UDITPA Rewrite Necessary, but Will States Listen?

by Brian Strahle

On November 1 Tax Analysts held a panel discussion regarding the Multistate Tax Commission's rewrite of Article IV of the Multistate Tax Compact, also known as the Uniform Division of Income for Tax Purposes Act. The panel consisted of Shirley K. Sicilian, general counsel for the MTC; Prentiss Willson, of counsel at Sutherland Asbill & Brennan LLP; Richard Pomp, Alva P. Loiselle Professor of Law at the University of Connecticut; and Arthur R. Rosen, partner at McDermott Will & Emery.

The speakers did an excellent job covering the issues from a theoretical and practical standpoint. They presented both sides of the arguments amicably, sometimes agreeing and other times agreeing to disagree.

The rewrite project attempts to address five key areas:

- apportionment formula factor weighting (Compact Art. IV.9);
- equitable apportionment (Compact Art. IV.18);
- definitions of business and nonbusiness income (Compact Art. IV.1(a));
- market-based sourcing (Compact Art. IV.17); and
- the receipts factor (Compact Art. IV.1(g)).

Start With Why

The panelists noted that the rewrite and proposed amendment process is designed to result not in a perfect solution (which doesn't exist), but in the best rules.

So why change the rules? According to the panel, because UDITPA is 56 years old and has become outdated. States have been moving away from it by playing follow-the-leader; one state changes its rules, and other states observe the revenue effects and make the same change. One example is the move away from an equally weighted, three-factor apportionment formula to a double-weighted sales and then to a single-sales-factor formula. Other examples include the trend toward market-based sourcing for sales of services and some states' repeal of the Multistate Tax Compact as a result of *Gillette*. Historically, states have enacted statutes and regulations that negate or customize their application of the compact. Only a few states "unconditionally follow the Act's apportionment formula."[1] UDITPA needs to be changed to catch up with what states are already doing, and possibly even to lead them.

Apportionment Is Art, Not Science

The MTC Uniformity Committee has proposed leaving apportionment formula factor weighting to each state, although it recommends double-weighted sales. The Tax Analysts panel speakers said the double-weighted sales factor is seen as a compromise between the equally weighted, three-factor formula and the single-sales-factor formula. They also said the apportionment formula is art, not science. In 1957, when UDITPA was created, it was unclear whether a sales factor should be included in the formula. Some specialized industries even used five or six factors in their formula, which is notable given that states are now moving toward a single-sales-factor formula.

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The panelists said all apportionment formulas could be put on a continuum, with one end reflecting all the taxpayer's activity and the other end reflecting no activity. The problem is that not only do apportionment formulas have inherent flaws, but they also can produce unreasonable results when applied to specific fact patterns. Some panelists suggested using industry-specific apportionment

[1]Pomp, "Report of the Hearing Officer: Multistate Tax Compact Article IV [UDITPA] Proposed Amendments," Multistate Tax Commission (Oct. 25, 2013).

formulas, because an apportionment formula is not a one-size-fits-all proposition.

Pay Tax for Resources Provided

Some of the panelists said businesses should pay tax on the resources states provide to assist or allow the business to produce income. That caught my attention because many policies, such as single-sales-factor apportionment and market-based sourcing, attempt to tax or increase tax on out-of-state businesses. The states then provide credits and incentives for companies to relocate to or remain in a state.

Companies located in a state arguably use more of the state's resources. Hence, based on the premise that companies should pay tax on resources provided, in-state companies should pay more than out-of-state companies. Single-sales-factor apportionment and market-based sourcing don't correlate with that premise. The apportionment formula should not ignore inputs such as property and payroll, and some of the panelists even said that a formula with only property and payroll factors could sometimes produce more reasonable results.

Economic Reality

One panelist said the apportionment formula should reflect economic reality. Unfortunately, every state has a different definition or method used to determine that reality — prompting the discussion on revisions to section 18, or alternative apportionment.

The panel noted that the word "distortion" doesn't even appear in the compact. However, panelists appeared to agree that the level of distortion produced by an apportionment formula is a reasonable factor in determining whether alternative apportionment should be used.

One of the biggest questions regarding section 18 is who bears the burden of proof when the section is invoked. The panel's consensus was that the burden should be placed on the party requesting alternative apportionment. However, the rule in some states is that the state does not bear the burden when it invokes alternative apportionment and assesses additional tax. Instead, the burden is on the taxpayer to prove that the assessment is incorrect. The state may change the apportionment method under section 18 and make the taxpayer prove the state is wrong or that an alternative method more clearly reflects economic reality. As a result, taxpayers are unable to follow statutes and regulations as written and are forced to anticipate what the state will consider fair and reasonable.

Some states, when invoking section 18, have required taxpayers to use apportionment methods not authorized by statute or regulation, thereby depriving taxpayers of notice.

The Law Doesn't Matter

Rosen said auditors have told him the "law doesn't matter." Some auditors (or tax departments) believe taxpayers should pay more tax because it seems fairer, regardless of the law. That raises the question: What do auditors really follow?

Auditors often follow tax department policies that may not comport with the law. State departments may change their policies on an issue for a specific industry and begin to audit all taxpayers in that industry. On audit, the taxpayers learn of the policy change and respond with evidence of department approval from a previous audit. The taxpayer might also point out that state statutes and regulations haven't changed. The taxpayer then learns that the issue is simply a result of a new departmental policy. Sometimes the auditor issues an assessment, leaving the taxpayer no choice but to file an appeal to resolve the matter. Those cases are often settled at the appeals level in the taxpayer's favor. The law matters, but it can be costly and time-consuming to apply.

Apportionable (Business) Income

Also discussed was the proposal to change the name of business income to apportionable income and non-business income to non-apportionable income. Panelists appeared to accept the change in terminology, but disagreed on whether the definition should include two tests (functional and transactional) or just one (transactional). The panelists discussed that in the context of whether gains on the sale of property used in a business are apportionable or allocable income. Strong arguments were made for both sides of the equation, with no consensus.

The panelists also discussed the trend in state legislation to define business income as all income apportionable under the U.S. Constitution. Taxpayers and practitioners often equate that change in definition to a change in policy or how business income is determined, when it should be viewed as simply a change in terminology. As one panelist pointed out, statutes have always been under the authority of the U.S. Constitution. Therefore, constitutional limitations should always be considered regardless of how business income is, or was, defined.

Where Services Are Delivered

The MTC Uniformity Committee recommended sourcing services, or applying market-based sourcing, based on where services are delivered. According to the panelists, the goal is to source sales to the market, and the belief is that delivery is a clearer distinction than benefit derived or benefit received. Although that standard may seem clearer, where a service is delivered can remain unanswered when services are provided by accounting, law, or architectural firms, for example.

Regardless of the terminology used, market-based sourcing is an attempt to reflect how sales of tangible personal property are sourced — by destination, not origin. That gets back to the argument that the sales factor should represent the market state, not the state where the inputs (property or payroll) are located. If the sales factor reflects the inputs, it is simply duplicating the property and payroll factors and apportioning a larger percentage to production states.

The panel suggested that the decades-long preference to use the cost-of-performance approach was not based on any empirical science or data. Therefore, changing to market-based sourcing need not be based on any strong data, but can simply be based on the notion that the sourcing of services should match the destination principle used for sourcing sales of tangible personal property.

Regardless of whether today's economy is more services-based than manufacturing-based, we are talking about apportionment. If all states use the same market-based sourcing approach, a taxpayer's income should simply be redistributed among the states (with some states receiving more income than before and some receiving less). A single state may see a material increase or decrease in tax revenue, depending on whether it is more of a market or production state. Regardless of whether UDITPA is changed, each state must conduct its own analysis to choose between the cost-of-performance and market-based approaches and must make those decisions in concert with its other policies.

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Regardless of a state's approach, a company should be able to follow the state's statutes and regulations as written. If a taxpayer has no sales in a cost-of-performance state, the state should be unable to use section 18 to require the taxpayer to use a market-based approach. A taxpayer should be able to follow a state's laws without fear that the state will require it to use a method not authorized by statute or regulation — what Rosen called "turning statutes and regulations on their head."

Factor Representation Not Required

The panel disagreed about whether factor representation was required within the apportionment formula, meaning that if the income from a transaction is included in the tax base, taxpayers argue that the receipts related to the transaction should also be included in the sales factor.

The proposed amendments include redefining receipts to reflect all receipts associated with transactional income, thereby excluding receipts related to occasional sales of fixed assets or treasury function activities. The goal is to limit the possibility of distorting the receipts factor with large, one-time transactions. That is a worthy goal, but the approach may not be representative of a taxpayer's activity or the income in the tax base. Therefore, regardless of how the term "receipts" is defined, factor representation should always be allowed or the income should be removed from the pre-apportioned tax base.

Conclusion

Factor weighting is a train that has already left the station — most states have moved away from the equally weighted, three-factor formula and have adopted the double-weighted sales factor or the single-sales-factor formula. Changes in the compact may have a negligible influence at this point.

States and taxpayers have increasingly used alternative apportionment under section 18 to obtain reasonable and fair apportionment results. More guidance is needed regarding the burden of proof and the ability of states to turn statutes and regulations on their head.

The distinction between business and nonbusiness income is not a new issue, but the tests required and court decisions vary among states and are contradictory. The change in terminology may be well-intentioned, but not helpful.

Market-based sourcing has become commonplace. Unfortunately, both it and the cost-of-performance approach present complexity and confusion. Thus, sourcing based on delivery may sound like simplification, but will probably result in complication.

The type of receipts that should be included in the sales factor has frustrated many taxpayers. Clarity is essential, but as usual, it will likely produce unfavorable results in some circumstances.

The rewrite project is laudable and most likely necessary. However, as Pomp and Rosen said, the devil's in the details. ☆

The SALT Effect is written by Brian Strahle, a state and local tax researcher, writer, blogger, and consultant. He provides research, writing, and help-desk services to accounting firms, law firms, and news organizations, and is also the author of the state tax blog LEVERAGE SALT (www.leveragestateandlocaltax.com). He welcomes comments at Strahle@leveragesalt.com.