

Extreme Apportionment

Bad Facts Make Bad Factors

Hartman SALT Forum

October 20, 2022



Jeffrey Friedman
Eversheds Sutherland
Washington, DC



Stephen Jasper
Bass Berry & Sims PLC
Nashville, TN



Brian Kirkell
RSM US LLP
Washington, DC

What do we mean by fair apportionment and how do we attempt to achieve it?

- *Complete Auto*
- The myth of 100%
- *Hans Rees' and Moorman*
- Modern internal consistency analysis

Four buckets of fairness

- Fairness in apportionability
- Fairness in the factors
- Fairness in computing each factor
- Fairness in resolving unfairness

What's the difference between unfair apportionment and extreme apportionment?

- Why does it matter?

What drives extreme results?

- Lack of uniformity between state approaches
- Unclear law
- Bad facts, good facts, uncertain facts
- Business transformation

Where do we find the most extreme results?

- Services – So many markets, so many ways to measure income producing activity.
- Restricted transactions – If you can't say where it is, it could be everywhere
- Selective exclusions – Treasury functions, intangibles, interest, executive payroll, occasional sales.
- Digital characterization – Could be anything, so it could be anywhere.
- TPP – Anywhere throwback, throwout, destination, and ultimate destination collide.
- Unitary determinations – Combination, pass-throughs, and business income.
- Factors du jour – the uneven weight of market vs. place of production.

Express Scripts Inc. v. Indiana Department of State Revenue, Dkt. No. 19T-TA-00018 (Ind. Tax Ct. May 14, 2021)

- The Indiana Tax Court upheld a pharmacy benefit management company's sourcing of its receipts under Indiana's costs of performance rules applicable to receipts from services.
- The court rejected the Department of Revenue's position that the receipts should instead be sourced according to the rules for sales of tangible personal property.
- Based on the taxpayer's designated affidavits and contracts stating that its clients engage it and pay for the provision of services and that it does not purchase any drugs for resale or ever acquire possession or title of any drugs sold to its insurer client's members, the tax court found that the taxpayer properly apportioned its income as a service provider and granted summary judgment in favor of the taxpayer.

Hegar v. Sirius XM Radio, Inc.
&
Synthes USA HQ Inc. v. Pennsylvania

Defender Security Co. v. McClain
&
LendingTree v. Dep't of Revenue

NASCAR Holdings, Inc., et al. v. Jeffrey A. McClain, Tax Commissioner of Ohio, et al., Case No. 2021-0578 (Ohio Supreme Court)

- The Ohio Board of Tax Appeals upheld the Department of Taxation's CAT assessment that used a viewership-based apportionment method to apportion revenue from licensing intellectual property, such as broadcast rights.
- NASCAR argued that its revenue from intangibles, such as intellectual property license agreements, should be sourced to the location of its licensees (i.e. location of the "purchaser's benefit").
- This matter is on appeal to the Ohio Supreme Court.
Oral arguments Jan. 25, 2022.

Virginia Department of Taxation v. R.J. Reynolds Tobacco Co., case number 201263 (Va. Feb. 10, 2022)

- Virginia Supreme Court ruled that taxpayer was entitled to a corporate income tax refund due to an adjustment to the property factor.
- The court agreed with the taxpayer that leaf tobacco stored in Virginia for an aging period of 13 to 23 months should not have been included in property factor because it was not being “used” in Virginia.
- The Virginia Department of Taxation argued that the taxpayer’s storage of the tobacco in the Virginia facilities constituted “use” for Virginia property factor purposes because the tobacco was aging during the time it was stored there, and aging was important to the subsequent use of the tobacco.

What about ad hoc apportionment?

Vectren Infrastructure Services Corp. v. Department of Treasury, Dkt. No. 17-000107-MT (Mich. Ct. App. Sept. 30, 2021)

- On remand from the Michigan Supreme Court, the Michigan Court of Appeals reaffirmed its March 2020 decision that application of the state's statutory apportionment formula was unconstitutionally distortive as applied to a taxpayer's Michigan Business Tax (MBT) liability for the sale of an entire business.
- The Court of Appeals previously upheld the trial court's decision that the taxpayer could not include the sale of the business in the sales factor denominator.
- The Department now seeks an appeal to the Michigan Supreme Court again and the Michigan Supreme Court granted review on March 23, 2022.

Laugh or cry moments in the world of extreme apportionment

- Don't ask us for relief. Tell the other states their law is wrong.
- It's perfectly constitutional multiple taxation.
- These sales aren't nowhere. They're definitely somewhere.
- How would I even know who my customers, customers, customers are, much less where?
- That software isn't software, but that service is.
- You only get to apportion when you have income.
- That's where the underlying value was generated.
- We don't have to prove we're right. You have to prove we're not.
- If the receipts aren't here, they must be excluded because they can't be sourced.
- It's distortive because there's not enough (or too much) tax.

Preemptive options

- Lobby for a better world
- Provide commentary on draft regulations.
- A well-placed amicus brief can go a long way.
- Look before you leap, and structure accordingly.
- Seek letter rulings and alternative apportionment requests.

It's too late, so let's make the best of it

- Where uncertainty exists, understand the positions.
- Be ready for audit.
- Sometimes settlement is the better part of valor.

Final Thoughts

