Life After *Equifax*: Offense or Defense?

by Brian Strahle

Equifax Inc. v. Mississippi Dep't of Revenue, No. 2010-CT-01857-SCT (Miss. 2013), raises several questions when choosing an apportionment method. In fact, a recent *State Tax Notes* article[1] suggested that *Equifax* "should be interpreted as an invitation for corporate taxpayers to apply allocation and apportionment rules that fit their business operations regardless of specific state law provisions." After reading the article, I understand the basis for that statement and point of view. I may even agree; however, for those companies that aren't willing to be, shall I say, "aggressive," what standards should they follow? If a state can disregard its own statutes and use its discretion to make an assessment, what can companies do to protect themselves? Should companies be just as aggressive or should they seek a reasonable approach?

This article reexamines *Equifax* and discusses other precedent to clarify how a company should choose its (fair) apportionment method.

A. Equifax

Equifax is a service business with customers in Mississippi. It followed the standard promulgated apportionment method to determine the extent of its business in Mississippi — that is, it relied on the Department of Revenue's regulations. Under those regs, Equifax had no income subject to tax in Mississippi.

The DOR determined that the apportionment method did not fairly reflect the extent of Equifax's business in Mississippi. Instead, it determined that the taxpayer should have used an alternative method (a market-based sourcing method) to calculate the sales factor.

Equifax attempted to argue that the DOR's use of a market-based sourcing method promulgated a new rule in violation of the Mississippi Administrative Procedures Act and therefore should not have been allowed to do so. However, the Mississippi Supreme Court held that the department was not promulgating a new rule, but simply using an alternative apportionment method in which the standard allocation method of income did not fairly represent a taxpayer's activity in the state. The court also said requiring the taxpayer to use an alternative apportionment method did not bind other service companies to use market-based sourcing or alter the standard apportionment method.

B. Was a New Rule Promulgated?

Some practitioners and taxpayers may disagree with the Mississippi court and argue that the decision allows the DOR to use an apportionment method not authorized by legislation.

The Mississippi regulations state:

> The Commissioner may authorize or require alternative methods of assigning income if the prescribed allocation and apportionment procedures do not fairly represent the extent of the corporation's Mississippi business activity. These may include: separate accounting, exclusion of one or more factors, inclusion of one or more factors to fairly represent the taxpayer's business activity in the state, or the employment of any other method to fairly allocate and apportion the taxpayer's income.[2]

The court relied on those regulations to hold the DOR was within its rights to use any other method, even market-based sourcing, to fairly apportion Equifax's income.

Equifax argued that the DOR had promulgated a new standard for all service companies because it did not rely on a single fact unique to Equifax's situation in support of invoking alternative apportionment, instead premising its requirement solely on the fact that Equifax is a service company and makes sales to customers in Mississippi.

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[1]Stephen P. Kranz et al., "Open Season on State Statutory Apportionment," *State Tax Notes*, Aug. 12, 2013, p. 429.

[2]Miss. Reg. 35.III.8.06(III)(B)(10).

The court held that the DOR did not promulgate a new rule or standard for all service companies, but it did base its decision on factors unique to Equifax. The court said the standard allocation method did not fairly represent Equifax's activity in the state because Equifax had employees in the state and received more than $22 million in service revenue from customers in Mississippi. Equifax's Mississippi customers requested and received services from Equifax at their Mississippi locations (those transactions primarily occurred electronically).

The problem with the court's conclusion is that the facts are not unique to Equifax. Other service companies have similar fact patterns in Mississippi and other states. Hence, the decision creates uncertainty regarding how other service companies should respond to it. Should a company be allowed to simply follow the standard apportionment methods authorized by a state's legislature without having to determine whether it results in a fair reflection of income (or more tax to a state)? If a company should choose an alternative method, can it choose a method not currently authorized by state legislation?

C. Right to Invoke Alternative Apportionment

Each state with a corporate income tax has a standard apportionment formula.

The standard apportionment method selected by a state cannot be arbitrary and must not produce unreasonable results.[3] If that occurs, the state may invoke an alternative apportionment regulation.

Uniform Division of Income for Tax Purposes Act section 18 (which has been adopted by most states) provides:

> 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, in respect to all or any part of the taxpayer's business activity, if reasonable: (a) separate accounting; (b) the exclusion of any one or more of the factors; (c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or (d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Section 18 is intended as broad authority for tax administrators to vary the apportionment formula and system of allocation when the provisions of UDITPA do not fairly represent the extent of the taxpayer's business activity in the state. The phrases in section 18(d) do not foreclose the use of one method for some business activity and a different method for a different business activity. Neither does the word "method" limit the administrator to substituting factors in the formula; it means any other method of fairly representing the extent of the taxpayer's business activity in the state.

Multistate Tax Commission Regulation IV.18.(a), which is adopted by several states, "permits a departure from the allocation and apportionment provisions of article IV only in limited and specific cases." It may be invoked when "unusual fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results under the apportionment and allocation provisions contained in Article IV."

Section 18 was originally intended to be used in unusual circumstances only; however, as *Equifax* shows, it has been invoked more frequently in common circumstances.

If a service company's facts are similar to Equifax's, there may be a risk of Mississippi and other states using their alternative apportionment regulations to impose an unauthorized method (at least, a not specifically authorized method) on audit. As a result, companies that determine that the standard method doesn't provide a fair reflection of income (from the state's perspective) may want to mitigate their risk by requesting alternative apportionment and paying more tax.

When a company follows the standard apportionment method authorized by a state and the amount of tax is too high in relation to the activity in the state, can a taxpayer alter its apportionment method? In most states, taxpayers can choose to use an alternative apportionment method, but they generally are required to petition the state before doing so. Some states strictly enforce the requirement that a petition must be filed. The petition requirement makes it more difficult for companies to obtain the relief they desire. It also makes it more difficult for companies to choose alternative apportionment methods that are not specifically authorized by state legislation.

D. Fair Reflection of Income

How do you know when the apportionment method does not fairly reflect income in a state? A corporation must demonstrate that the apportionment method in question grossly distorts the amount of income actually earned in the state. There are several evidence standards for proving distortion, with the clear and convincing standard being most common.

Distortion results when the economic result (how much tax is paid or how much income is apportioned to a jurisdiction) does not correlate with how much business or activity is done in the state. Distortion

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[3] *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920).

can occur in many ways, including when some items of sales or income are included/excluded from the sales factor, when property is valued at cost versus appreciated value in the property factor, or when gross proceeds versus net proceeds are included in the sales factor.

Probably the most common form of distortion occurs when a company is involved in a small unrelated activity in a state that causes the company to include its main business activity in the tax base and apportionment. As a result, under the standard apportionment formula, the state would tax income unrelated to the company's activity in the state.

Taxpayers have generally found it difficult to prove that a state's standard apportionment provisions are inequitable, but it can be done.

In *Stonebridge Life Insurance Co. v. Dep't of Revenue*, 18 Ore. Tax. 423 (2006), the taxpayer's primary business locations were outside Oregon. All of Stonebridge's Oregon insurance policies originated through marketing by direct mail or telephone solicitation, and all business related to them occurred at one of its primary business locations outside Oregon.

During the tax year in question, Stonebridge received almost $6 million in premiums from Oregon customers. Its premiums for the year from all states totaled more than $660 million. Stonebridge had a total payroll of $39 million but no payroll in Oregon. However, Stonebridge did receive gross income of $250,000 from Oregon real and tangible personal property. The income from that property was wholly from the interest received on two loans secured by Oregon property. Neither that income nor the loans were integral or necessary to Stonebridge's insurance business in Oregon or elsewhere.

In *Stonebridge*, the Oregon tax court held the standard apportionment formula allocated to Oregon a share of the taxpayer's income that was "out of all appropriate proportion" to the business Stonebridge transacted in Oregon. The company's low insurance sales and wage and commission factors did not balance out its high real estate income and interest factor. The latter "grossly distorted" the value generated by the company's Oregon operations, the court said.

Stonebridge is an insurance excise tax case, but it provides an informative discussion on determining the constitutionality of a state's apportionment formula. Generally, taxpayers have a heavy burden to prove a state's standard apportionment formula is unconstitutional. Taxpayers must present the court with clear and cogent evidence of constitutional distortion. The U.S. Supreme Court has considered dozens of cases on that topic and has struck down a state's apportionment as unfair only twice in the last 75 years.[4]

In *Hans Rees' Sons v. Maxwell*, 283 U.S. 123 (1931), the U.S. Supreme Court struck down the application of North Carolina's single-factor property formula to a New York company that sold its goods worldwide but had its sole factory in North Carolina. To prove distortion, the company offered detailed, separate accounting evidence regarding the geographic origin of its profits and the methods by which it derived those profits. That evidence showed that while North Carolina apportioned 80 percent of the company's profits to itself, no more than 22 percent of those profits actually originated in North Carolina, and, on average, only 17 percent did. The distortion created by the application of North Carolina's formula to the company was thus between 363 percent and 470 percent. The Court found that degree of distortion unconstitutional.

Taxpayers have generally found it difficult to prove that a state's standard apportionment provisions are inequitable,[5] but it can be done. One thing to keep in mind is that distortion in one apportionment factor does not necessarily result in the unfair reflection of the business activity in a state if the other two factors mitigate the distortive effect of the third. The three factors in combination may fairly represent the taxpayer's business activity in the state.

E. Burden of Proof

Normally, a taxpayer has the burden to challenge an audit assessment. With alternative apportionment, most state statutes say the burden of proof to prove that distortion exists rests with the party that requests to deviate from the standard apportionment formula.

The following cases prove the importance of understanding a state's statutes and regulations, and how their procedural rules work together. Knowing who has the burden and if it shifted can make all the difference.

Equifax originally appealed the audit assessment to the Mississippi Tax Commission Board of Review. It then appealed to the three-member Tax Commission, which upheld the board's decision. Equifax paid the assessments under protest and appealed to the Hinds County Chancery Court. At every level, Equifax was burdened to prove its entitlement to

[4] *Norfolk & Western*, 390 U.S. at 329-330.

[5] *Hans Rees' Sons,* 283 U.S. 123; *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978); *Container Corp. of Am.*, 463 U.S. 159 (1983); *Unisys Corp. v. Pa. Bd. of Fin. and Rev.*, 812 A. 2d 448 (Pa. Sup. Ct. 2002); *Colgate-Palmolive Company Inc. v. Bower*, No. 01 L 50195 (Ill. Cir. Ct., Cook Cty. 2002).

relief — that the commission's decision was reversible by a preponderance of the evidence.

Equifax appealed the chancery court's decision to the court of appeals, which was the only court to agree with Equifax that the party invoking alternate apportionment has the burden to prove that the standard apportionment method is not a fair representation of the taxpayer's activity in the state and that its chosen alternative method is reasonable.

The Mississippi Supreme Court held that in a taxpayer's action in a chancery court appealing a final judgment of the commission, as in all other judicial proceedings, the party petitioning the court for relief bears the burden of proving its claims by at least a preponderance of the evidence. Further, the taxpayer must raise and prove that the DOR's decision was (1) unsupported by substantial evidence, (2) arbitrary and capricious, (3) beyond the power of the DOR to make, or (4) in violation of the taxpayer's statutory or constitutional rights. Hence, the court held the burden was on Equifax and it was not swayed by other jurisdictions that have adopted UDITPA and placed the burden on the taxpayer deviating from the standard apportionment formula.

In *Indiana Dep't of State Revenue v. Rent-A-Center East Inc.,* 963 N.E.2d 463 (2012), the Indiana Supreme Court ruled that the Indiana DOR's notice of proposed assessment against Rent-A-Center was based both on the DOR's reasonable belief that the taxpayer had not reported the proper amount of tax due and on the best information available. It also found the assessment was prima facie evidence that the DOR's claim for the unpaid tax was valid, with the burden of proving the proposed assessment incorrect resting with the taxpayer against whom the assessment was made.

Rent-A-Center East had a few twists and turns. The taxpayer filed a separate return as required by Indiana law. On audit, Indiana attempted to force the taxpayer to file a combined return, but the taxpayer protested and ended up in Indiana's Tax Court. The Tax Court held that the burden of proof that the standard separate return and apportionment is invalid rests on the party that is deviating from the standard method. Hence, it found the burden of proof to be on the state of Indiana.

According to Indiana law, each corporation with Indiana adjusted gross income must report on a separate company basis according to the generally applicable allocation and apportionment rules in Indiana Code section 6-3-2-2(a)-(k) (standard sourcing rules).

The legislature enacted a limited exception to the standard sourcing rules, giving the DOR discretionary authority to grant prospectively or require retroactively that a taxpayer determine its Indiana source income using an alternative method:

> If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> - separate accounting;
> - the exclusion of any one or more factors;
> - the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana;
> - the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.[6]

The party seeking to depart from the standard sourcing rules must first show that the return filed using the rules does not fairly represent the taxpayer's income derived from sources within Indiana and then show that its alternative method is a reasonable method of fairly allocating or apportioning its income. The DOR's authority is further limited if it chooses a combined income tax return as the alternative method.

Based on those guidelines, the Tax Court held that the burden of proof rested on Indiana, the party who was deviating from the standard filing (separate company basis) and apportionment method.

The state appealed to its Supreme Court, which said "the state may make a proposed assessment if it reasonably believes that a person has not reported the proper amount of tax due."[7] The court also said "the General Assembly has provided that the notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Therefore, the court held that Indiana did not have to meet the burden related to the deviation from the standard filing method; rather, Rent-A-Center had to meet the burden of proving the proposed assessment was wrong.

In *CarMax Auto Superstores West Coast Inc. v. South Carolina Dep't of Revenue,* No. 4953 (S.C. Ct. App. 2012), the South Carolina Court of Appeals held that CarMax did not bear the burden of proving that an alternate apportionment method, proposed by the DOR, was not reasonable and that the DOR was required to establish that its proposed method was "not only appropriate, but more appropriate

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[6]Ind. Code section 6-3-2-2(l).

[7]Ind. Code section 6-8.1-5-1(b).

than any competing methods." Thus, the burden rested on the state, which was deviating from the standard method.

The DOR contended there is a shifting burden of proof. First, it argued that it does have the burden of proving CarMax's chosen method of apportionment is not reasonable. Once it meets its burden, CarMax bears the burden of proving by clear and convincing evidence that under the DOR's alternate method, the income attributed to South Carolina is "out of all appropriate proportions to the business transacted in South Carolina or has led to a grossly distorted result."

The Court held that CarMax did not bear the burden of proving the DOR's alternative accounting method was unreasonable. The DOR bears the burden of proving its alternative accounting method is reasonable and more fairly represents CarMax's activity in South Carolina.

F. Conclusion

Equifax adds more fuel to the alternative apportionment fire but can be used by both states and taxpayers to be more aggressive regarding a company's apportionment formula. States with statutes similar to Mississippi's may be able to impose any other method, even if that method is not authorized by the state's legislation. Hence, taxpayers who are risk averse may want to review the results of using the standard apportionment formula in a state and request alternative apportionment to benefit the state (if it results in a more reasonable reflection of income) to reduce the risk that a state will do what Mississippi did in *Equifax*.

Taxpayers seeking alternative apportionment relief because of the detrimental result of the standard formula can use *Equifax* to choose methods not authorized by state legislation. When requesting relief, taxpayers should be prepared to show, using various calculations, how the standard apportionment formula is distortive and how the proposed alternative method is more reasonable. When challenged by a state, taxpayers should be aware of who has the burden of proof and how it may have shifted depending on the forum or issues in dispute.

Equifax *adds more fuel to the alternative apportionment fire but can be used by both states and taxpayers to be more aggressive regarding a company's apportionment formula.*

Alternative apportionment is not really about a standard formula versus an alternative formula. It is about fair apportionment. Therefore, whether the formula results in more or less tax to a state is not the issue. The issues are whether the formula is internally and externally consistent and whether the amount of income attributed to the state as a result of that formula is reasonable based on the taxpayer's business. ✩

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