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Fair Reflection: Defending Against or Applying Alternative Apportionment

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Learning Outcomes

- Identify requirements for deviating from the standard apportionment formula.
- Identify the burden of proof to employ an alternative apportionment formula.
- Identify situations where the standard apportionment formula does not fairly reflect business conducted in the jurisdiction.
- Identify reasonable alternatives to the standard apportionment formula.
- Identify procedural issues for requesting alternative apportionment.



Agenda

- Alternative Apportionment Standard
- What Is Not A Fair Reflection of Income
- What is a Reasonable Alternative
- Practical Considerations
- Industry Specific Apportionment Formulas
- Special Sales Factor And Property Factor Rules



Alternative Apportionment Standard



Alternative Apportionment Standard

- The drafters of the Uniform Division of Income for Tax Purposes Act (“UDITPA”) recognized that having “some alternative method must be available to handle the constitutional problem as well as the unusual cases.”
- As a result, UDITPA § 18 was “designed to permit the use of methods different from those prescribed in the Act only in unusual cases and in cases where the application of specifically prescribed methods might be held unconstitutional.”



Alternative Apportionment Standard

- The standard alternative apportionment provision is found in UDITPA § 18.
- “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” alternative apportionment.



Alternative Apportionment Standard

The party seeking to diverge from the standard apportionment formula (state tax authority or taxpayer) has the burden of proving that distortion exists, and that a proposed alternative method is reasonable.

- The standard of proof is generally high (greater than a preponderance of evidence).
- Burden applies to the state taxing authority, despite the fact that tax assessments are generally presumed to be correct. (See e.g., *Carmax Auto Superstores West Coast, Inc. v. South Carolina Department of Revenue*, 725 S.E.2d 711 (S. Car. 2012).



Alternative Apportionment Standard

Polling Question

States assert alternative apportionment against my company/clients:

- a) Never
- b) Rarely
- c) Occasionally
- d) Frequently



What Is “Not a Fair Reflection of Income”?



What Is Not a Fair Reflection of Income

UDITPA § 18 – The standard apportionment formula does not fairly reflect a taxpayer’s presence in the jurisdiction

- Most states have found that the Constitutional “gross distortion” requirement is not necessary to justify alternative apportionment.



What Is Not a Fair Reflection of Income

Constitutional Limitation – Gross Distortion

- 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; Ill. Admin. Code § 100.3390(c).



What Is Not a Fair Reflection of Income

Consistent with UDITPA § 18 – California and other UDITPA states require only a showing that the statutory formula does not fairly reflect the extent of the taxpayer's activities in the state.

- *Microsoft Corp. v. FTB*, 39 Cal.4th 750, 765 n. 16 (2006)



What Is Not a Fair Reflection of Income

California Standard for Distortion:

- 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 Co. v. FTB*, Case Docket No. CGC 05-442465 (Cal. Super. Ct., San Francisco, April 11, 2007), 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.



What Is Not a Fair Reflection of Income

Appeal of Home Depot, SBE No. 298683 (Dec. 18, 2008)

- The FTB denied 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.



What is Not a Fair Reflection of Income

Polling Question

My company/clients assert alternative apportionment

- a) Never
- b) Rarely
- c) Occasionally
- d) Frequently



What Is A “Reasonable Alternative?”



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.



Reasonable Alternative – Net v. Gross Receipts

California uses alternative apportionment to combat inclusion of treasury receipts in the sales factor.

- *Microsoft Corp. v. Franchise Tax Bd.*, 39 Cal.4th 750 (2006)
- *General Motors Corp. v. Franchise Tax Bd.*, 39 Cal.4th 773 (2006)
- California Regulation § 25137(c)(1)(D)
- California Revenue & Taxation Code § 25120(f)



Reasonable Alternative – Modified Sourcing of Receipts

Bellsouth Advertising & Publishing Co. 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 earnings-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.
- Taxpayer's petition of review to the Tennessee Supreme Court was denied.



Reasonable Alternative

Alternative Formula is Not Reasonable

- *Montgomery Ward LLC v. Franchise Tax Bd.*, Docket No. GIC 802767 (Cal. Super. Ct., San Diego County, December 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 that its proposed alternative is reasonable.
- Note: net investment income from the treasury function has been found to be a reasonable (e.g., *Microsoft*, *Square D*) and unreasonable (e.g., *Montgomery Ward*) alternative, depending on the specific facts of the case.



Alternative Apportionment: Practical Considerations



Alternative Apportionment – Practical Considerations

Can one party suggest an alternative method in response to the other?

- *Media General, Inc. et al. v. South Carolina Department 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.”
- *Carmax Auto Superstores West Coast, Inc. v. South Carolina Department of Revenue*, 725 S.E.2d 711 (S. Car. 2012).
 - Taxpayer filed using statutory formula; on audit, separate accounting was applied, and following audit the Taxpayer filed amended returns applying a gross receipts formula. Court reversed and remanded lower court's application of separate accounting because Department had burden of proving separate accounting was reasonable.



Alternative Apportionment – Practical Considerations

Use of alternative apportionment in combined report setting

- Is the standard formula fairly reflecting the in-state business activities of each taxpayer in the combined report group?
 - E.g., matching tax credits with taxpayer's intrastate apportioned income and activities generating the credit
 - Note: FTB's position that intrastate apportionment is not a proper subject for distortion analysis (see FTB CCR 2012-1)
- Application of alternative apportionment to all members of combined reporting group
 - *Swift Transportation Co., Inc.*, SBE No. 266318 (Feb. 4, 2008) (applying special formula for trucking companies to all members of taxpayer's combined reporting group)



Alternative Apportionment – Practical Considerations

- Anticipating states' assertion of equitable apportionment
 - states invoking alternative apportionment to achieve market sourcing (e.g., *BellSouth* and *Equifax* cases)
- Asserting alternative methods offensively
- Documentation (contemporaneous) is key
- Identifying the applicable burden of proof



Alternative Apportionment – 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 Board 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.



Alternative Apportionment – 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.
- 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.



Alternative Apportionment – Practical Considerations

Taxpayers may be able to seek alternative apportionment even if they fail to satisfy all procedural requirements.

- *Becton Dickenson and Company v. Tax Commission*, 374 Mass. 230 (1978).
 - Taxpayer allowed to seek alternative apportionment despite failure to strictly comply with procedural requirements.
- *Sidney Frank Importing Co., Inc. v. Michigan Department of Treasury*, Michigan Tax Tribunal Case No. 383623, October 5, 2011.
 - Taxpayer denied request to seek alternative apportionment for failure to strictly follow procedural requirements.



Alternative Apportionment – Practical Considerations

Polling Question:

My company/clients usually assert use of an alternative apportionment methodology:

- a) Before filing the original return
- b) During an audit
- c) During protest or appeal
- d) All or some of the above
- e) None of the above



Industry Specific Apportionment Provisions



Industry Specific Apportionment

- Industry specific formulas
 - Trucking companies
 - Airlines
 - Financial Institutions
 - Television and Radio
 - Franchisors
 - FTB Regulation 25137-3
 - FTB CCR 2010-2 (applying franchisor special formula to franchise and royalty payments).
 - General/Financial Corporations
- Query, what if a special industry formula results in distortion?



Special Sales Factor And Property Factor Rules



Special Sales Factor And Property Factor Rules

- Exclusion of gross receipts and net gains from a taxpayer's treasury function activities
- Substantial amounts of gross receipts from occasional sales
- Insubstantial amounts of gross receipts from incidental or occasional transactions or activities
- Income producing activity cannot be readily determined
- Government owned property



Special Sales Factor And Property Factor Rules

- After applying special sales factor rules, is there a disconnect between business income and the sales factor?
- Alternative apportionment under a single sales factor regime?



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