Apportionment Rules Evolve As Business Environment Changes

By Michael S. Schadewald

Michael S. Schadewald examines apportionment rules with a focus on the sales factor.

Introduction

Corporations that are taxable in two or more states use apportionment formulas to determine the percentage of their business income that is taxable in each state. These formulas generally reflect the model statutes found in the Uniform Division of Income for Tax Purposes Act (UDITPA), and the related Multistate Tax Commission (MTC) regulations. UDITPA was promulgated by state tax officials in 1957, and there have been massive changes in the U.S. business environment during the past 50 years. Examples include growth in the service sector, export sales and outsourcing, as well as the increased importance of intellectual property and marketing intangibles. These changes have created significant challenges for state tax officials and corporate taxpayers as they struggle to apply a somewhat antiquated framework for apportioning income. This article analyzes how states are responding to these challenges, with a focus on the sales factor.

Importance of Sales Factor

In most state apportionment formulas, the sales factor is preeminent. The UDITPA apportionment formula places equal weight on the sales, property and payroll factors. In 1978, however, the Supreme Court ruled that a three-factor formula is not constitutionally required.[1] Since that ruling, many states have modified their apportionment formulas to place more weight on the sales factor. State lawmakers are attracted to a formula that super-weights the sales factor because it tends to shift the tax burden from in-state corporations that have significant facilities in the state to out-of-state corporations that have little or no property or payroll in the state, but do have in-state customers.

Roughly 10 states currently use an apportionment formula that equally weights sales, property and payroll. About 20 states, including California, Florida, Massachusetts, New Jersey and North Carolina, use a formula that weights sales twice as much as property and payroll. Six states, including Illinois, Iowa, Nebraska, New York (effective in 2007), Oregon and Texas, use a formula that includes only a sales factor. In addition, several other states have enacted legislation to adopt a sales-only formula, including Georgia and Wisconsin (effective in 2008), Indiana (effective in 2011) and Minnesota (effective in 2014). Michigan, Ohio and Pennsylvania also super-weight the sales factor.

UDITPA Rules for Computing the Sales Factor

The sales factor is a fraction, the numerator of which is the taxpayer's total in-state sales during the tax year, and the denominator of which is the taxpayer's total sales everywhere during the tax year (UDITPA §15). For this purpose, the term *sales* means all gross receipts of the taxpayer other than receipts related to nonbusiness income (UDITPA §1(g)).

Under the general rule, sales of tangible personal property are attributed to the state in which the prop-

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erty is "delivered or shipped to a purchaser" within the state (UDITPA §16(a)). This *destination test* reflects the purpose of the sales factor, which is to recognize the contribution of the market states to the production of business income. An exception applies to sales to a purchaser in a state in which the taxpayer is not taxable, which are attributed to the state in which "the property is shipped from an office, store, warehouse, factory, or other place of storage in this state" (UDITPA §16(b)). This *throwback rule* ensures that all of a taxpayer's sales are attributed to a state in which the taxpayer is taxable. Sales to the U.S. government are also assigned to the state from which the property is shipped.

A different attribution rule applies to sales other than sales of tangible personal property, such as services, rental, royalty and interest income. These types of gross receipts are attributed to the state in which "the income producing activity is performed" (UDITPA §17(a)). If the income producing activity is performed in two or more states, the gross receipt is attributed to the state in which a greater proportion of the income producing activity is performed, based on costs of performance (UDITPA §17(b)). Many practitioners refer to UDITPA §17 as the *costs of performance rule*.

Outsourcing and the Costs of Performance Rule

MTC Reg. IV.17(2) provides that for purposes of applying the costs of performance rule, a taxpayer's income producing activity does not include activities performed on a taxpayer's behalf by an independent contractor. Thus, if a taxpayer outsources a portion of the income producing activity, payments made to the independent contactor are excluded from the costs of performance analysis. This rule may reflect, in part, a desire to avoid the administrative difficulties associated with determining where an independent contractor performs an income producing activity.

In *General Motors Corp.*,[2] the Virginia Supreme Court ruled that a state regulation which excluded payments made to independent contractors from the costs of performance was invalid. As a consequence, the taxpayer could include payments made to out-of-state independent contractors in its costs of performance analysis, which reduced its Virginia apportionment percentage. General Motors argued that the regulation was invalid because the controlling statute did not specifically require costs of performance to be based solely on the costs of activities directly engaged in by the taxpayer. The Virginia Department of Taxation argued that excluding payments to independent contractors was a practical interpretation of the statute because its auditors may be unable to determine an independent contractor's costs of performance, given that the independent contractor could be located anywhere in the world and may not be obligated to cooperate with the Department. Although the court acknowledged these practical difficulties, it concluded that this was a matter to be addressed by the state legislature rather than the court.

The MTC is considering a draft amendment to MTC Reg. IV.17 (November 2006) which would include payments to independent contractors in the costs of performance and provide guidance for determining where an independent contractor performs an income producing activity. The proposed amendment reflects the common, present-day practice of outsourcing business activities to third parties.

Licensing Intellectual Property and Marketing Intangibles

Consistent with UDITPA §17, for Massachusetts tax purposes, royalties and licensing fees are attributed to Massachusetts if the income producing activity is performed in Massachusetts. For this purpose, the income producing activity is considered to be performed in Massachusetts to the extent the intangible property is used by the licensee in Massachusetts. On October 6, 2006, the Massachusetts Department of Revenue provided guidance for determining the place of use of intangible property (Mass. Regs. §63.38.1). The new regulations distinguish between royalties and licensing fees derived from marketing intangibles (*e.g.*, trademarks or trade names), as opposed to nonmarketing intangibles (*e.g.*, patents or copyrights). Special rules apply to software transactions.

Royalties and licensing fees derived from marketing intangibles are attributed to Massachusetts to the extent the income is attributable to the sale of goods or services purchased by Massachusetts customers. In the absence of actual evidence of the licensee's receipts derived from Massachusetts customers, the income is attributed to Massachusetts based upon the percentage of the Massachusetts population in the geographic area in which the licensee is permitted to use the intangible property to market its goods or services.

Royalties and licensing fees derived from nonmarketing intangibles are attributed to Massachusetts to the extent that the use for which the royalties or fees

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are paid takes place in Massachusetts. If the taxpayer or the IRS can not reasonably establish the location of the actual use, it is presumed that the use takes place in the state of the licensee's commercial domicile.

Treasury Department Operations

In *Microsoft Corp.*,[3] the California Supreme Court ruled that Microsoft could include in the sales factor the entire amount of its gross receipts, including both income and return of capital, from the redemption of investments in short-term marketable securities. This significantly reduced Microsoft's California apportionment percentage because the gross receipts were attributed to its treasury department operations in the State of Washington. The California Supreme Court also ruled, however, that the Franchise Tax Board had met its burden of proving that California's standard apportionment provisions did not fairly represent Microsoft's activities in California, and that an alternate formula should be used to calculate its apportionment percentage. Including the full redemption price of a marketable security in the sales factor seriously distorted Microsoft's California apportionment percentage because the profit margins on its redemptions of marketable securities was only 0.2 percent, compared to a profit margin in its primary business of 31.4 percent. The sales factor assumes that a taxpayer's profit margin on gross receipts does not vary significantly from state to state. In reality, Microsoft's margin on the gross receipts from redemptions of marketable securities, all of which was attributable to its treasury operations outside California, was far lower than its average profit margin on all its gross receipts. As a consequence, applying Microsoft's average margin to its California gross receipts severely underestimated the amount of income attributable to Microsoft's activities in California.

Concurrent with its decision in the *Microsoft* case, the California Supreme Court also issued an opinion in *General Motors Corp.*[4] In *General Motors*, the court ruled that only the interest portion of the gross receipts generated from repurchase agreements is includable in the sales factor, and remanded the case to determine whether the Franchise Tax Board could meet its burden for using an alternate apportionment formula to prevent distortion.

Market-Based Source Rule for Sales of Services

The UDITPA §17 costs of performance rule for sales of services does not accurately measure a service company's customer base when the service provider performs services in one state and the service recipient is located in another state. Doing business with an out-of-state service provider was a rare occurrence when UDITPA was drafted in 1957. Half a century later, however, it is a common business practice. In such cases, the costs of performance rule functions as an origination test, mimicking the property and payroll factors, rather than as a destination test. In response to these concerns, six states, including Georgia, Iowa, Maryland, Minnesota, Ohio and Wisconsin, have adopted a market-based source rule which attributes sales of services to the state in which the service recipient is located. This approach provides a better measure of the taxpayer's customer base, and has the political appeal of shifting the tax burden from in-state service companies that have significant facilities in the state to out-of-state companies that have little or no property or payroll in the state, but do have in-state customers.

Wisconsin is the most recent state to modify its rules for sourcing sales of services. Effective for tax years beginning on or after January 1, 2005, sales of services are attributed to Wisconsin if the "purchaser of the service received the benefit of the service" in Wisconsin (Wis. §71.25(9)(dh)). The benefit of a service is received in Wisconsin if any of the following apply: (i) the service relates to real property located in Wisconsin; (ii) the service relates to tangible personal property located in Wisconsin at the time the service is received or tangible personal property delivered to customers in Wisconsin; (iii) the service is provided to an individual who is physically present in Wisconsin at the time the service is received; or (iv) the service is provided to a person engaged in a trade or business in Wisconsin and relates to that person's business in Wisconsin. If the purchaser receives the benefit of the service in more than one state, the sale is attributed to Wisconsin based on the portion of the benefit received in Wisconsin. Finally, a throwback rule applies if the taxpayer is not taxable in the state in which the benefit of the service is received and the taxpayer performs the service in Wisconsin.

Sales of "Personal Services"

MTC Reg. IV.17(4)(B)(c) provides a special rule for applying the UDITPA costs of performance rule to sales of personal services, under which the gross receipts from personal services performed in two or more states are prorated among the states based on the ratio

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of the time spent in performing the services in each state to the total time spent in performing the services everywhere. In Legal Ruling 2005-1 (Mar. 21, 2005), the California Franchise Tax Board addressed the issue of what constitutes personal services for purposes of applying this special rule. It concluded that *personal services* means any service where capital is not a material income-producing factor, and is not limited to specialized services performed by one individual for the personal benefit of another (*e.g.*, a doctor) or professional services (*e.g.*, an accountant).

Throwback of Export Sales

For purposes of the UDITPA §16(b) throwback rule, a taxpayer is taxable in another state if it meets either a subject-to-tax test or a jurisdiction-to-tax test (UDITPA §3). The subject-to-tax test is met if the taxpayer carries on business activities in a state and the state imposes a net income tax, franchise tax, or corporate stock tax on those activities (MTC Reg. IV.3.(b)). The jurisdiction-to-tax test is met if the taxpayer's business activity in the state is sufficient to give the state jurisdiction to impose a net income tax, taking into account the protections afforded by both the U.S. Constitution and Public Law 86-272, regardless of whether the state actually imposes the tax (MTC Reg. IV.3.(c)). In terms of constitutional protections, in *Quill Corporation*,[5] the Supreme Court ruled that an economic presence is sufficient to satisfy the Due Process Clause minimum connection requirement, whereas a physical presence is required to satisfy the Commerce Clause substantial nexus requirement, at least with respect to sales and use taxes. Public Law 86-272 prohibits a state from imposing a net income tax on an out-of-state corporation if the corporation's only activity in the state is the solicitation of orders by company representatives for sales of tangible personal property, which orders are sent outside the state for approval or rejection, and if approved, are filled by shipment or delivery from a point outside the state.

The application of the jurisdiction-to-tax test can be ambiguous when dealing with export sales made by a U.S. corporation to purchasers located in a foreign country. One possible jurisdictional standard is U.S. constitutional nexus as limited by Public Law 86-272. Another possible standard is the foreign country's nexus standard for taxing the business profits of a U.S. corporation. If the United States has entered into an income tax treaty with the foreign country, the jurisdictional standard generally is doing business in the foreign country through a fixed place of business, such as a sales office (*e.g.*, Articles 5 and 7, U.S. Model Income Tax Treaty of 2006). According to MTC Reg. IV.3.(c), the determination of whether a taxpayer's business activity in a foreign country satisfies the jurisdiction-to-tax test is made as if the jurisdictional standards applicable to a U.S. state applied in the foreign country, and the impact of any income tax treaty provisions is ignored.

In *Morton International, Inc.*,[6] the Illinois circuit court ruled that sales of goods shipped from Illinois to purchasers in foreign countries did not have to be thrown back to Illinois because the U.S. exporter was taxable in the destination countries for throwback purposes. Morton shipped goods from an Illinois facility to purchasers in six foreign countries. Morton also derived royalties from patent licenses in the same six countries and dividends from foreign corporations in two of the countries. Morton's royalty and dividend income had no direct relationship to its sales of goods. Although Morton did not pay foreign income taxes on the export sales of goods, it did pay foreign withholding taxes on the royalty and dividend income. The Illinois Department of Revenue argued that for throwback purposes, the term "taxable" means that the tax must be paid on the particular sales at issue. The court rejected this argument, and ruled that the taxpayer need only be subject to some type of income tax in the destination country to avoid throwback. Therefore, the export sales of goods did not have to be thrown back to Illinois because Morton was clearly taxable in the six foreign countries, albeit on unrelated royalty and dividend income.

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Destination Test and Combined Unitary Reporting

Another complexity of applying the destination test and throwback rule to sales of tangible personal property arises when a state requires a group of related corporations to compute their taxable income on a combined unitary basis. In such cases, does the term *taxpayer* mean the specific member of the unitary group that is making the sale or does it mean all of the members of the unitary group? The two approaches to resolving this issue are known as *Joyce* and *Finnigan*, in reference to the related court decisions.[7]

Under *Joyce*, the term *taxpayer* means the specific member of the unitary group that is making the sale, in which case an out-of-state member's sales into a state are included in the numerator of the state's sales factor

only if the selling member has nexus in the state. The other implication of *Joyce* is that throwback is avoided only if the selling member has nexus in the destination state. Under *Finnigan*, the term *taxpayer* means all members of the unitary group of which the seller is a member, in which case an out-of-state group member's sales into a state are included in the numerator of the state's sales factor, regardless of whether the selling member has nexus in the state. The other implication of *Finnigan* is that throwback is avoided if any member of the unitary group has nexus in the destination state.

In *Disney Enterprises, Inc.*,[8] Disney and its subsidiaries computed their New York corporate franchise tax on a combined unitary basis. Buena Vista Home Video ("Video") was a California subsidiary that made wholesale-level sales of Disney movie videos. Video employees traveled to New York to solicit sales from retailers which were headquartered in New York. Although Video made significant sales to purchasers located in New York, it included none of its sales in the numerator of the Disney group's New York sales factor because Video was protected from New York taxation on a separate company basis by Public Law 86-272. The Appellate Division of the New York Supreme Court ruled, however, that Video's New York sales are includible in the numerator of the group's New York sales factor, and that doing so did not result in New York imposing a tax upon Video. Instead, the inclusion of Video's sales was merely a device to obtain the best measure of the Disney group's in-state activities. New York had jurisdiction to tax the income of the Disney group and, in finding a formula that fairly apportions the group's taxable income, it may look beyond its borders.

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Dock Sales

The proper application of the UDITPA §16 destination test also is uncertain when an out-of-state purchaser uses its own trucks or hires a third-party common carrier to take delivery (*i.e.*, possession) of the goods at the seller's loading dock, and then transports the goods back to its place of business in another state. These are known as *dock sales*. In such situations, UDITPA §16 can be interpreted as requiring the application of either a *place-of-delivery rule* or an *ultimate-destination rule*. Under a place-of-delivery rule, the dock sale is attributed to the state in which the property is delivered to the purchaser at the seller's loading dock. Under an ultimate-destination rule, the dock sale is attributed to the state in which the purchaser is located.

In *Gilmour Manufacturing Co.*,[9] the Pennsylvania Supreme Court ruled that a Pennsylvania manufacturer's dock sales to out-of-state purchasers are not included in the numerator of the Pennsylvania sales factor. The court concluded that the regulation which required dock sales to be attributed to the "state in which delivery to the purchaser occurs" was contrary to the plain meaning of the controlling statute, which required that sales of goods be attributed to Pennsylvania if the property is "delivered or shipped to a purchaser ... within this state." The court reasoned that the phrase "within this state" was intended to modify the word "purchaser" and not the word "delivered." As a consequence, sales to out-of-state purchasers who pick up the goods at the seller's place of business in Pennsylvania and then transport the goods out of Pennsylvania are not attributed to Pennsylvania. The court noted that this interpretation is consistent with the intended purpose of the sales factor, which is to measure the customer base within the state.

In *Paccar, Inc.*,[10] an administrative law judge ruled that, regardless of where the seller initially delivers the goods or passes title, a sale of goods is attributed to Alabama if the goods are ultimately delivered to a purchaser in Alabama. Paccar manufactured trucks at facilities located outside Alabama, and sold the trucks to independent dealers throughout the United States, including dealers located in Alabama. Paccar hired a third-party common carrier to pick up the trucks at it manufacturing facility outside of Alabama, and deliver them to the dealers in Alabama. The risk of loss, title, and control over the trucks passed from Paccar to the dealers at the out-of-state shipping dock. The controlling statute provided that sales of goods are attributed to Alabama if the goods are "delivered or shipped to a purchaser ... within this state." The judge concluded that, as a matter of statutory construction, the issue could reasonably be decided either way. Therefore, the judge looked to the legislative intent of the sales factor, which is to recognize the contribution of the market states to the production of business income, and ruled that the ultimate destination rule applies to Paccar's dock sales.

Conclusion

Vast changes in the U.S. economy and the business practices of corporations have placed numerous strains on the UDITPA framework crafted in 1957. Until UDITPA is updated to reflect modern business realities, state tax officials and corporate taxpayers will continue to grapple with its many uncertainties.

Endnotes

[1] *Moorman Manufacturing Co. v. Bair,* 437 US 267 (1978).
[2] *General Motors Corp. v. Dep't of Tax'n,* 268 Va. 289, 602 SE2d 123 (2004).
[3] *Microsoft Corp. v. Franchise Tax Board,* 39 Cal. 4th 750, 139 P3d 1169 (2006).
[4] *General Motors Corp. v. Franchise Tax Board,* 39 Cal. 4th 773, 139 P3d 1183 (2006).
[5] *Quill Corporation v. North Dakota,* 504 US 298 (1992).
[6] *Morton International, Inc. v. Dept. of Rev.*, Ill. Cir. Ct., Cook Cty., No. 01 L 50752 (July 8, 2004).
[7] *Appeal of Joyce, Inc.,* Cal. St. Bd. of Equalization, No. 66-SBE-069 (Nov. 23, 1966); and *Appeal of Finnigan Corp.,* Cal. St. Bd. of Equalization, No. 88-SBE-022 (Jan. 24, 1990).
[8] *Disney Enterprises, Inc.*, N.Y. Sup. Ct., App. Div., No. 99719 (Mar. 1, 2007).
[9] *Pennsylvania v. Gilmour Manufacturing Co.*, 573 Pa. 143, 822 A2d 676 (2003).
[10] *Paccar, Inc. v. Dept. of Rev.*, Ala. Admin. Law Div., No. Corp. 04-715 (Jan. 11, 2006).

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