

Seeking Apportionment for a Fair Reflection of Business Activity? Which is the Fairest of Them All?

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Agenda

- History of UDITPA Section 18
- Situations Where Section 18 Is Used
- Examples of Application of Section 18 in Case Law
- What Is “Distortion”?
- Burden of Proof / Are Extraordinary Circumstances Required?
- Procedure for Asserting Relief / Identifying Reasonable Remedies

History of UDITPA Section 18

UDITPA Section 18 Standard

- Uniform Division of Income for Tax Purposes Act (UDITPA) was approved by National Commission on Uniform Laws as a Model Act in 1957
 - Addressed equitable allocation and apportionment of income via three-factor formula (property, payroll, sales).
 - Sec. 18 provided for variation when standard formula did not fairly represent the extent of the taxpayer's business activity.
- UDITPA (including sec. 18) was incorporated into the Multistate Tax Compact, Art. IV.

UDITPA Section 18 Standard

- Sec. 18 relief includes:
 - separate accounting;
 - 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.
- Principal drafter of the Act, Professor William Pierce, wrote:
 - departures from the basic formula should be avoided except where reasonableness requires. Nonetheless, some alternative method must be available to handle the constitutional problems 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.

“Fair Apportionment”

- State apportionment formula must satisfy Due Process and Commerce Clauses.
 - Commerce Clause requires that income be fairly apportioned (*Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983)).
 - Fair = internally/externally consistent, not discriminatory
- BUT Sec. 18 “not confined to correcting unconstitutional distortions.”
 - (*Microsoft Corp. v. Franchise Tax Bd.*, 39 Cal. 4th 750 (2006); *Twentieth Century Fox Film Corp. v. Department of Revenue*, 700 P.2d 1035, 1039–1040 (Or. 1985))

Situations Where Section 18 Is Used

Situations Where Section 18 Is Used

- **Individual Taxpayer Situations:** UDITPA Section 18 has primarily been used by *states* in audits or litigation to modify a taxpayer's use of a standard apportionment formula. Much less frequently, taxpayers have successfully asserted Section 18 in audits or litigation to change the standard apportionment formula.
- **Taxpayer Petitions:** Taxpayers have had occasional success in petitioning states to approve in advance modifications to the standard apportionment rule, although it is still uncommon for states to agree to this.
- **Special Apportionment Regulations:** UDITPA Section 18 is the basis for states' adoption of various special apportionment regulations, most of which are focused on specific industries. In these situations, the states are determining that the standard rules do not fairly apportion the income of broad groups of taxpayers and those rules should be modified.

UDITPA Section 18 Regulations

- **Can Regulations Promulgated Under Section 18 Be Modified By Section 18 Itself?**
 - In theory, it is possible to modify Section 18 apportionment regulations in individual taxpayer situations.
 - Same burden for proving need for Section 18 relief should apply, as discussed below.
 - As a practical matter, states likely would resist modifying special apportionment rules except in truly unique situations.
- **Are Broad Regulations That Apply to All Taxpayers Appropriate Under Section 18?**

Examples of Application of Section 18 in Case Law

Recent Alternative Apportionment Cases

- California
 - Excluding Treasury Receipts from Sales Factor
 - *Microsoft Corp. v. FTB*, 139 P.3d 1169 (Ca. 2006)
 - *General Motors Corp. v. FTB*, 139 P.3d 1183 (Ca. 2006)
 - Excluding Receipts from Hedging Transactions from Sales Factor
 - *General Mills, Inc. v. FTB*, 146 Cal.Rptr.3d 475 (Cal. Ct. App. 1st Dist., Aug. 29, 2012).

Recent Alternative Apportionment Cases

- Other States
 - Allowing Unitary Combination in Separate Entity States
 - *Media General Communications, Inc. v. South Carolina Department of Revenue*, 694 S.E.2d 525 (S.C. 2010)
 - Allowing Use of Separate Accounting
 - *CarMax Auto Superstores West Coast, Inc. v. South Carolina Dept. of Rev.*, 725 S.E.2d 711 (S.C. App. 2012), *cert. granted*, No. 2012-212203 (S.C. Aug. 29, 2013)
 - Allowing Use of Market-Based Sourcing in COP States
 - *Equifax, Inc. v. Mississippi Department of Revenue*, 125 So. 3d 36 (Miss. 2013), *rehearing denied* (Miss. 2013), *cert. denied* 134 S.Ct. 2872 (2014)
 - *Vodafone Americas Holdings, Inc. v. Roberts*, No. M2013-00947-COA-R3-CV (Tenn. Ct. App. June 23, 2014), *cert filed* (Tenn. 2014)
 - *BellSouth Advertising & Publishing Corp. v. Chumley*, 308 S.W.2d 350 (Tenn. Ct. App. 2009)

What Is “Distortion”?

What is Distortion?

- Section 18 provides: “If the allocation and apportionment provisions...do not fairly represent the extent of the taxpayer’s business activity in this state.”
- Commerce Clause requires that the “apportionment formula must be fair and reflect a reasonable sense of how income is generated.”

What is Distortion? (cont'd)

- “Distortion is not proved by comparing results. To determine whether there is distortion, the analysis must focus on the relationship between the apportionment factors and the taxpayer’s business activity providing the taxable income...Measuring income by factors which are unrelated to the production of income can result in unfair apportionment”.
(*Crocker* (OR))

How Do You Prove Distortion?

- *Microsoft* held that the party seeking to prove distortion must demonstrate both qualitative and quantitative distortion in treasury cases.
- What is qualitative distortion?
 - Activities in question are qualitatively different from the taxpayer's principal business activities.
- What is quantitative distortion?
 - The quantitative differences between the standard apportionment formula and the proposed alternative must be significant.

Qualitative Distortion

- Key question is determining what are the taxpayer's principal business activities.
- Compare/contrast *Microsoft* (treasury function activities ancillary to principal business activities) with *Merrill Lynch* (broker dealer activities a fundamental segment of taxpayer's financial services business)
- Where does *General Mills* (commodity /price hedging) fall?

Quantitative Distortion

- While rough approximation is permissible, when is a formula too rough?
- Must look at the entire formula, not just one factor.
- Is the formula assigning too much or too little income to California? What about to other states?
- Is there a significant aspect of the business which is not properly reflected in the formula?
- Are the profit margins of various aspects of the business disparate?
- How significant are the differences between the income assigned to California under the standard formula and the proposed alternative?
- Whether sufficient quantitative distortion exists may be dependent upon which quantitative test is applied.
- No bright line percentages.

Intrastate Apportionment

- Query, can distortion exist in intrastate apportionment?
 - Purpose of intrastate apportionment is to determine the California tax liability of each taxpayer member of the unitary group.
 - Since the tax liability of an individual taxpayer member is determined under RTC 25101 and UDITPA, RTC 25137 relief is appropriate where intrastate apportionment has resulted in a distortion of a taxpayer member's California tax liability.

Intrastate Apportionment (cont'd)

- How can distortion arise in intrastate apportionment?
 - Most common situation is when intercompany transactions occur and the relative presence in California of a taxpayer member may be understated.
 - This may result in a mismatch between the apportionment factors for that taxpayer member and the income which it generated, thus causing its California tax liability to be overstated, because credits, for example, can not be fully utilized.
 - See FTB Legal Ruling 95-2 which required the use of intrastate apportionment of tax payments among unitary members when separate assessments/refunds are required.
 - Compare FTB Chief Counsel Ruling 2012-01 where the FTB states that intrastate apportionment is not a proper subject for analysis under RTC 25137.

Burden of Proof / Extraordinary Circumstances?

Burden of Proof: What Is Required

For taxpayers or states seeking alternative apportionment under Section 18, the burden of proof is on the party seeking alternative apportionment. The moving party must show:

That standard apportionment does not fairly represent the extent of the taxpayer's activities in the state (i.e. distortion), and

The proposed alternative is reasonable.

California does not follow the out-of-state cases requiring the moving party to show that the proposed alternative method more fairly represents the taxpayer's business activity in the state.

(E.g., CarMax Auto Superstores West Coast, Inc. v. South Carolina Dep't of Revenue, (2012) 397 SC 604, 725 SE2d 711, 714.)

Burden of Proof: Scope

Section 18:

- Only addresses whether the standard formula is a fair representation of the taxpayer's activities in the state.
- Does not address questions about the size of the tax base to which the formula is applied.
- The size of the tax base should already be decided before issues of alternative apportionment are addressed.

Burden of Proof: Statutory

The burden that must be carried is the statutory burden and not the burden to show that the constitution has been violated, which is generally a much higher standard that,

- " 'the income attributed to that State is in fact "out of all appropriate proportions to the business transacted ... in that State," [citation], or
- has "led to a grossly distorted result," [citation].' "

(Microsoft, supra, fn 16.)

Standard of Proof: California

The California Supreme Court held in *Microsoft Corporation v. Franchise Tax Board* (2006) 39 Cal 4th 750, 765, that the moving party "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) the "proposed alternative is reasonable."

Note: In South Carolina, the courts have held that the standard is a preponderance of the evidence. (*CarMax Auto Superstores West Coast, Inc. v. South Carolina Dep't of Revenue* (2012) 397 SC 604, 725 SE2d 711, 714.)

Burden of Proof: Special Regulations

When facts fall within a special regulation CCR 25137-1 through -14:

- Does the special regulation automatically apply?
- Must distortion be shown before the regulation applies to the taxpayer?

Burden of Proof: Special Rules

CCR 25137(a) and (c)

- These regulations operate as standard apportionment if found to apply.
- Party seeking to vary from these subsections carries the burden.
- Example: Substantial/Occasional sales (c)(1)(A) (“5% rule”)

Extraordinary Circumstances: Multistate Tax Commission

- **Pre-2010**, MTC Reg. IV.18(a):
[UDITPA §] 18 permits a departure from the allocation and apportionment provisions of [UDITPA] only in limited and specific cases. *[UDITPA § 18] may be invoked only in specific cases where unusual fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results under the apportionment and allocation provisions contained in [UDITPA].*
- **July 2010 and Later**: The regulation was amended to delete the italicized language and now reads as follows:

[UDITPA §] 18 permits a departure from the allocation and apportionment provisions of [UDITPA] only in limited and specific cases where the apportionment and allocation provisions contained in [UDITPA] produce incongruous results.

(MTC Reg. IV.18(a), amended July 29, 2010.)

Extraordinary Circumstances: California

- **Regulation:** CCR §25137 contains the language "Section 25137 may be invoked only in specific cases where unusual fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results under the apportionment and allocation provisions contained in these regulations."
- **Case Law:** *Microsoft Corporation v. Franchise Tax Board, supra*, (emphasis added) the taxpayer asserted that R&TC §25137 could not be applied by the Franchise Tax Board because having a large corporate treasury department with investment receipts was not a unique and nonrecurring factual situation. The California Supreme Court found otherwise:

Systematic oversights and undersights are equally a matter of statutory concern. Nothing in the language of [the regulation] persuades us otherwise. While [UDITPA §18] "ordinarily" applies to nonrecurring situations, **it does not apply only to such situations**; the touchstone remains an inquiry into whether the formula "fairly represent[s]" a unitary business's activities in a given state, and when it does not, the relief provision may apply.

Procedure for Asserting Relief / Identifying Reasonable Remedies

Procedure for Seeking Relief

What is a valid petition?

- Clear statement of grounds upon which relief is being sought and proposed alternative
- No particular format required

Procedure for Seeking Relief

When may a petition be filed?

- During an audit
- During a protest
- Within a claim for refund
- As a separate petition / Assert position on return
 - However, see FTB Notice 2004-5 (taxpayer required to petition FTB in advance for approval of method in order to avoid accuracy-related penalties).

When is it too late? Appeal/Litigation:

- After protest: Failure to exhaust administrative remedies; file at protest.
- After claim: If SOL closed cannot raise new issue on claim for refund; issue must have been included in original claim.

Procedure for Seeking Relief: Franchise Tax Board Process

- Initial Review
- Factual Development, if needed
- Staff Recommendation
- Committee Meeting
- Appeal from adverse determination to 3-member Franchise Tax Board, but must waive confidentiality (CCR 25137(d))
- Raise issue later?

What are the Typical Remedies?

- Modification of costs of performance rules to apply market sourcing
- Throw out of gross receipts considered to be distortive
 - Treasury receipts
 - Substantial, occasional sales
- Inclusion of intangible property in property factor if intangibles are substantial income-producing activity
 - Special regulations requiring banks to include loan intangibles
- Separate apportionment formulas where disparate lines of business are combined in single unitary group

Questions?

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