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# Navigating State Apportionment

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# Navigating State Apportionment

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# Polling question 1

What is your biggest concern around apportionment?

A. Getting it right.
B. Consistency (or inconsistency) among states.
C. Relief when the statutory apportionment method does not fairly reflect activities in the state.

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# Agenda

- Historical background
- Fair apportionment considerations
- Apportionment considerations in unusual or non-recurring transactions
- Distortion and agency deference
- Q&A

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# Historical background

# Historical background

Constitutional Right to Fair Apportionment

*Complete Auto Transit, Inc. v Brady (1997)* - A Mississippi tax on the privilege of doing business in the State *held* not to violate the Commerce Clause when it is applied to an interstate activity (here, the transportation by motor carrier in Mississippi to Mississippi dealers of cars manufactured outside the State) with a substantial nexus with the taxing State, **is fairly apportioned**, does not discriminate against interstate commerce, and is fairly related to the services provided by the State.

# Historical background

## Constitutional Distortion Requirements

- Internal Consistency
  - The test for fair income apportionment involves two components. The first component, referred to as "internal consistency," is present if the formula, when applied by every jurisdiction, results in no more than 100% of that business's income being taxed. Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983). Internal consistency tests the constitutionality of a specific state's statute and is not fact specific.
- External Consistency
  - The second component of fairness is "external consistency" which requires that the apportionment formula actually reflect a reasonable sense of how income is generated. Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983). External consistency assumes the state's statute is fair, and tests whether the statute is fair for this particular taxpayer. External consistency is fact driven.

# Historical background

## Constitutional Distortion Guidance

- The level of distortion required for a finding of constitutional significance is by no means a known factor. In Hans' Rees Sons, Inc. v. North Carolina ex re. Maxwell, 283 U.S. 123 (1931), the Court rejected a single (property) factor method which distorted the portion of income attributed to the state by more than 250%. Short of such a significant effect, it is difficult to predict the success on the merits of a distortion approach.
- An apportionment method will be struck down on constitutional grounds if:
  - Its application has led to a grossly distorted result; or
  - Income attributed to the state is out of all appropriate proportion to the level of business transacted. Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 170 (1983).
- As a practical matter, petitioning for a change in an apportionment factor is rarely granted because the level of distortion required is unknown.

# Historical background

Gross Distortion or Fair Reflection Standard?

- Most states have found that the constitutional “gross distortion” requirement is not necessary to justify alternative apportionment – some lesser standard usually applies.
- Consistent with UDIPTA Sec. 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.

# Fair apportionment considerations

# Fair apportionment considerations

Alternative Method Guidance

- Analytical framework for distortion/correction through use of alternative formula. Crocker Equipment Leasing, Inc. v. Department of Revenue, 838 P.2d 552 (Or. 1992); Twentieth Century Fox v. Department of Revenue, 700 P.2d 1035 (Or. 1985).
  - Statutory formula does not fairly represent this taxpayer's business activity in state.
  - Alternative formula proposed by taxpayer is reasonable.
    - Results in no more or less than 100% of taxpayer's income being subject to tax.
    - Does not create or foster lack of uniformity among UDITPA jurisdictions.
    - Reflects economic reality of business activity.

# Fair apportionment considerations

What constitutes fair apportionment?

- Occasional Sale Rules
  - What is occasional?
- Gross Receipts in the denominator
- Net Gain in the denominator
- State rules excluding gains from apportionment
- Goodwill
- Apportionment Factors unrelated to the gain used to apportion
- Gains attributable to foreign repatriation
- Distortive Results

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# Apportionment considerations in unusual or non-recurring transactions

# Unusual or non-recurring transactions – common examples

- Sale of a Partnership Interest; Stock of Corporation, Tangible or Intangible Assets
- Intercompany Distributions
  - Actual
  - Deemed
- Foreign Repatriation
  - Distributions from foreign CFCs
  - Impact of TCJA

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# Unusual or non-recurring transactions – recent cases

Minnesota Tax Court approves Department's alternative apportionment - E.I. DuPont v. Commissioner of Revenue, Mn. Tax Ct., No. 9485-R (6/24/24)

- During the 2013-2015 tax years DuPont conducted significant international operations resulting in a large number of currency transactions. To manage its foreign exchange exposure, DuPont buys and sells foreign exchange contracts (FECs). No activities regarding the FECs were conducted in Minnesota.
- As noted, the FECs involved buying and selling of contracts. DuPont argued that it should include the gross amount of receipts involving FEC transactions in its sales factor denominator. Because no activities associated with FECs were in Minnesota, no FEC revenue was included in its Minnesota numerator.
- The Department acknowledged that statutorily DuPont would include all gross receipts in its sales factor. However, the Department asserted its alternative apportionment authority to require DuPont to include only its net receipts in its sales factor. The Department argued that including gross receipts would lead to a distortive measure of DuPont's Minnesota activity.
- The Tax Court agreed with the Department, holding that excluding gross receipts, but including net receipts, fairly reflects DuPont's net income in Minnesota.

# Unusual or non-recurring transactions – recent cases

Illinois DOR denies Taxpayer alternative apportionment request – IT-23-0018-GIL, January 2024

- Taxpayer received royalties from foreign sources, but Taxpayer was unable to include such royalty revenue in its sales factor denominator because Illinois statutes require royalties earned from licensing intangible personal property to comprise more than 50% of a taxpayer's total gross receipts to be included in the sales factor.
- Taxpayer argued that the standard apportionment formula, which operates to exclude Taxpayer's foreign royalties, does not fairly represent the market for its business income and requested an alternative apportionment method.
  - Taxpayer supported its position by providing the percentage of total gross income that royalties represented in the entity receiving the royalties and the percentage of total Illinois combined unitary income comprised of royalties.
  - Taxpayer also noted that the royalties' profit margin was higher than the profit margin of Taxpayer's other income.
- The DOR concluded that the facts presented by Taxpayer were not sufficient to satisfy the burden required of a taxpayer to receive an alternative apportionment.
  - The DOR stated that "[a]n alternative apportionment method may not be invoked, either by the Department or a by a taxpayer, merely because it reaches a different apportionment percentage than the required statutory formula. . . . Merely indicating separate accounting would effectuate equitable allocation and apportionment of . . . royalties, without any explanation of why these methods are more accurate than formulary apportionment, is insufficient to meet the burden of proof."
- Accordingly, the DOR denied Taxpayer's alternative apportionment request.

# Unusual or non-recurring transactions – recent cases

New Jersey Tax Court allows taxpayer to use alternative apportionment - Solix v. N.J. Div. of Tax. N.J. Tax Ct., Dkt. No. 011113-2019 (4/11/24)

- For the 2011 and 2012 tax years, Taxpayer applied a market-based approach to source its service income.
- Taxpayer used this method believing it to be most reflective of the economic realities of its business, which primarily was being a third-party administrator of governmental subsidy programs.
- The Division rejected this approach in favor of the statutory cost of performance (“COP”) method reasoning that a major portion of Taxpayer's services were performed in New Jersey, which is also where its computer servers and core management were located, and because Taxpayer allocated over 90% of its payroll to New Jersey.
- In 2019, New Jersey enacted market-based sourcing. The Division argued that market-based sourcing was unavailable to taxpayers prior to 2019.
- On appeal, the Tax Court disagreed that market-based sourcing was barred prior to 2019. New Jersey law provided that revenue from services were sourced to New Jersey for services "performed within the State."
- Regulations provided a COP method, but not exclusively. The regulation allowed "some other reasonable method that should reflect the trade or business practice and economic realities underlying the generation of the compensation for services.”
- The Tax Court determined that "Taxation’s preference for the COP method does not foreclose consideration of the alternative methods permitted under the regulation.“

# Unusual or non-recurring transactions – recent guidance

Pennsylvania issues Corporate Tax Bulleting 2024-01 on January 5, 2-24 providing market-based sourcing guidance.

- Enacted on July 8, 2022, H.B. 1342 generally provides for market-based sourcing for intangible income starting with tax years beginning after 2022.
- For tax years beginning before December 31, 2022, Pennsylvania imposed a costs of performance sourcing treatment for gross receipts that were neither (1) sales of tangible personal property nor (2) sales of services.
- For tax years beginning after 2022, H.B. 1342 provides specific sourcing treatment for several categories, including gross receipts from the sale of intangible property; securities; interest, fees, and penalties from certain loans; and other intangible property.
- Gross receipts from intangible property not specifically provided for by statute is excluded from the numerator and denominator of the Pennsylvania sales factor.

# Unusual or non-recurring transactions – recent guidance

South Carolina enacts Senate Bill 298 on March 11, 2024 providing rules and requirements around alternative apportionment and forced combination.

- Previously, under S.C. Code Ann. § 12-6-2320, SC Department of Revenue (DOR) had broad discretionary authority to adjust income to fairly represent taxpayer's business activity in the state, including separate accounting, exclusion/inclusion of factors, and "employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."
- S.C Code Ann. § 12-6-2320 now includes several new provisions, most notably:
  - SC DOR must provide written notice for information reasonably necessary to determine whether taxpayer transactions have economic substance and are at fair market value.
  - SC DOR may adjust net income by adding back, eliminating, or adjusting intercompany transactions, or if those adjustments are inadequate, require a combined filing. Either the DOR or taxpayer may propose a combination fewer than all members of the unitary group. If the DOR proposes fewer member, taxpayer needs to consent.
  - Requires SC DOR to provide a written statement of findings.
  - Provides definitions of "economic substance" and "affiliated group".
  - Explicitly adopts IRC § 482.
  - Taxpayer appeals to Administrative Law Court, ALJ shall review de novo: (i) whether separate returns fail to fairly represent taxpayer SC activity; (ii) whether SC DOR adjustments are appropriate; and, (iii) if a combined return was required by SC DOR, whether other adjustments would have been adequate.

# Distortion and agency deference

# Distortion and agency deference

*Vodafone Americas Holdings, Inc. & Subs. v. Roberts*, 486 S.W.3d 496 (Tenn. 2016)

- Background
  - TP owned a partnership interest in Verizon Wireless, which provided wireless communication and data services nationwide.
  - TP initially sourced Tennessee sales by customer location (principal-place-of-use, “PPU”).
  - TP changed position and sought refund: earnings-producing activity were thrown by costs of performance (“COP”) to other state based on network-wide costs and other factors.

# Distortion and agency deference

- Variance
  - Commissioner imposed a “variance”—Section 18 alternative apportionment.
  - Essentially restored PPU approach.
  - Asserted that this served principles of UDITPA:
    - Uniformity to ensure no state taxed the same income.
    - No income escapes taxation.
- Issues
  - Did the Commissioner abuse discretion in rejecting COP and imposing PPU?
  - Was the Commissioner’s decision an abuse of discretion in light of statutory and regulatory limitations on use of Section 18?

# Distortion and agency deference

- Quantified Distortion
  - Historical Benchmark Examples
    - *Hans Rees* – 250% - Impermissible Distortion
    - *Container* – 14% - Not Impermissible Distortion
  - *Vodafone*: Sometimes "the statutory formulas just do not work and the tax collector would necessarily have to impose a variance." 523 (quoting BAPCo at 367).
- Prima Facie Distortion – Vodafone
  - Vodafone had $1.3 billion in receipts from Tennessee customers.
  - Under the Taxpayer's COP analysis, its Tennessee numerator fell to $150 million.
  - The decisive question is whether it made sense for a Taxpayer that indisputably had $1.3 billion in receipts in the taxing state to source only 11% of those receipts to that state and whether the resulting impact on apportioned income was reasonable.
  - The COP sourcing—as calculated by the TP—was distortive on its face.

# Distortion and agency deference

- Quantified or Conceptual
  - The Vodafone Court first determined that the statutory method—as calculated by the TP—was not reasonable.
    - (“[T]he Commissioner had ample basis to conclude that application of the statutory apportionment formula to Vodafone's telecommunications services would not result in a fair representation of Vodafone's business activity in Tennessee.” 525-26).
  - It then reviewed the Commissioner’s action to determine its reasonableness as a reflection of the TP’s Tennessee income.

# Distortion and agency deference

- The Flexibility of “Unusual Fact Situations”
  - Tennessee’s Rule 35 adopts an MTC model regulation:
  - Section 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 the Franchise and Excise Tax Laws.” Tenn. Comp. R. & Regs. 1320-06-01-.35(d).
- The Flexibility of “Unusual Fact Situations”
  - TP argued that this limitation on the use of Section 18 authority should mean “peculiar to a specific taxpayer” or “rare.” 528.
  - Commissioner noted that these are situations that “produce incongruous results under the [statutory] apportionment and allocation provisions.” 529.

# Distortion and agency deference

- The Flexibility of “Unusual Fact Situations”
  - The Court’s application flowed from the underlying analysis.
  - “[M]illions of dollars in receipts from Vodafone's Tennessee customers … vanish[ing]” is an incongruous result. 530.
  - The qualifier “ordinarily” allows for this flexibility.
  - Pointed also to the administrability issues. 531.

# Distortion and agency deference

- Standard of Review – Abuse of Discretion
  - "We review the Commissioner's decision to impose a variance for an abuse of his discretion. … This standard "does not permit the reviewing court to second-guess the Commissioner or substitute the reviewing court's discretion for that of the Commissioner." 513-14.
  - Three Inquiries:
    - (1) Was the action supported by evidence?
    - (2) Did the agency identify the appropriate legal principles?
    - (3) Was the action within range of acceptable alternative dispositions?

# Distortion and agency deference

- Impact of Deference
  - Agency deference places a substantial but not insurmountable burden on taxpayers challenging determinations.
  - Vodafone sets out a clear and specific course of review.
  - Vodafone majority criticized the lone, partial dissent for a "micro-focus" on the construction of Rule 35. This was "at odds with the larger 'bird's eye' view judges must maintain in reviewing agency and executive decisions." 533-34.

# Distortion and agency deference

- Impact of Deference
  - What would the alternative entail?
  - Would result of legislative apportionment be subject to de novo challenge?
  - Are there impacts on the efficiency and cost of tax dispute resolution?
  - On predictability?

# Distortion and agency deference

Burden of proof

- Clear and convincing evidence – Somewhere between preponderance of evidence and beyond a reasonable doubt
- 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

# Distortion and agency deference

What is burden of proof?

- When a state or taxpayer wants to use an alternative apportionment method, they carry the burden of proof in showing that distortion exists, and that a proposed alternative method is reasonable.

Who should have the burden of proof?

  - *Carmax Auto Superstores West Coast, Inc. v. S.C. Dep't of Revenue*, Op. No. 4953 (S.C. Ct. App. March 14, 2012) "It is only logical that a party seeking to override the legislatively determined apportionment method bears the burden of proving that method is not appropriate and an alternative method more accurately reflects the taxpayer's business activity within the state."
  - The court concluded that the Department bears the burden to prove both that the statutory formula does not fairly represent taxpayer'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."

# Distortion and agency deference

UDIPTA – Requiring versus asking

- 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 may include:
    - Separate accounting
    - The exclusion of one or more factors,
    - The inclusion of one or more factors that represents the taxpayers activities in the state,
    - Or the employment of any other method to reach equitable apportionment.
  - Read literally, the taxpayer may only <u>ask</u>; while the tax department may <u>require</u> alternative apportionment.

# Polling Question 2

If you have had distortion in a state, how have you handled it?

A. Requested alternative apportionment on an original return.
B. Requested alternative apportionment on an amended return.
C. Dealt with the issue on audit/protest.
D. Other.

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