers to effectively use alternative apportionment in order to fairly reflect how they earn income in those states. States attempting to amend existing regulations or statutes should consider adopting more equitable rules, and taxpayers should remain vigilant so that this important component of state income tax to which they are constitutionally entitled is not undermined any further. ■