Multistate Taxation: Income Taxation. Fall 2017 (all sections)

The casebook is Pomp, State and Local Taxation, 8th ed., 2015, available at the NYU bookstore. It is also available at richardpomp.com. That site has a thumb drive version of the Book for PCs only, no Macs. If you buy the casebook used, make sure it is in good condition and that the binding is not broken.

There will be a take home exam that can be written any time during the examination period. There is no time limit on the exam but there will be a word limit on each answer. You must return the exam by the end of the examination period. The registrar will contact you with details later in the semester. Other than drawing up the exam and grading it, I have no role in the administration of the exam. All questions should be directed to the registrar.

I do not monitor the NYU e mail system. You can contact me via rickpomp@outlook.com. I welcome your substantive questions. For the on-line students, should you have any questions about the tapes, the rules on viewing the tapes, or any administrative matters whatsoever, contact John Stephens. Tel. 212 998 6394, or john.stephens@nyu.edu.

I have no power other than dealing with the substantive aspects of the class. NYU has a very large and able administrative staff. I am sure you are already familiar with two of the best: John Stephens and Josh Blank. My very capable administrative assistant is Greg Zwahlen. Tel 212-998-6152; or zwahleng@exchange.law.nyu.edu.

For the day students, please fill up the class starting from the first row and working towards the rear. Avoid the last two seats at the extreme left and extreme right of each row. I want no stragglers in the rear. I want a tight formation conducive to conversation.
For the first class, please read in the Casebook the Preface to Students, p. xv, Chapter Ten, pages 10-1 to 10-32, stop at “IV. Composition of the Factors of the Apportionment Formula.” In Chapter Eleven, read Underwood, at 11-26, and be prepared to answer Questions 1, 2, 3, 6, and 9. Included here as a one-time courtesy.

A syllabus will be distributed shortly.
Preface for Students

Once upon a time, issues of state and local taxation played to a small audience. Federal tax matters held center stage; state and local issues were relegated to the wings. State and local tax matters have finally emerged from their secondary status and have moved into the spotlight. The major accounting firms have expanded their state and local services and have organized special consulting divisions to work with state officials. Law firms are competing for what was formerly the domain of accountants. Academics have discovered what a small but devoted number of their colleagues had already known: that state and local tax issues present all of the intellectual challenges inherent in the study of the federal corporate and personal income taxes and the estate tax, with the additional challenge of a constitutional dimension. Further, whereas many of the weaknesses in the federal tax system are well documented, intensely analyzed, and subject to lively scholarly debate, state tax issues are, by comparison, a relatively unexplored territory. Many fundamental questions remain unresolved. Some of you will find that exhilarating because you will participate in formulating the answers; others will find that frustrating and long for the highly embroidered Internal Revenue Code and regulations.

Most state tax systems are ripe for reexamination by policymakers, legislators, and academics. The premises that underlie a traditional state tax system are under severe attack. State tax systems developed in a far simpler time—a time when substantial sectors of the economy, such as transportation, communications, banking, financial services, and power generation were either regulated or subject to significant federal controls. State tax systems evolved when the economy was dominated by mercantile and manufacturing activities, and little thought had to be given to the tax treatment of services or intangible property. Multinational corporations and conglomerates were yet to emerge, and few corporations had substantial amounts of foreign income. It was a world in which corporations did not electronically transfer funds around the globe, 800 telephone numbers were not widespread, large mail order houses had not yet proliferated, national credit cards did not exist, UPS and FedEx were just dreams, the Internet did not exist, and the pace of federal tax reform was comfortably slow. In addition, state taxes were typically low enough to discourage much litigation.

Today, state tax systems are being overtaken by technological advances, new forms of business organizations, the globalization of business, changes in the judicial climate, the relaxation of federal controls over the economy, and the possibility of significant federal tax reform. Despite these issues, other countries are looking to the states to see how they have handled the challenging problem of cross-border transactions.

Many states have organized some type of temporary commission to study their tax structures. Although in most cases these commissions, like California’s, were responding directly to a financial crisis, others, like New York’s, were formed because of legislative concerns that the existing tax structure was atavistic.

Federal tax changes also helped move state tax issues onto center stage. The most significant change was the Economic Recovery Tax Act of 1981 (ERTA), which gutted the federal corporate income tax by revamping the treatment of depreciation and by introducing safe-harbor leasing. Many of the largest corporations in the United States paid no corporate income tax for several years as a consequence of ERTA.

ERTA had a major impact upon the field of state taxation. Because no state wishes to reinvent the Internal Revenue Code, state personal and corporate income taxes are, with varying degrees of fidelity, based on federal concepts. If ERTA’s rules on depreciation and safe-harbor leasing had been incorporated into state tax laws, however, many states would have suffered significant loss of tax revenue without any commensurate benefits. Accordingly, many states refused to embrace fully the federal changes and “decoupled” from ERTA’s rules on depreciation and safe-harbor leasing. More fundamentally, many states started to question the degree to which other aspects of their tax laws should emulate and mimic the Internal Revenue Code. The decoupling issue sharply focused both the revenue costs and the administrative benefits of conforming to the federal system.
ERTA also had severe repercussions for state and local tax practitioners. By decreasing the impact of the federal income tax on many corporations, ERTA substantially increased the relative significance of state income taxes, especially in states that had decoupled. In many cases, a corporation’s state corporate tax was greater than its federal corporate tax—a situation that did not escape notice by CEO's or corporate tax managers. State and local tax practitioners became the object of new interest on the part of corporate management. Consciousness about state tax issues was also heightened by the U.S. Supreme Court's decisions in Complete Auto, Japan Line, Moorman, Commonwealth Edison, Maryland v. Louisiana, Westinghouse, Mobil, Exxon, ASARCO, Woolworth, and Container (see Chapters 1 and 11), all of which were decided between 1977 and 1983. Corporations that had typically treated state issues as secondary to federal concerns reexamined their own priorities. Emphasis shifted from issues of compliance to those of planning.

The Tax Reform Act of 1986 also had a major effect on the state tax profession. By lowering federal marginal tax rates, the Act increased the after-tax cost of deductible state taxes. The Act generated additional pressure on lawyers and accountants to reduce state taxes through planning. This pressure was exacerbated by increases occurring in state taxes across the country. New forms of doing business, such as limited liability companies (LLC’s) and partnerships (LLP’s), the increased use of intellectual property holding companies, more sophisticated tax minimization strategies, and the rise of electronic commerce are forcing tax administrations to respond more aggressively. This combination of pressures has generated an unprecedented demand for legal and accounting services.

There are a fairly small number of well known, extremely capable law firms with active, full-time state tax practices. They are staffed with the luminaries in the field, among the best lawyers in the legal profession. These firms, however, are the exception. Many large, prominent firms with traditionally strong federal tax practices have been late in recognizing the potential of the state tax market. Such firms have displayed the common bias of federal tax lawyers who traditionally have looked down on their state counterparts. But times have changed, and these firms are now playing catch up and trying to compete with the more established state tax practices—and not being very successful at doing so.

Meanwhile, the bigger accounting firms are no longer content to do compliance work and have dynamic and growing state practices geared to planning and tax minimization strategies. Some of the cases that you will read in this course are challenges by state tax departments to strategies that were created and marketed by major accounting firms.

The accounting firms now actively recruit from law firms, industry, and government, and woo recent graduates with attractive starting salaries, often commensurate with those of law firms. These accounting firms now claim some of the brightest minds in the business, people who combine technical virtuosity with a creativity and a boldness that were more commonly associated in the past with the federal tax bar. With their extensive network of offices, their computer simulation models, their large staffs that can handle an array of state tax issues, and their increased willingness to be involved in dispute resolution, the accounting firms have changed the nature of a state tax practice and have emerged as major players.

State tax departments, helped by the shortage of jobs in the private sector caused by the legal recession, hire young, ambitious, and often well-trained professionals who know where the bodies are buried and raise cutting edge issues. These tax departments typically have a core of sophisticated persons who can go toe-to-toe with those in the private sector. They are wonderful mentors to a younger crop of talent.

As some states have increased their rates and expanded their bases, the ante has been raised, which means taxpayers are more willing to litigate because the stakes are now higher. It is also increasingly worthwhile for clients to spend more time and money on tax planning.

In short, by any measure—adoption of new taxes, legislative changes in existing taxes, amount of litigation, breadth of court decisions, number of scholarly articles, or extent of job opportunities—the field of state and local taxation is in ferment. It is one of the two hottest areas in taxation. Consequently, whether your
interests run to the public or private sectors, are mercenary or intellectual, or any combination thereof, your timing in taking a course in state and local taxation is excellent.

A word about statistics. There is a smattering of statistics throughout this book. As lawyers, you should appreciate that underlying the collection of data are usually definitional issues. For example, the government collects useful data on sales taxes (see infra Chapter Six), but the way that sales taxes are defined may not correspond with the way that we lawyers would define them. To take just one illustration, the term “gross receipts taxes” can refer to either a sales tax like New Mexico’s, or a business activity, turnover tax like Ohio’s (more about this in Chapter Nine). To a data collector, this distinction, which has legal and constitutional significance, may be lost.

Also, always make sure you know who is collecting the data and for what purpose. Special interest groups abound. There are many legitimate judgment calls that have to be made in collecting, characterizing, and analyzing data. Rarely will an outsider be aware of the scope of judgment calls and assumptions that are behind the presentation of the data. The tendency is consciously (or not) to make those assumptions that are consistent with the group’s outlook. Another group of an opposite persuasion, working with the same raw data, might well reach significantly different results. This is not a question of honesty or dishonesty, but rather a case where having a particular view or mindset will lead you to make certain types of assumptions—defensible assumptions to be sure, but not the only ones that could be made. The lesson is to treat all of the statistics and data herein as suggestive rather than definitive.

State taxation is in turmoil. The recession that started in 2007 has forced many states to reexamine their tax systems. Further, the current anti-tax climate has led Congress to introduce bills that would pre-empt state taxes. Although every attempt has been made to ensure that the material in this book is accurate as of July 2015, it may well have been overtaken by subsequent developments.
The next chapter presents the leading cases on state corporate income taxes. Studying judicial cases has a number of advantages, but seeing the “big picture” is not one of them. To be able to understand these cases, the reader needs to see how all the pieces fit together. That background is necessary before the reader can explore the strengths, weaknesses, and implications of the decisions. Further, an appreciation of the structure of a corporate income tax is required before evaluating tax planning strategies. Accordingly, this chapter provides a fairly lengthy and detailed overview of state corporate income taxes to provide a background and context for evaluating the subsequent material. Some of the material is dense, but mastering it will be worth the effort.

I. A Brief Historical Overview

A. Early History

Before the advent of general incorporation statutes in the United States, corporations were typically chartered through special legislative acts. As a result, this form of doing business was relatively uncommon. At the beginning of the nineteenth century, for example, only 317 corporations operated in the United States, primarily in banking, insurance, and transportation (turnpike roads, canals, railroads, and toll bridges); few were in manufacturing. With the invention of the power loom, which led to the growth of the textile industry, manufacturing corporations became more common. By the 1830’s, charters for manufacturing corporations exceeded those for banking, insurance, and transportation. By the 1870’s, general incorporation statutes were the norm in the United States, and the corporate form of doing business became widespread. (With the advent of pass-through entities, the corporate form has become less popular for small businesses.)

During most of the nineteenth century, a tax on real and tangible property was the dominant form of state taxation. As the ownership of corporate stock became increasingly common, the states grew more concerned with how to tax corporate stock under the property tax than with how to tax corporations on their income. Despite some state flirtation with corporate income taxes, no pattern of taxing corporations emerged. To the


2. Id. at 300; Edwin R. A. Seligman, Essays in Taxation 137-38 (1895).


6. For a trend line, see id.
contrary, a leading public finance economist, writing at the end of the nineteenth century, identified thirteen different methods of taxing corporations, marked by a "chaos of principle."\(^7\)

A major impetus for the state corporate income tax was the 1909 adoption of the federal corporate income tax.\(^8\) Inspired by the federal corporate income tax, the states enacted similar taxes.\(^9\) Wisconsin adopted the first modern state corporate income tax in 1911 (as well as a personal income tax), and by 1920 Connecticut, Massachusetts, Missouri, Montana, New York, North Dakota, and Virginia had followed Wisconsin’s lead.\(^10\) Eight more states adopted corporate income taxes in the 1920’s.\(^11\) The Great Depression forced the states to turn to new revenue sources to finance relief programs and to offset the shortfall in existing taxes. The District of Columbia and sixteen states used corporate income taxes as a new revenue source.\(^12\) In the 1940’s and 1950’s, state economies were generally robust, which diminished interest in the tax, and only Delaware, New Jersey, and Rhode Island adopted corporate income taxes during this period.\(^13\) The increased public spending of state governments in the 1960’s and 1970’s touched off the last major round of adoptions.\(^14\)

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7. Seligman, supra note 2, at 176. In 1823, New York became the first state to refer specifically to corporations as one of the persons subject to the property tax. Id. at 138. Corporations could, however, commute the property tax by paying a tax equal to ten percent of their dividends, profits, or income. Seligman speculates that “dividends, profits, or income” were presumed by the Legislature to be identical. Accordingly, this alternative to paying the property tax could be viewed as one of the earliest versions of a corporate income tax. The ability to commute the property tax by paying a tax on profits was eliminated in 1857. Id.

   Pennsylvania was also one of the early states to experiment with a corporate income tax. In 1814, Pennsylvania adopted a tax on the dividends or net profits of banks. Id. at 143. This tax went through various permutations and in 1868, Pennsylvania imposed a three percent tax on the net earnings or income of most corporations. This tax applied to corporations incorporated in Pennsylvania and to corporations doing business in the state. Virginia applied an income tax to corporations in 1844, and during the Civil War, Georgia and a few other states also taxed corporate income.

   Taxes on capital stock were common during the nineteenth century and still exist in many states. These taxes come in many forms. For a general discussion, see Richard D. Pomp, Reforming a State Corporate Income Tax, 51 Alb. L.Rev. 375-43 (1987).

8. A federal corporate income tax was enacted in 1894 as part of a statute that also taxed individuals. This statute was declared unconstitutional in Pollack v. Farmer’s Loan & Trust Company, 158 U.S. 601 (1895). The 1909 corporate income tax was part of the Payne-Aldrich Tariff Act and upheld in Flint v. Stone Tracy Company, 220 U.S. 107 (1911). The Sixteenth Amendment authorized the type of federal personal income tax used today.

9. Very often a state personal income tax was enacted at the same time as the state corporate income tax. See Clara Penniman, State Income Taxation 2, Table 1 (1980).


11. Arkansas, California, Georgia, Mississippi, North Carolina, Oregon, South Carolina, and Tennessee. Half of these states adopted their taxes in 1929. Penniman, supra note 9.

12. South Dakota and West Virginia adopted corporate income taxes during the Great Depression, but subsequently repealed them. Penniman, supra note 9. West Virginia reinstated its corporate income but South Dakota levies a tax only on financial institutions. In addition to corporate income taxes, the states also adopted sales taxes during the Great Depression. See supra Chapter Six.

13. Both Alaska and Hawaii had corporate income taxes at the time of their admission to statehood in 1959. Penniman, supra note 9.

Early on, the courts were generally protective of the rise of the multijurisdictional corporations and the general view was that the states could not tax them on their interstate commerce. Over time, however, the Supreme Court relaxed the rules. As interstate activities became widespread, and as the need for revenues increased to finance ever-growing public goods, services, and infrastructure, the courts granted the states more latitude in taxing multijurisdictional corporations.

The courts did not require the use of identical tax systems, however. State sovereignty in structuring a tax system was respected. Accordingly, state taxation of multistate corporations was characterized by the lack of nationwide uniformity. Some corporations complained about being taxed on more than 100% of their income whereas the states complained about some corporations being taxed on less than 100%. Moreover, businesses complained that the tax differences among the states imposed substantial compliance costs. There was general dissatisfaction among both the states and the corporate community. As multijurisdictional activities became the norm rather than the exception, both sides grew concerned about the states’ various forms of corporate income taxes.

B. Designing an Apportionment Formula

The growth of interstate mercantile and manufacturing activities in the early part of the 20th century was accompanied by calls for uniformity in state taxation. The Counsel of State Governments recommended that a model law be developed. The National Tax Association (NTA) took up the challenge and proposed an evenly-weighted, three-factor formula for apportioning the income of multistate corporations. The three factors consisted of a state’s percentage of a corporation’s total property, payroll, and sales. The NTA did not claim that this formula was based on any economic principle or theory, or that it was better than other formulas at measuring where income was generated. To the contrary, the NTA recognized that all formulas were arbitrary. The most important thing was uniformity, and that meant a formula on which the states could agree. The property and payroll factors were attractive to the manufacturing states (the origin or production states) and the sales factor was attractive to the market or destination states. By recommending the evenly-weighted, three-factor formula (the so-called Massachusetts formula), a formula that reflected what many states were already doing, and one that was attractive to both the origin and destination states, the NTA opted for political expediency, which would remove obstacles to its widespread adoption.

1. The NCCUSL and the Adoption of UDITPA: Establishing a Framework

Responding to the work of the NTA and calls for uniformity, the National Conference of Commissioners for Uniform State Laws (NCCUSL), known today as the Uniform Law Commission (ULC), drafted the Uniform Division of Income for Tax Purposes Act (UDITPA) in 1957. UDITPA was the culmination of the earlier calls for uniformity in state taxation. UDITPA incorporated what was essentially the existing practice in 1957 in a

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15. The evenly-weighted, three-factor formula is known as the Massachusetts formula, presumably because of that State’s early use of the method. The formulas in the eight taxing states in 1920 included various combinations of tangible and intangible property, receivables, sales, manufacturing costs, wages, salaries and purchases. Underwood, Bass, and Hans Rees’, infra note 61, show that Connecticut, New York, and North Carolina initially used single-factor property formulas. By 1928, the 17 states then taxing corporations on their income used nine different formulas, the most common being based on either property or sales. By 1948, nearly 45% of taxing states, compared with 12% two decades earlier, used the three-factor formula. See infra note 90.

16. UDITPA and the MTC Regulations under UDITPA are contained in an Appendix to this Chapter.
Chapter 10

number of states: an equally-weighted, three-factor formula--property, payroll and sales, previously proposed by the NTA. The Act imposed rules for attributing or assigning property, payroll and sales to a particular state. It also adopted definitions to distinguish unitary business income, which is apportioned using the formula, from non-unitary (non-business) income, which is allocated in total to a particular state. (As discussed below, the Multistate Tax Commission has recently proposed changing the term “business income,” to “apportionable income,” and changing the term “non-business income” to “non-apportionable” income, along with many other proposals.)

UDITPA initially received little attention from the states. Between 1957 and 1964 only three states--Alaska, Arkansas, and Kansas--had adopted it. The failure of UDITPA to be widely adopted frustrated those wanting uniformity. But interest in UDITPA grew once the Supreme Court ruled in 1959 in Northwestern Portland Cement,17 that Minnesota could tax the income of a corporation engaged in interstate commerce. That decision shocked the multistate business community,18 which had hoped the Court would strike down the Minnesota tax. Businesses immediately turned to Congress for the protection from state income taxation that they did not obtain from the Court. Pressure was brought on Congress for a solution; the resulting debate changed the tax landscape forever.

Within two months of Northwestern States Portland Cement—a remarkably short period of time--Congre

2. The Willis Committee

The Willis Committee concluded that the benefits of increased uniformity were compelling. The Report criticized states' efforts at uniformity. "For 50 years, State tax administrators have been discussing ways of achieving simplicity and uniformity. One proposal after another has been formulated, discussed, revised, and in spite of the expenditure of enormous effort, discarded. And, today, the States appear to be as far from a solution as they have ever been . . . " "There is every reason to believe that, without congressional action, the worst features of the present system will continue to multiply." "Each of the state laws contains its own inner logic, the aggregate of these laws—comprising the system confronting the interstate taxpayer—defies reason." H.R. Rep. No. 952, 89th Cong., 1st Sess., Pt. VI, at 1128, 1143 (1965).

The Report was particularly critical of the variation in apportionment formulas. The Committee offered a number of recommendations for Congress, some of which were embodied in the 1965 Interstate Taxation


18. The business community was further agitated when the Court refused to review two Louisiana cases involving interstate commerce that held for the State. Brown-Forman Distillers Corp. v. Collector of Revenue, 359 U.S. 28 (1959); International Shoe Co. v. Fontenot, 359 U.S. 984 (1959). See the discussion in Wrigley, infra Chapter Eleven.


20. One commentator attributes this uncharacteristic haste to the intense lobbying by small- and medium-sized businesses that faced liability for income taxes in numerous states in which their activities were relatively modest. James H. Peters, Why the Multistate Tax Compact?, 12 State Tax Notes 1607 (1997).


10-4 State & Local Taxation
Act, H.R. 11798. Among the bill’s provisions were a uniform two-factor apportionment formula, consisting of property and payroll, a business location nexus standard, full apportionment of all corporate income using federal taxable income as the starting point, the consolidation of corporations having more than a 50% ownership, and federal oversight of state corporate income taxation by the Secretary of the Treasury.

The states were vehemently opposed to the bill, which was viewed as a threat to their sovereignty. The states feared that they would lose control of their tax system should it be “federalized,” that is, should Congress impose uniform rules for the taxation of multistate businesses and delegate oversight to the Treasury. For some states, the proposed two-factor formula would have reduced tax revenue, thus further fermenting state opposition, although the Willis Report claims that in the aggregate the change in revenue would not be great. The market states were particularly upset with the lack of a sales factor. At the least, the two-factor formula was inconsistent with the evenly-weighted, three-factor formula, which most states used (which is why UDITPA chose it).

Business was not happy either. One objection by certain multinational corporations was the bill’s apportionment of foreign source dividends. Taxpayers wanted an exemption for foreign source income and sought to allocate all taxable dividends to the state of commercial domicile. The consolidation rule was also unacceptable to many. Some of the comments by business casts doubt on whether they wanted uniformity at all.

3. The Multistate Tax Compact

The states moved quickly. A group of tax administrators and Attorneys General started work in 1966 on a strategy to keep Congress at bay. The Council of State Governments and the National Association of Tax Administrators (the predecessor of today’s Federation of Tax Administrators) organized a special meeting in Chicago, which proposed a multistate tax compact. Various state Attorneys General and tax administrators started the drafting, and in January 1967 the Multistate Tax Compact was presented to the states. The Compact sets out the following goals: to facilitate the proper determination of state and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes; to promote uniformity or compatibility in significant components of tax systems; to facilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration; and to avoid duplicative taxation. There is no explicit reference to safeguarding state sovereignty. The centerpiece of the Compact was the incorporation of UDITPA, and the creation of the Multistate Tax Commission (MTC).

The Multistate Tax Commission is an intergovernmental state tax agency, composed of the tax administrators from member states, charged with developing and recommending proposals to further the goals of

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23. Extensive hearings were held from January to April 1966. After these hearings, a substitute bill, H.R. 16491 was introduced.

24. Peters, supra note 20. “Business has favored some general pronouncement by Congress on the limits within which states are to be permitted to tax interstate commerce. I doubt that business will favor the subcommittee recommendations after reviewing them completely and carefully. I suggest that the business members review this report and the bill (HR. 11798) which incorporates the recommendations of the subcommittee. Business should concern itself with the underlying philosophy of the proposal, which is toward a partial federalization and centralization of a substantial segment of the state and local tax structures.” John M. Barker, Director of Taxes for General Mills, Inc., New Orleans, Proceedings of the 58th Annual Conference of the National Tax Association, pp. 552-554. “The tax systems of all the states should compete with one another and Federal intervention and involvement should be minimal.” Id. at 561. Competition usually means favorable rules for business.

25. Multistate Tax Compact, Article I.

26. A state adopting the Compact is automatically a member of the MTC. These states are represented by the heads of the tax agencies administering corporate income and sales and use taxes. These states govern the Commission and participate in a wide range of projects and programs. So-called sovereignty members are states that support the purposes of the Multistate Tax
simplicity and uniformity, conducting joint audits, and administering the Compact.

The MTC describes itself as being created in “an effort by states to protect their tax authority in the face of previous proposals to transfer the writing of key features of state tax laws from the state legislature. For that reason, the Commission has been a voice for preserving the authority of states to determine their own tax policy within the limits of the U.S. Constitution.” The MTC, under the talented leadership of its Executive Director, Joe Huddleston, who after ten years at the helm resigned as of August, 2015, and its General Counsel, Helen Hecht, has had a major impact on the development of state tax systems.

The Compact’s goals addressed the professed concerns of the business community, although some might argue, without being unduly cynical, that these concerns were just stalking horses for the taxpayers’ real agenda, which was the federal imposition of higher jurisdictional barriers of the type represented by P.L. 86-272 and the adoption of other favorable rules. Some argue that because multistate businesses are adept at exploiting the differences in state laws, they have no reason to actually desire uniformity as a goal. In support of this proposition, they note that taxpayers stopped the Uniform Law Commission’s recent attempts to modernize UDITPA because they preferred the status quo and no real interest in uniformity.

The Compact became effective on August 4, 1967, when under its terms seven states adopted it. At the end of 1969, 13 states had adopted the Compact.

By demonstrating that the states could clean their own houses without federal intervention, the Compact, the MTC, and UDITPA helped save the state tax system from being taken over by Congress. The Compact’s great contribution to achieving uniformity was its adoption of UDITPA and its administration, through the proposal of uniform regulations by the MTC. At the same time, the Compact ensured state sovereignty by preserving a legislature’s freedom to set tax rates, provide for tax incentives, control the definition of the tax base, and provide for exemptions, deductions, and the like, as well as the power to adopt or reject recommendations by the MTC.

To encourage the states to adopt the Compact and thus prevent it from becoming only an academic exercise, and to blunt corporate resistance, the Compact offered “carrots” to both groups to encourage their support.

First, sales and use tax credits, already common in many states, were made mandatory. This eliminated the potential for the double taxation (and avoided a constitutional problem) which would otherwise arise if a business purchased equipment, for example, in one state, paid a sales tax there, transported it into a second state, and paid a use tax in that state. The Compact also relieves a vendor that accepts a resale or other

http://www.mtc.gov/The-Commission/Member-States.

27. The MTC issues regulations interpreting UDITPA. These regulations are advisory only. To have the force of law, a state must adopt them.


29. The current embodiment of this goal is the Business Activity Tax Simplification Act (BATSA), which has been introduced in the House of Representatives over the last few years. See, e.g., H.R. 2992, The Business Activity Tax Simplification Act of 2013. The Internet Tax Freedom Act, supra Chapter Eight, represents a successful attempt to limits a state’s jurisdiction to tax access charges to the Internet.

30. Multistate Tax Compact, Article V.
exemption certificate in good faith from liability.  

Second, the Compact provides that any taxpayer may elect to apportion income in the manner provided by the laws of such state without reference to the Compact, or may elect to apportion income using the UDITPA formula contained in Article IV of the Compact. The election can be made on a state-by-state basis.

The Compact attempted a balance between maintaining state autonomy over tax issues, and achieving a degree of uniformity through the adoption of UDITPA, to avoid businesses either being overtaxed or undertaxed. The election allowed taxpayers to maintain the status quo ante should that be more desirable.

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31. Id. See supra Chapters Six and Seven.

32. Id. Article III.

33. In most cases, however, the election was initially irrelevant because the state had already been using UDITPA’s evenly-weighted, three-factor formula even before the Compact was adopted, and if it were not, it replaced whatever formula it had been using with the Compact’s formula. Hence there was no benefit to electing the state’s apportionment formula, which was identical to UDITPA’s.

Over time, states started to deviate from the UDITPA formula, first by double-weighting the sales factor and more recently by using only the sales factor. The election was “rediscovered” by Michael Herbert of PriceWaterHouseCoopers. His client, Gillette, brought suit in California arguing that it had the right to use the UDITPA evenly-weighted, three-factor formula. That formula was adopted by statute in 1966, and again in 1974 when the Legislature adopted the Compact. As an out-of-state corporation, Gillette preferred the Compact’s formula to the State’s double-weighted sales factor, which was adopted in 1993. California argued that the 1993 adoption of double-weighting superseded the Compact’s election. Consequently, according to the State, Gillette had to use the double-weighted sales factor even though that increased its California tax compared with the Compact’s formula.

It was Herbert’s theory that the UDITPA election was available because the Legislature had not—and could not—amend the Compact and had not repealed the Compact. Consequently, Gillette could make the Compact’s election, despite the statutory change in 1993.

Gillette lost in the trial court. Gillette was consolidated with other cases and appealed to the Court of Appeals. In 2012, the California Court of Appeals held that the Compact is a valid interstate compact and that the State was bound by it and the election. California could withdraw from the Compact by repealing it, but the Legislature has not done so. Gillette Co. v. Franchise Tax Bd., 147 Cal. Rptr. 3d 603 (Cal. Ct. App. 2012) review granted and opinion superseded sub nom. Gillette v. Franchise Tax Bd., 291 P.3d 327 (Cal. 2013). On June 27, 2012, California repealed the Compact and stated that claims for refund in prior years must have been made on an original, timely filed return for the taxable period for which the election is to apply. As this book goes to press in the summer of 2015, the California Supreme Court has granted review and oral argument is expected in the fall of 2015.

The so-called Gillette litigation spread to other states.


IBM sued in the Court of Claims, arguing that it had properly based its tax liability on the UDITPA formula set forth in the Compact. The Court of Claims ruled against IBM, which appealed to the Court of Appeals. In an unpublished per curiam opinion, the appellate court upheld the Court of Claims. On appeal, the Michigan Supreme Court held in a 4-3 decision that IBM was entitled to use the Compact’s formula. That decision was July 14, 2014. Less than a month later, the Legislature repealed the Compact, retroactive to January 1, 2008. The constitutionality of that retroactive repeal is now being litigated.

Minnesota: Minnesota adopted the Compact in 1983. In 1987, the State started down a path of overweighting the sales factor and repealed Articles III and IV of the Compact but remained a member “to the extent provided” by statute. Kimberly-Clark argued in the Minnesota Tax Court that it was entitled to use the Compact formula. On June 19, 2015, the Minnesota Tax Court held that the Legislature’s 1987 repeal of Articles III and IV of the Multistate Tax Compact was valid and did not substantially impair a binding contractual obligation. Accordingly, the court held that Kimberly-Clark could not elect the Compact’s evenly-weighted, three-factor formula. Kimberly-Clark Corporation & Subsidiaries v. Commissioner of Revenue, Minn. Tax Court Docket No. 8670-R (Jun. 19, 2015), slip op. The case is on appeal.

Oregon: In 2012, Health Net, a California-based insurance company with operations in Oregon, filed in the Oregon Tax Court. The company argued that the Compact, which the State adopted in the 1960s, trumps newer state laws that differ from it. Four hours of argument took place on July 22, 2014. A decision is pending.

Texas: Graphic Packaging lost a motion for summary judgment denying its right to use the Compact formula. The trial court issued a summary grant of the State’s motion without providing any reasons. The Texas Court of Appeals heard arguments in Graphic Packaging on June 3, 2015. A decision is pending.
In this manner, the Compact was intended to be politically attractive to key stakeholders, which would encourage its adoption.

The Compact, however, did not address many issues that were of concern to the business community: preventing worldwide combined reporting, exempting foreign source dividends, or setting high thresholds for nexus. Taxpayers continued their opposition to the Compact, lobbying Congress and state legislatures for favorable rules. As a result of this lobbying, several states withdrew from the Compact. And the Compact was challenged (unsuccessfully) on constitutional grounds.34

Today, the District of Columbia and forty-five states have broad-based corporate income taxes. These taxes have many similar features, reflecting the influence of the MTC and UDITPA. Some states have adopted UDITPA by adopting the Compact; others have adopted UDITPA independently of the Compact; whereas still others have cherry picked selected provisions of UDITPA.

C. Conformity with the Internal Revenue Code

UDITPA and the Compact focus only on the division of the tax base and not on the base itself. For the latter, the states have been influenced by the Internal Revenue Code (IRC). With various degrees of fidelity, state corporate income taxes conform to the IRC and share a large body of common concepts and doctrines.35

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34. Almost immediately, the Compact and the MTC were challenged by U.S. Steel and others as violating the Compact Clause of the Constitution. The 16 plaintiffs also challenged the MTC’s joint audits, which often imposed combined reporting, which is not mentioned explicitly in the Compact. This litigation, started in 1972 and financed by the Committee on State Taxation (COST, known today as the Council on State Taxation), cast a cloud over the MTC until the Supreme Court ruled in its favor six years later.

The Supreme Court held that: the Multistate Tax Compact was valid under the rule of Virginia v. Tennessee, 148 U. S. 503; the Compact’s multilateral nature and its establishment of the MTC did not, standing alone, present significant potential for conflict with the principles underlying the Compact Clause; the Compact did not purport to authorize member states to exercise any powers they could not exercise in its absence; and there was no delegation of sovereign powers to the MTC because each state was free to adopt or reject the MTC’s rules and regulations and to withdraw from the Compact at any time. United States Steel Corp. v. Multistate Tax Comm’n, 434 U.S. 452 (1978). This antiseptic description fails to capture the bitterness and scorn that accompanied the litigation, with the MTC being accused of “abusing its powers by conducting a campaign of harassment” against multistate taxpayers. COST remained an early critic of the MTC and lobbied states against adopting the Compact. In the early days, members of COST refused to speak on panels with MTC officials. Today, under the leadership of Doug Lindholm, the current Executive Director of COST, and Joe Huddleston, the current Executive Director of the MTC (who has resigned effective August 1, 2015), two charismatic, exceedingly bright, and sophisticated leaders, this early animosity has been replaced by a softer and gentler relationship. Lindholm and Huddleston often appeared together at tax conferences, playing to rave reviews. Huddleston has been replaced by Greg Matson, the former Deputy Executive Director of the MTC. Matson is a talent in his own right and should easily continue the warm working relationship with Lindholm and COST.

While the U.S. Steel litigation was proceeding, Congress unsuccessfully tried to pass legislation dealing with the taxation of interstate business. See, e.g., the Mathias bill (S. 1245), 93rd Cong., 1st Sess. (1973) and the Magnuson Bill (S. 2092), 93rd Cong., 1st Sess. (1973). Members of the business community generally favored these bills.

35. One major difference between the state rules and the IRC arises with depreciation. Congress often uses the rules on depreciation to stimulate the economy. President Reagan, however, carried this approach to its extreme, by convincing Congress to virtually gut the federal income tax in 1981 by introducing the Accelerated Cost Recovery System (ACRS) and safe harbor leasing. These generous rules on depreciation reduced federal taxable income, sometimes to zero, and, if the states had not reacted, state taxable income would have been reduced or eliminated as well. Consequently, many states “decoupled” from these rules, adding an inevitable source of complexity. Subsequent presidents have also used the rules on depreciation to stimulate the economy. The generous depreciation provisions adopted to stimulate the country starting with the Bush II administration and continuing with President Obama, created the same dilemma for the states and many responded by decoupling. In general, see LeAnn Luna and Ann Boyd Watts, Federal Tax Legislative Changes and State Conformity, State Tax Notes, Feb. 25, 2008.

Other differences between federal and state taxable income typically involve interest, state and local income taxes, net operating losses, dividends, expenses related to exempt income, and payments to related entities. For a recent case, see Schlumberger Technology v. Alaska, where the Alaska Supreme Court held that Alaska had not adopted by reference IRC Section 882. For a general discussion of conformity, see John C. Healy and Michael S. Schadewald, 2015 Multistate Corporate
Conformity to some degree is fully understandable. No state wants to reinvent the IRC and develop its own rules on gross income, taxable income, business income, deductions, capital gains and losses, issues of timing, capitalization, depreciation, amortization, assignment of income, realization, accounting periods, net operating losses, LLC’s, LLP’s, S corporations, C corporations, insurance companies, and so forth. Conformity represents substantial administrative savings for the tax department and for taxpayers. Enforcement burdens are reduced; neither the states nor the taxpayers have to master a new tax regime. It is far simpler for a state system to conform to the federal system.

Conformity provides a degree of simplicity in that once a taxpayer has prepared its federal tax return, the state return is easier to complete. A state tax department can identify certain lines on the federal return that can be used as the starting point in preparing the state return. The taxpayer can keep one set of books for both federal and state tax law.

Second, conformity with the IRC means that the Internal Revenue Service (IRS) can partner with state tax departments by exchanging tax data with them. This partnering saves state tax departments time and money and provides administrative economies. Conformity means that states and the IRS can undertake cooperative tax administration and compliance efforts. The states benefit from federal audits and third party reporting requirements. The federal and state governments exchange information, which the states can use in the enforcement of their laws. States typically require a taxpayer to report any changes to its federal taxable income. The knowledge of this partnering presumably encourages voluntary compliance.

Third, conformity provides taxpayers with predictability, which encourages investment and economic activity. Many difficult interpretive issues have already been confronted and resolved by the IRS. To the extent a tax department incorporates these interpretations, both taxpayers and administrators know how transactions will be treated.

Fourth, conformity with the IRC means that the states will have the same, or at the least similar, rules. The likelihood of double taxation is thus reduced, as are transaction costs for multistate taxpayers. This interstate harmonization encourages interstate commerce and investment.

Fifth, tax avoidance techniques that have been rejected at the federal level will also not work at the state level. The state can rely on federal decisions involving business purpose, economic substance, step transactions, disguised dividends, personal versus business deductions, thin capitalization, and so forth.

Sixth, the IRS has more resources than any state tax department. As common problems develop, the IRS is in a far stronger position to develop an administrative position that mediates conflicting needs. The states can rely on experienced federal tax drafting, regulatory interpretation, and dispute resolution. A state can then piggyback on these federal activities without spending an inordinate amount of its more limited, and perhaps less experienced, administrative staff and resources.

Despite the role they have played in bringing about conformity, neither UDITPA nor the Internal Revenue Code address key elements of a state corporate income tax: rates, credits, rules on nexus, combined reporting, tax incentives, industry-specific apportionment formulas, and the like; consequently, these will

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Tax Guide, Vol. I (hereinafter Multistate Guide), I-3001 et seq. This Guide is a wonderful research tool and a worthy addition to any library.

Not every state automatically conforms its tax laws to the Internal Revenue Code. Some states have to explicitly enact conformity legislation every year.


36. If the IRS makes a change to a taxpayer’s federal corporation tax return, the state corporate income tax return may be affected. Consequently, the states have an interest in learning of such changes. See Friedman, Ganz, and Hedstrom, State RAR Reporting—Simplifying Unnecessary Complexities, State Tax Notes, Mar. 10, 2010.
vary among the states. The MTC has formulated nearly 40 model regulations and statutes dealing with some of these issues, which have hortatory value even when they have not been adopted by a state.

The issues involving the corporate income tax are complex and sophisticated. Administering and complying with state corporate income taxes is expensive and time consuming. Much litigation abounds. Corporations engaged in cross-border transactions feel that they are sometimes taxed on more than 100% of their income and put at a competitive disadvantage. On the other hand, intrastate corporations feel that their larger, out-of-state competitors are able to use sophisticated tax planning strategies to escape taxation on part of their income. Enough examples abound to support both views.

Heavy intellectual firepower in both the public and private sectors is directed at the corporate income tax. Yet the tax is not a major component of most states’ revenue structures. In 2014, state corporate income taxes were, $46.3 billion, approximately 5.3% of state taxes. To be sure, corporate income taxes increased 3.1% from 2013. This was the fourth consecutive increase. Of the 45 states that impose a corporation net income tax, 10 saw increases of 10% or greater in 2014. In 2013, 20 states saw increases of 10% or greater. By comparison, general sales taxes were 31.3% and individual income taxes were 35.9% of state taxes.

Besides the relatively small contribution of the corporate income tax to state revenue, corporate profits are also skewed toward the largest companies. For example, while most corporations making up the most recent Fortune 500 list made less than $1 billion in profits, 18 made more than $10 billion—and those 18 account for almost one-third of the total profits of the companies listed. A relatively few taxpayers are responsible for the majority of the state corporate income tax, suggesting that generous exemptions could be provided to remove smaller corporations from the tax base without much loss in revenue. Of course, many small taxpayers no longer operate in the corporate form, opting instead to use a pass-through entity.

D. Pass-Through Entities

One of the reasons the corporate income tax may not be flourishing is the growth of limited liability companies (LLCs) and limited liability partnerships (LLPs). These entities combine the pass-through tax aspects of a partnership with the limited liability protection of a corporation. The use of LLCs expanded once


38. The model statutes and regulations proposed by the MTC are advisory only and must be adopted by a state to have the force of law. Compact, Article VI.3(b) (“In addition to powers conferred elsewhere in this compact, the Commission shall have power to: . . . (b) Develop and recommend proposals for an increase in uniformity or compatibility of State and local tax laws with a view toward encouraging the simplification and improvement of State and local tax law and administration); Article VII (“The Commission shall submit any regulations adopted by it to the appropriate officials of all party States and subdivisions to which they might apply. Each such State and subdivision shall consider any such regulation for adoption in accordance with its own laws and procedures.”)

39. For a very readable survey of some of the issues in this Chapter by a sophisticated and insightful commentator, see David Brunori, State Tax Policy: A Political Perspective 83-97 (2d ed., 2005).

40. U.S. Census Bureau, State Government Tax Collections: 2014, available at http://www2.census.gov/govs/statetax/G14-STC-Final.pdf. Of course, the relevant question is what percentage of state taxes the corporate income tax would represent if not for the aggressive and borderline efforts of tax planners.

41. Id. p.3.

42. Id. See supra Chapter Six.

43. http://fortune.com/fortune500

the Internal Revenue Service clarified the federal treatment of such companies. All fifty states now have enabling statutes.

The state treatment of LLCs and LLPs varies. Most states classify them in the same manner that they are classified for federal purposes, which typically means the entities will be treated as partnerships. Practitioners have been very creative in using LLCs and LLPs, and most state tax administrators are familiar with common tax-planning strategies. In general, pass-through entities, such as LLCs, LLPs, partnerships, and S corporations, provide useful tax minimization vehicles. Because of the growing importance of LLCs and LLPs, this chapter concludes with a presentation co-authored by Bruce P. Ely, one of the country’s leading practitioners in this field.

E. Franchise Taxes v. Income Taxes

Generally speaking, state income taxes can be imposed in two different ways. One way is to impose a franchise tax on the privilege of conducting business in the state, as measured by net income. The other way is to tax directly a corporation’s net income. The difference should be just a matter of form and not substance but it took the courts a while to reach that position.

The difference between these two forms of corporate income tax reflects anachronistic Supreme Court jurisprudence. In 1951, the Court held in Spector Motor that an income tax imposed on the privilege of doing business in a state violated the Commerce Clause when applied to an exclusively interstate business, notwithstanding that the measure of the tax was income apportioned to activities taking place in the state. Long before Spector, the Court had held non-income taxes unconstitutional when applied to transactions in interstate commerce. These early cases fueled fears by the states that a tax on the privilege of conducting a business would be unconstitutional if measure by the income of an interstate business. This concern, which proved to be justified by the later holding in Spector, encouraged legislatures to adopt a direct tax on net income that was derived from activities in the state. The formalistic school of constitutional interpretation that held sway at this time suggested that a direct tax on net income might rest on stronger constitutional footing than a tax on the privilege of conducting business, measured by the net income of a multistate business.

When Spector was decided in 1951, some states had both a direct tax on income and a franchise tax on the privilege of conducting business (a taxpayer subject to one would not pay the other), whereas other states had one or the other. After Spector, some states that had only a franchise tax adopted a direct income tax, believing (correctly, as it turned out), that such a tax would avoid the holding in Spector.

The view that a direct income tax on the net income of an interstate business might overcome the infirmities of a franchise tax was vindicated in 1959. In Northwestern States Portland Cement Co. v. Minnesota, the Court upheld an apportioned income tax levied directly on the profits of a corporation conducting an

46. See the material by Bruce Ely at the end of this Chapter.
47. A “franchise tax” is an unhelpful term because it can refer to many different types of taxes. States use the term to refer to income taxes, capital stock taxes, or property taxes. The only thing that can be said with certainty is that a “franchise tax” is imposed on a corporation rather than on an individual. Beyond that, a “franchise tax” must be examined carefully to identify the base upon which it is imposed.

Although after Complete Auto and Northwestern States Portland Cement, states can tax the income of interstate corporations under either a franchise tax or a net income tax, the franchise tax retains one, seemingly anachronistic advantage. Interest on federal securities can be included in the income of a corporation and taxed under a nondiscriminatory franchise tax; such interest cannot be taxed under a net income tax unless Congress so provides—which it has not yet done. This formalism is based on the premise that under the franchise tax—as opposed to an income tax—the state is not imposing an unconstitutional direct tax on the federal government.

The text uses the term “corporate income tax” to refer to both of these general forms of income taxation: a franchise tax and a net income tax. The text also follows the common practice of referring to corporations that conduct all of their activities in one state as in-state or intrastate corporations. These corporations do not raise the distinctive problems that surround the taxation of income generated by cross-border transactions. Nonetheless, designing and administering a state corporate income tax is complicated, even if the majority of corporations are intrastate. But some of this complexity is mitigated because, as discussed above, a state can fashion its corporate tax provisions after those of the federal income tax, and by adopting UDITPA. In nearly all states a corporation’s federal taxable income is the starting point in calculating its state taxable income.

The term “out-of-state corporation” is commonly used in state tax writings, despite its ambiguity. The term is usually used to suggest a corporation that has most of its activities outside the taxing state. But sometimes it is used to mean a corporation incorporated in a state other than the taxing state, or one that has its commercial domicile in another state.

This Chapter focuses on the unique problems of taxing corporations that have contacts and activities in more than one state. For example, a corporation may manufacture a product in State A, warehouse it in State B, and sell it through a sales division in State C, to a customer in State D. States A, B, C, and D are free, subject to federal constraints, to tax the corporation on a share of its total net income. The difficulty lies in determining the “appropriate” share. This problem of dividing, sharing, or assigning the tax base of a corporation among the states asserting acceptable claims of tax jurisdiction is a dominant theme of the cases that are discussed in the next Chapter.

F. Federal Approach to Multijurisdictional Corporations

The need to share a tax base among jurisdictions is not limited to the states. Any taxing jurisdiction must design rules regarding the taxation of income generated by cross-border transactions. The United States, for


51. These corporations are sometimes referred to as domiciliaries. The term domicile usually refers to commercial domicile, commonly defined as the principal place from which the business is directed or managed. See, e.g., UDITPA, Sec. 1(b). Less frequently, domicile refers to the state of legal incorporation. Intrastate corporations, which tend to be smaller corporations, commonly incorporate in the same states in which they are commercially domiciled.

52. States will often adjust a corporation’s federal taxable income to reflect differences in the treatment of depreciation, depletion, state and local taxes, net operating losses, interest from state and local bonds, interest from federal bonds, and dividends. There may also be a different filing unit at the state level. See Multistate Guide, supra note 35, at I-3001 et seq.

53. The Commerce Clause grants the federal government the power to regulate, and thus restrict state taxation of interstate commerce. Although Congress has not been quick to exercise this power, it has imposed one significant restriction in the aftermath of Northwestern States Portland Cement, known as P.L. 86-272. See infra §IX(A). See also Wrigley, infra Chapter Eleven. State constitutions can also restrict the powers a state would have under federal law. Moreover, a state legislature may decline to assert the powers of taxation it possesses. See infra §XI(D)).
example, also needs rules regarding U.S. corporations having business and investment income abroad and foreign corporations having business and investment income from the United States. The United States’ rules differ from those of the states in many respects, but especially because with some exceptions they do not rely on formulary apportionment. These differences in part reflect the constitutional constraints that are applicable to the states but not to the federal government.

In brief, the United States taxes U.S. corporations (defined as those incorporated in one of the 50 states) on their worldwide income. Because the same income might be taxed by other countries, a U.S. corporation is allowed to take a credit against its U.S. tax for foreign income taxes paid on its foreign source income. The effect of the credit is that foreign source income is taxed at the higher of the U.S. effective tax rate or the foreign jurisdiction’s effective tax rate.

Foreign corporations are taxed (with some minor exceptions) only on their U.S. source income. The rules on the taxation of foreign corporations with U.S. source income differ, depending on whether the income is from a U.S. trade or business, called effectively connected income, or from categories of income known as fixed and determinable, annual and periodical income, which includes non-trade or non-business dividends, interest, rentals, and royalties.

In order to maintain competitive equity between U.S. corporations and their foreign competitors, effectively connected income is basically taxed under the normal U.S. rules; a foreign corporation is entitled to the usual deductions and is taxed under the same rate schedule that applies to all U.S. corporations. Fixed and determinable, annual and periodical income is taxed under a special tax regime that can be either more or less favorable than the normal U.S. rules. Typically, however, in order to encourage foreigners to buy U.S. stock and bonds, the rules are more favorable than the rules that apply to U.S. persons.

The treatment of U.S. corporations is known as residence-based taxation because a corporation that is resident, that is, incorporated in the United States, is taxable on all of its income regardless of where that income is sourced. The U.S. treatment of foreign corporations is known as source-based taxation because jurisdiction is limited to income having its source within the United States.54

The United States has a set of source rules that categorize income (including related expense) as either U.S. source income or foreign source income. The role played by these rules is different, depending on whether the taxpayer is a U.S. corporation or a foreign corporation. For U.S. corporations, the source rules determine the amount of their credit for foreign income taxes, which is a function of the amount of their foreign source income. For foreign corporations, the source rules play a jurisdictional role, determining whether they will be taxed by the United States.

The United States has entered into an extensive network of bilateral tax treaties, which provide special rules of taxation.55 These treaties generally have little jurisdictional effect on state taxation, except that the starting point of the state corporate income tax is typically the federal corporate income tax. If a tax treaty results in a non-U.S. corporation having no federal income, it will report no state income. State law can, and should, be changed to address this situation.

54. Is the common state rule that allocates nonbusiness income to the taxpayer’s commercial domicile, see infra §II(A)(3), an example of residence-based taxation or source-based taxation? See New Jersey Natural Gas Co. v. Div. of Taxation, 24 N.J. Tax 59 (N.J. Tax Ct. 2008).

55. For a discussion of the U.S. rules on the taxation of income generated by cross-border transactions that is both prescriptive and descriptive, see Michael J. McIntyre, The International Income Tax Rules of the United States, Professional Edition (2000 with annual updates). Although the treatise has not been updated after the death of Professor McIntyre, the descriptive and normative material is still well worth reading.
One final note on nomenclature. In the context of state taxation, “foreign” corporations are those that are incorporated outside of the taxing jurisdiction. For example, if you are reading a case involving State A’s corporate income tax, a reference to a “foreign” corporation will usually mean a corporation incorporated in a jurisdiction other than State A. That might be Delaware, or it might be Bermuda. But be careful if the context suggests otherwise.

II. Conceptual Overview of the Major Issues in State Corporate Income Taxation

A. Methods for Dividing, Sharing, or Assigning the Tax Base of a Corporation Engaged in Cross-Border Transactions

Under the U.S. Constitution, a state may tax that portion of a corporation’s income that has a sufficient connection or relationship with the state. This necessary connection or relationship is referred to as “nexus.” Nexus means that the income is attributable in a meaningful way to activities taking place in the state and that “some definite link, some minimum connection” exists between the taxing state and the activities generating the income. A further condition is that a rational relationship must exist between the income taxed and the activities conducted within the state. A state may tax only that part of a corporation’s income that is fairly attributable to its income-producing activities in the state.

The states have developed three general approaches for determining the amount of a corporation’s taxable income they may tax under the U.S. Constitution: separate accounting, formulary apportionment, and specific allocation. Most of the cases in this Chapter and the next involve formulary apportionment because this is the dominant method of state taxation. The Court has granted the states considerable latitude in applying this approach.
1. Separate (Geographic) Accounting

Separate geographic accounting, known more commonly as simply separate accounting, is based on the premise that it is both possible and practical to isolate the taxable income of portions of the business that a corporation carries on within a state. This approach attempts to determine how much taxable income would be earned if a distinct and independent entity conducted the corporation’s activities within a taxing state, hence the more accurate name, separate geographic accounting. Taxable income is calculated under state law for this discrete, hypothetical business.\footnote{62} In the early days of the state corporate income tax, separate accounting was commonly used.\footnote{63} Today, it is the least common method, long replaced by formulary apportionment.

To illustrate the workings of separate accounting, consider a corporation that manufactures a product in State A, warehouses it in State B, and sells it through a sales division in State C, to a customer in State D. In calculating its State A tax using separate accounting, the corporation would assume that its manufacturing activities in State A were conducted by an independent business entity that sells the manufactured good to a third party that will warehouse and distribute it.

One approach to calculating the manufacturing entity’s taxable income in State A is to determine the hypothetical price at which the assumed entity manufacturing the good would sell it to an assumed independent and unrelated third party.\footnote{64} That hypothetical arm’s length sales price would determine the assumed entity’s sales proceeds, which in turn would determine the amount of its taxable income. Put differently, income and expenses would be imputed to the portion of a multistate business that is located in the taxing state as though it engaged in transactions with the rest of the business outside the taxing state.

Both theoretical and practical problems limit the utility of separate accounting. Administratively, determining the arm’s length transfer price is difficult in many cases. One way to determine a hypothetical transfer price in the above example would be to examine the prices at which comparable manufacturers sell comparable goods to their independent distributors.\footnote{65} But comparable manufacturers might not exist, or, if they exist,
they might not manufacture comparable products, and even if they do, they might not sell them to independent distributors. Even if comparable transactions exist, other hurdles remain. Comparable transactions provide only an estimate of the relevant transfer price. Such transactions may establish a range within which the appropriate transfer price might fall, but if this range is too wide, no useable information will be provided.

Establishing what might be hundreds or thousands of hypothetical transfer prices is another administrative problem. Separate accounting is an expensive system to operate for both the public and private sectors. A state tax department would not have the resources to police the large number of corporations engaged in cross-border transactions. Small and medium-sized businesses would not have the capacity to implement separate accounting and perhaps neither would larger corporations. More generally, separate accounting cannot be easily applied to many types of cross-border activities. Consider, for example, the difficulties of applying separate accounting to a taxpayer providing interstate telecommunication services, to an airline that both loads and offloads passengers in the state, or to a company that provides access in the taxing state to the Internet. Situations involving intangible property also pose challenges for separate accounting. A company whose profitability is due to a trademark, patent, trade secret, franchise, customer list, copyright, unique management system, or know-how will often be unable to find identical third-party transactions and inevitable disagreements will arise over whether comparables exist.

Finally, in separate accounting a theoretical flaw arises whenever a corporation’s overall profitability is attributable to activities that are interdependent, integrated, or synergistic. In such a case, each activity of the business contributes to the business as a whole and reasonable efforts at imputing a transfer price for a hypothetical transaction might fail to capture the inherent transfers of value. As a common example, consider the transfer of value that occurs when a vice president of manufacturing based in State A

be assigned to it. For example, suppose a bank raised money in State B and lent it to a taxpayer commercially domiciled in State A for use in the latter’s multistate business. Compared to the manufacturing example in the text, the rules for determining what part of the profits generated by this cross-border transaction should be assigned to State A are not obvious. Such rules have remained unexplored. One of the reasons this area of state taxation has remained undeveloped is that formulary apportionment soon became the dominant method of accounting, which made it unnecessary to develop sophisticated rules for separate accounting. No doubt the difficulty of applying separate accounting in these types of situations helped accelerate the development of formulary apportionment.

For a comparison of the federal rules on separate accounting and the state rules on formulary apportionment, see Michael J. McIntyre, The Use of Combined Reporting by Nation States, infra Chapter Eleven.

66. One commentator, writing during a period when separate accounting was commonly used, described it as so expensive to implement that the bookkeeping costs could far exceed the tax due under formulary apportionment. Charles W. Gerstenberg, Allocation of Business Income, 1931 Nat’l Tax Assoc. Proc. 301, 306. He also stated that “a system of separate accounts for branches or subsidiaries is, in the majority of cases, impracticable.” Id. For a more conceptual criticism, see Controllership Foundation, Apportionment and Allocation Formulae and Factors Used by States in Levying Taxes Based on or Measured by Net Income of Manufacturing, Distributive and Extractive Corporations (1954).


In 1994, the Treasury Department promulgated new regulations under §482. These regulations were in response to the prior difficulties encountered by taxpayers and the Internal Revenue Service. For a discussion, see McIntyre, supra note 55, ch. 6. See also The United States Government Accountability Office Report to Congressional Requesters, Comparison of the Reported Tax Liabilities of Foreign- and U.S.-Controlled Corporations, 1998-2005, GAO-08-957 (July 2008), available at http://www.transferpricing.com/pdf/GAOJuly08.pdf.
telephones a vice president of research and design based in State B and resolves a problem in a way that will increase corporate profitability. How can separate accounting impute a value to that telephone call in order to calculate State A’s and State B’s appropriate share of the corporation’s increased income? As the Court has recognized, separate accounting “often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise.”

As a further illustration, consider a corporation that operates two stores. Store A operates in State A and Store B operates in State B. The corporation buys its inventory centrally on behalf of its two stores. On a separate accounting basis, the corporation shows a high profit in State A and consistently breaks even in State B.

Suppose, however, that if Store B were closed, a seemingly logical step to take with a break-even operation, the profits of Store A would decline. This counterintuitive result might occur if the amount of inventory sold by Store B allowed the corporation to obtain a volume discount on all of the inventory it purchased, including that sold by Store A. In other words, even though Store B appears on the basis of separate accounting to break even, it actually contributes to the corporation’s overall financial profitability. Separate accounting might reach a misleading result under these circumstances.

As a final example, consider an oil company that is assured by its geologists that a rich field straddles States B and C. The geologists estimate that if 100 wells are drilled, one is likely to be a gusher and the others will be dry. The company drills test wells in B and in C. Although the wells in B were dry, they provided significant information on where to drill in C, where oil is discovered. Under separate accounting, none of the profits from that well would be apportioned to B. Yet the wells in B were integral to finding oil in C.

Because of the defects inherent in separate (geographic) accounting, it has fallen into disfavor. Formulary apportionment is the most common method today, and co-exists with specific allocation; some items of a corporation’s income might be subject to formulary apportionment, whereas others might be subject to specific allocation.

Nonetheless, separate (geographic) accounting has a role to play. It is usually used to impeach formulary apportionment. As will be seen, taxpayers have a constitutional right (and typically a statutory right) to challenge the application of formulary apportionment to their particular situation. One way to do this is to marshal evidence, usually based on some form of separate accounting, which shows an amount of income attributable to the state that is dramatically different from the result the statute produces. To be sure, the Supreme Court has stated, “separate accounting, while it purports to isolate portions of income received in

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68. Container, supra note 61, at 164-65.

69. See Butler Bros., supra note 61. Similar examples might involve hotels and airlines that have locations or routes that viewed in isolation seem unprofitable, but are integral to the overall business model.


71. Mississippi and Oklahoma generally use separate accounting for the oil and gas industries. (Mississippi might also apply it more generally; see McWilliams Dredging Co. v. McKeigney, 86 So.2d 672 (1956).) While separate accounting is not commonly employed by the states outside of the natural resource industry, taxpayers will sometimes try to use it to prove that the state’s statute, typically based on formulary apportionment, leads to a distorted and unconstitutional result. See, e.g., Hans Rees’, Butler Bros., Exxon Corp., and Container, supra note 61. In many states, taxpayers can challenge their assessments under statutory relief provisions known as equitable or alternative apportionment, see infra §X, and they often use separate accounting to impeach the method applied by the tax administration or what the statute generally mandates (typically formulary apportionment).

72. See Bass, Hans Rees’, Exxon, Container, supra note 61. The Court sometimes refers to separate accounting as formal geographical or transactional accounting. See, e.g., Container, supra note 61, at 164-65.
various states, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale.” Nevertheless, separate accounting is available as a potential alternative if allocation and apportionment do not fairly represent the extent of the taxpayer’s business activity in the taxing state. This approach is known as equitable apportionment and is discussed below.

2. Formulary Apportionment

Because of the theoretical and administrative problems inherent in separate accounting, the states developed an alternative method—formulary apportionment—for dividing and sharing the tax base of a corporation. As the name suggests, a formula is used to apportion a corporation’s taxable income to those states with which it has certain relationships. More specifically, a formula is used to generate an apportionment percentage that is based on the relative amount of a taxpayer’s in-state activities or “presence.” The application of one of the oldest formulas, and the one used by UDITPA is:

73. Mobil Oil, supra note 61, at 438.

74. See, e.g., UDITPA §18; Hans Rees’, supra note 61; infra §X.


Although separate entity accounting is the dominant method of accounting at the federal level, the regulations issued under the Internal Revenue Code and the administrative practices of the IRS incorporate features of formulary apportionment. See, e.g., Treas. Reg. §§1.882-5(b), 1.863-3(b), 1.864-6(c). In practice the IRS often applies principles of formulary apportionment in determining transfer prices under §482. The Treasury Department admits there is widespread use of formulas in the administrative and judicial resolution of disputes under §482. United States Department of the Treasury, A Study of Inter-Company Pricing [the Treasury “White Paper”], ch. 4 (1988), Notice 88-123, 1988-2 C.B. 458.


In 1962, the House of Representatives passed a bill providing that unless a taxpayer’s transfer prices were consistent with comparable uncontrolled prices, taxable income was to be apportioned under a formula. H.R. 10650, §6, 87th Cong., 2d Sess., 56 (1962). The Treasury Department did not oppose this bill. See Hearings Before the Committee on Finance on H.R. 10650, 87th Cong., 2d Sess. 79, 105 (April 2, 1962). The bill was not enacted by the Senate because the Conference Committee believed the Treasury already had the authority to utilize formulary apportionment and encouraged it to do so. H.R. Rep. No. 2508, 87th Cong., 2d Sess. 18-19 (1962).

76. More accurately, the formula apportions income to those states in which the corporation has factors that enter into the formula. As the formula in the text illustrates, typical factors are property, payroll, and receipts, although the recent trend is to only use receipts.

77. The Internal Revenue Code provides a set of rules (§§861-63, 865) to determine the source of gross income. These rules generally describe the source of gross income on a transaction-by-transaction basis. In contrast, formulary apportionment is not applied on a transaction-by-transaction basis, but instead is applied to the entire taxable business income of a corporation. The receipts factor, however, in contrast to the property and payroll factors, is determined on a transaction-by-transaction basis.
Corporate Taxation: Introduction

\[ T_{IA} = T_{IWW} \times \frac{1}{3} \left( \frac{\text{Sales}_A}{\text{Sales}_{WW}} + \frac{\text{Payroll}_A}{\text{Payroll}_{WW}} + \frac{\text{Property}_A}{\text{Property}_{WW}} \right) \]

Where:

1. \( T_{IA} \) is the amount of the corporation’s worldwide taxable income, computed under State A law, which is apportioned to A;
2. \( T_{IWW} \) is the amount of the corporation’s worldwide taxable income apportionable under State A law;
3. \( \text{Sales}_A \) is the amount of the corporation’s sales (or receipts) within State A;
4. \( \text{Sales}_{WW} \) is the amount of the corporation’s worldwide sales (or receipts);
5. \( \text{Payroll}_A \) is the amount of the corporation’s payroll in State A;
6. \( \text{Payroll}_{WW} \) is the amount of the corporation’s worldwide payroll;
7. \( \text{Property}_A \) is the amount of the corporation’s property located in State A;
8. \( \text{Property}_{WW} \) is the amount of the corporation’s worldwide property.

A corporation calculates its tax in State A by first calculating its apportionable worldwide taxable business income under State A law. This amount represents a corporation’s pre-apportionment tax base. The corporation then calculates its apportionment percentage based on whatever formula the state uses. Only factors that helped generate the apportionable income should enter into the formula. Next, the corporation multiplies its worldwide apportionable taxable income by the apportionment percentage. The result is the amount of the taxable income of the corporation that is apportioned to State A. The final step is to apply the state’s rate schedule to determine the corporation’s tax liability and to reduce that amount by any credits.

3. Specific Allocation

In addition to separate accounting and formulary apportionment, a third method of dividing, sharing, or assigning the tax base is called specific allocation, which assigns certain types of income to a particular state using non-formulary rules. In general, allocable income is assigned in full to only one state, which is a major difference from apportionable income, which is divided up among several states.

a. General Pattern

Like other issues in state taxation, no uniform practice exists regarding the use of specific allocation. One general pattern, however, is to apply rules of specific allocation to income that is not subject to formulary apportionment because such income does not constitute the operational or unitary business income of the taxpayer. This approach has been adopted by UDITPA. As discussed below, the MTC has proposed that the term “business income” be changed to “apportionable income.”

78. As will be discussed shortly, not all of a corporation’s income is apportionable. The formula in the text should be interpreted as applying to only that part of a corporation’s worldwide income that is subject to apportionment. Nonbusiness income, for example, is not apportionable but instead is subject to rules on specific allocation, discussed in the next Section in the text.

79. Some states tax corporations under a progressive rate structure. This practice is criticized in Pomp, supra note 7, at 484-508.
Nonbusiness income is defined as “all income other than business income,” although the MTC has proposed that the term “nonbusiness income” be replaced by “nonapportionable income.” The characterization of income as either business income or nonbusiness income is critical to its treatment. UDITPA apportions all business income whereas nonbusiness income is specifically allocated. Depending on the facts, income from intangibles, such as income from stock, bonds, patents, copyrights, and other forms of intellectual property, might be classified as either nonbusiness or business income.

b. General Rules

Allocable nonbusiness interest and dividends are assigned to the taxpayer’s commercial domicile. UDITPA allocates nonbusiness rents from real property to the state in which the property is located. Nonbusiness capital gains and losses from the sale of real property are allocated to the state in which the property is located. Capital gains or losses from the sale of nonbusiness tangible property are allocated to the state of the property’s situs at the date of sale, or to the taxpayer’s commercial domicile if the taxpayer is not taxable in the state of the property’s situs. Apparently, these rules on allocation mirrored some existing state practices at the time UDITPA was adopted.80 One way to understand these rules is that they assign income to the states considered to be the “source” of such income.

A less common approach is to apply rules of specific allocation to designated categories of income, regardless of whether they are part of the business income of the taxpayer.81 These categories typically include dividends, rents, royalties, interest, or capital gains. Louisiana, for example, allocates rents and royalties from real or tangible property to the state where the property is located; Oklahoma attributes income from mineral leases, royalty interests, or oil payments to the state where the resource is located. These rules no doubt reflect each State’s self-interest.

On the one hand, this less common approach may reflect the outdated view that such income was somehow different from the more ordinary trading, mercantile, services, or manufacturing profits of a corporation. Allocation was once thought to be appropriate for interest, dividends, rents, and royalties, which formed “no part of the trading profit and do not need to be apportioned by formula, since they can readily be specifically allocated to their proper sources.”82 Because of this philosophy, the allocation rules attempt to assign income to those states that could be viewed as the “source” of such income. On the other hand, this approach may reflect the fairly modern view that it is unfair to apportion the income from intangibles

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80. UDITPA §1(e). Professor Pierce of the University of Michigan Law School drafted UDITPA. See William J. Pierce, The Uniform Division of Income for State Tax Purposes, 35 Taxes 747 (1957). He was not a tax specialist; neither were the Uniform Law Commissioners. His first draft, completed in 1956, used rules of specific allocation for assigning all intangible income, including capital gains, to specific sources. See James H. Peters, What is Nonbusiness Income?, State Tax Notes, Dec. 9, 1991.

Several state tax administrators expressed concern about the emphasis on assigning intangible income to a specific state rather than apportioning it. A staff attorney of the California Franchise Tax Board, John Warren, now a leading practitioner in Los Angeles, suggested that the business/nonbusiness test be extended to income from intangibles. Accordingly, intangible income considered to be business income would be apportioned; intangible income considered to be nonbusiness income would be allocated to the state of commercial domicile. This approach reflected the position of the Franchise Tax Board in several of its earlier cases. See, e.g., Appeal of Houghton Mifflin Co., 1946 Cal. Tax Lexis 16; Appeal of IBM, 1954 Cal. Tax Lexis 4; and Appeal of National Cylinder Gas Co., 1957 Cal. Tax Lexis 33. Apparently, there was little discussion about how to treat intangible property for purposes of the receipts and payroll factors.

Would it make more sense to define nonbusiness income and make business income the default category?

81 This approach is consistent with the earlier draft of UDITPA, described supra note 80.

82 Report of the Committee of the NTA on Allocation of Income, 1939 NTA Annual Conference 190, 207. Historically, income from intangibles might be allocated to a single state, such as the state of legal incorporation, or commercial domicile, whether or not the income was business income; allocated if not business income and apportioned if it were; apportioned whether business income or nonbusiness income; allocated to the business situs of the intangible property if business income. Under UDITPA, income from intangibles can be either business income or nonbusiness income. The former is apportionable, the latter is allocable. Dividends, interest, and capital gains are typically allocated to the state of commercial domicile. UDITPA, Secs. 6(a), 7. Special rules apply to nonbusiness royalties from patents and copyrights. UDITPA, Sec. 8.
without including the underlying property and the receipts therefrom in the property and receipts factors of the formula—which can be difficult.

In the case of real or tangible property, allocation rules usually assign income to the state in which the property is located. In less sophisticated times, the property and the income that it generated were regarded as one and the same. From this perspective, it would be natural for the state in which the property was located to be viewed as having the exclusive right to tax the income, much as it has the exclusive right to levy a property tax on the underlying asset that generates the income. This perspective might explain why the earliest apportionment formulas consisted of only one factor: property. Income would be apportioned to the states where the plant and equipment were located, which would comport with early notions that regarded income as being sourced according to the location of the underlying property generating the income. As time went on, income from property became seen as something distinct from the underlying asset and became viewed as being generated by the business as a whole.

c. Intangible Assets and Intangible Income

Unlike real or tangible assets, intangible assets are not easily located in a specific state except through legal fictions. One old doctrine, known as mobilia sequuntur personam, treats intangibles as being attached to the person that owns the intangible. Presumably this doctrine explains why income from intangibles is commonly allocated to the state of commercial domicile under rules of specific allocation. Alternatively, the commercial domicile might be viewed as the place from which the intangibles were managed and thus the “source” of the income.

Today, it is widely recognized that income from all types of property, including intangible property, can be part of a corporation’s unitary business income and is properly apportionable. In states that follow the UDITPA rule of bifurcating a corporation’s income into apportionable business and allocable nonbusiness income, it is irrelevant whether income can, in some sense, be attributed to a specific category of property or even a particular asset. The difference between apportionable income and allocable income should not turn on whether the income is generated by tangible or intangible property, but rather on the relationship of the property or income to the operation and activities of the business.

Categorizing that relationship has generated much litigation, with a state usually arguing that an item of income should be apportioned to it and with the taxpayer arguing that the state has no nexus with the income. If, however, a loss is involved, a state and a taxpayer may switch hats. The state may then argue that the loss should be allocated to some other state and not reduce apportionable income, whereas the taxpayer may argue that the loss should properly reduce its apportionable income in the taxing state.

To illustrate the application of specific allocation, consider a manufacturing corporation with production activities in States A and B and that has a capital gain from the sale of a long-term, passive investment in a discrete business unrelated to its manufacturing business. Assume that the capital gain is not considered part of the operational or business income of the manufacturing business and thus is not subject to formulary apportionment. Assume further that States A and B have adopted the common rule that allocates nonbusiness capital gains from the sale of intangible property to the state that serves as the corporation’s commercial domicile.

83. More cynically, the single-factor property formula might have been used because it maximized the revenue for an industrial state. Note that some of the early Supreme Court cases on apportionment involved single-factor property formulas, see e.g., Underwood, Bass, Hans’ Rees, supra note 61, used by east coast states (Connecticut, New York, North Carolina). The United States developed from east to west, with eastern states having capital-intensive, industrial, multistate corporations. By using only the property factor, such a state would not dilute the apportionment formula by taking into account out-of-state sales. (In this early era, the payroll factor would generally track the property factor and would not change the formula much even if it were added.)
In calculating its State A tax, the corporation would determine its apportionable business income and exclude the capital gain. The corporation would calculate its apportionment formula using only those factors associated with its manufacturing business. If State A were the corporation's commercial domicile, it would have the right under its statute to tax the capital gain in its entirety.

If State A were not the corporation's commercial domicile, its allocation rule would assign the capital gain in its entirety to another state. In this case, the only effect of State A's rule would be to remove the gain from State A's taxing jurisdiction. The fact that gain is allocated under State A's rules to the corporation's commercial domicile elsewhere is irrelevant to how the gain will actually be taxed by any other state, including the state of commercial domicile. The corporation's state of commercial domicile might have entirely different rules on the allocation of capital gains or might exempt such income from tax. Indeed, it might even treat the capital gain as apportionable income. State A, whose rules on specific allocation assign income to some other state, can surrender only its own taxing jurisdiction; State A's rules do not have any effect on how any other state will actually tax the income, including the state to which the income is allocated under State A's rules.

State laws do not always mesh well. Suppose that State C, the state of commercial domicile in the preceding example, has a rule that says income that would otherwise be allocable to State C, can, at the election of the taxpayer, be apportioned. The purpose of this election is to make State C attractive as a headquarters state. If the taxpayer makes this election, the capital gain would be apportioned to C, and only to C. Less than 100% of the gain would be taxable. This situation is sometimes described as creating “nowhere income.” Sometimes the taxpayer is criticized for taking inconsistent positions, telling States A and B that the gain is allocable nonbusiness income, and telling its state of commercial domicile that the gain is apportionable. But if the taxpayer is faithfully following the statutes of States A, B, and C, the cause of the perceived problem is that State C has chosen to provide an election that deviates from the common rule that nonbusiness income is allocated to the state of commercial domicile. Had State C chosen to exempt allocable income the result would be even more favorable for the taxpayer.

d. Intangible Income Characterized as Apportionable Income

Not all capital gains constitute allocable investment or nonbusiness income. Suppose that the capital gain arose from the sale of stock in a newly-organized subsidiary of the taxpayer. Assume that the subsidiary had been organized to comply with the terms of the sale of one of the operational divisions of the parent. In negotiating the sale of the division, the parties agreed that the assets of the division would first be transferred to a newly-organized subsidiary and that the stock in this subsidiary would then be sold to the buyer. In this situation, some states would treat the sale of the stock as generating business income, as if it were a direct sale of the assets of the division. Other states might treat the liquidation of a business as generating non- apportionable income.

As a related example involving dividends, assume a corporation conducting a unitary business incorporates one of its unitary divisions. Dividends paid by this subsidiary would in many states be treated as business income because the “dividends . . . reflect profits derived from a functionally integrated enterprise . . . . One must look principally at the underlying activity, not at the form of investment, to determine the propriety of apportionability.”

There are two differences, however, between how the parent would have been taxed as a separate entity had it not incorporated its division and how the dividends would be taxed. First, had the parent not incorporated its division, the factors attributable to the division would have entered into the apportionment formula. Second, after the incorporation, the income formerly generated by the division would now be taxable—but

only when distributed as a dividend—and the factors of the subsidiary would typically not enter into the formula. Taxpayers have argued that if the dividends are taxed, then the subsidiary’s factors must be taken into account—so-called factor representation.85

e. Summary

As the above discussion demonstrates, one has to see how the pieces fit together before appreciating how a multistate corporation might be taxed. As a review, consider that UDITPA and nearly all states relegate separate accounting to a secondary status. Formulary apportionment and less so, specific allocation, are the dominant methods. In general, a corporation bifurcates its total income into two categories: business income and nonbusiness income. Formulary apportionment is used to identify what portion of the business income of a corporation may be taxed by a state with which nexus exists. A corporation uses a state-prescribed formula to calculate a fraction that is based on the relevant amount of its in-state activities compared with its total activities. That fraction represents the state’s share of the corporation’s business income.

Nonbusiness income is specifically allocated to particular states. Unlike formulary apportionment, which shares the business income of a corporation among the states with which it has nexus, specific allocation generally assigns an item of income in total to a designated state. Specific rules are used in designating the state of taxation. These states are selected because they can be viewed in some rough sense as the “source” of the income to be allocated. For example, income from real property is allocated to the state in which the property is located. Intangible income is allocated to the corporation’s commercial domicile, presumably on the theory that the underlying property is managed there.

As a metaphor, you can think of the business income of a corporation as a pie; formulary apportionment determines a state’s slice of the pie. Nonbusiness income can be thought of as a scoop of ice cream; specific allocation determines which states get to eat the ice cream along with their share, if any, of the pie.

This basic structure for taxing multistate corporations is very old—and rickety—dating back to the beginning of the 20th century, and later memorialized by UDITPA.

B. The Failed Uniform Law Commission’s Attempt to Reform UDITPA

No one can deny that UDITPA is woefully out-of-date. This so-called “model” for taxing multistate businesses was developed in 1957 and has been adopted in whole or in part by most states. UDITPA was adopted when there were only 48 states, before the widespread use of cable or satellite television, computers, videos, laptops, tablets, DVDs, smart phones, before the deregulation of banking, transportation, telecommunications, and power generation, and of course, before the Internet. Hula Hoops, not Hulu, were the country’s obsession when this so-called “model” tax act was enacted. Amazingly, UDITPA has never been amended.

Obviously, a tax system built on a 1957 foundation cannot begin to cope with today’s highly technological and digital world. Without the benefit of a model that can accommodate the 21st century, the states have been left on their own to try to modernize their laws. The result has been constant change and flux and the lack of consistency among the states, which sacrifices fundamental goals of a sound tax system. The law generally, and tax law specifically, should provide certainty and stability, allowing businesses to invest confidently and allowing state legislatures to predict their annual revenue so they can plan their spending. Tax rules should not be overtaken and rendered obsolete by new ways of doing business, especially in an area marked by rapid technological innovation.

85. See Mobil, supra note 61.
Chapter 10

Taxpayers and state governments should not have to resort to costly and distracting litigation to fit new business practices into outdated statutes. Nor should legislatures be constantly asked to shift their attention and resources to amending their tax statutes to keep up with new practices. Constant change creates an unfavorable business climate and discourages investment. By contrast, tax rules that can accommodate unpredictable technological developments are to be welcomed by taxpayers and state governments.

Many important provisions in UDITPA are significantly outdated. States have begun to revise these provisions unilaterally. In response to these developments, the MTC, committed to uniformity and thereby opposed to these disparate unilateral efforts, formally recommended to the ULC in 2006 that it initiate a project to revise UDITPA. In particular, the MTC recommended that the following five provisions be the focus of review:

1. Sales factor numerator sourcing for services and intangibles (market-based sourcing) (Compact Art. IV.17)
2. Sales Definition (Compact Art. IV.1(g))
3. Factor Weighting (Compact Art. IV.9)
4. Business Income Definition (Compact Art. IV.1(a))
5. Equitable Apportionment (Compact Art. IV.18)

In 2007, after receiving the MTC’s recommendations and additional input from the Federation of Tax Administrators, the Council on State Taxation, and others, the ULC determined that it would review and revise UDITPA in its entirety. A committee was formed and two reporters were appointed, one of whom is the author of this casebook.86

The co-reporters developed a discussion draft of reform proposals and solicited broad public input. During this time, the ULC became the target of a well-orchestrated pushback by business. Although business opposition and resistance were predictable, and the co-reporters had warned the ULC to expect it, and that this project was not in the same vein as the Anatomical Gift Act, the Commission was nonetheless unprepared. It does not normally get involved in such contentious projects, where billions of dollars are at stake and where business has a large stake in preserving the status quo. The ultimate blow came when those opposing the project threatened to have legislatures reduce their funding of the ULC. After that, the project was abandoned in 2009. Although no one, including business, would defend a more than half-century old statute as any kind of “model,” the Uniform Law Commission has nonetheless refused to withdraw UDITPA.

C. The MTC’s Proposals to Reform UDITPA

Once the ULC abandoned its project, the MTC stepped into the vacuum and started its own project to revise UDITPA. In 2009, the MTC Executive Committee directed its Uniformity Committee to report back with reform proposals—specifically, the five areas previously suggested to the ULC for its consideration. The Uniformity Committee completed its work in early 2012, and in December 2012 the Executive Committee approved the Uniformity Committee’s revisions for public hearing. The author of this casebook was appointed Hearing Officer, and after holding a hearing and soliciting input from broad constituencies, he issued his report in 2013. Many of the proposals by both the Executive Committee and the Hearing Officer were adopted at the MTC’s Annual Meetings in 2014 and 2015.

The MTC’s proposals have no force of law. They are hortatory in nature and serve as recommendations to state legislatures and tax departments. Whether they will be adopted broadly or not, the MTC proposals and its Report on reforming UDITPA are probably the most important study since the Willis Committee issued its 1965 four-volume work. Because this Report has already altered the national debate over the state corporate income tax, and is likely to influence corporate planning and litigation even in states that have not adopted

86. The other co-reporter was Prentiss Willson, one of the luminaries in the field. He is currently associated with the Sutherland law firm.
the proposals, parts of the MTC recommendations, its Report, and the Report by the Hearing Officer, are excerpted below. These are set off from the text by four centered ellipses ("**"). In these excerpts, "Act" refers to UDITPA, and "Draft" refers to the proposed changes by the Uniformity Committee of the MTC.

What follows below is a more detailed investigation of some of the issues sketched above, and the MTC's proposals. The material allows you to graze or feast, depending your level of interest.

III. The Weighting of the Factors of the Apportionment Formula

A. Early Formulas

Some of the earliest apportionment formulas consisted of one factor: property. The formula was calculated by dividing the value of a corporation’s in-state property by the value of its property everywhere. Some formulas incorporated a payroll factor in addition to the property factor. Because these two factors tended to apportion income to the “origin” states where production activities took place, this formula was politically unattractive to “destination” states having relatively little production activities but which served as the market for goods produced elsewhere. Not surprisingly, a sales factor was added to the formula.

87. Report by Shirley Sicilian, then-General Counsel of the MTC, to Cory Fong, then-Chair of the Executive Committee, Multistate Tax Compact, Article IV, Recommended Amendments, May 3, 2012, available at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Events/2013-14_Committee_Meetings/Exhibit%202%20Memo%20from%20Shirley%20Sicilian%20to%20Cory%20Fong%20Art%20IV%20%20(05-03-2012).pdf. After ten years with the MTC, Ms. Sicilian joined KPMG in 2013. She is an extraordinary talent and the MTC's proposals would not have occurred without her remarkable leadership.


89. See, e.g., Underwood, Bass, and Hans Rees’, supra note 61 and supra note 83. The constitutional constraints on apportionment and the unitary business concept were initially developed by the Court in property tax cases involving telegraph companies and railroad companies. See, e.g., Western Union Tel. Co. v. Taggart, 163 U.S. 1 (1896); Pullman’s Palace Car Co. v. Penn., 141 U.S. 18 (1891); Union Pacific Railway v. Cheyenne, 113 U.S. 516 (1884); State Railroad Tax Cases, 92 U.S. 575 (1875); Allied Signal, supra note 61. In dealing with railroads, a state that had track within its borders but not valuable terminals or switching yards, would apply its property tax to an apportioned share of the cost or value of the entire railroad. The Court upheld this approach on the theory that the track was valuable because of the integral role it played in connecting the terminals. This approach was extended to the income tax cases. See Allied Signal supra. See Huddleston and Sicilian, “History and Considerations for Combined Reporting: Will States Adopt a Model Combined Reporting Statute?” State and Local Tax Lawyer (2008 Symposium Edition).

90. "Initially, States required that income earned within the state be separately accounted for . . . . Formula apportionment was available but separate accounting was more commonly used. Eventually, the states adopted apportionment ‘out of sheer necessity’ as they searched for a workable and simple method to divide multistate income across the states . . . . since there was little coordination among the states, apportionment formulas varied widely. For example, the formulas in the eight taxing states in 1920 included various combinations of tangible and intangible property, receivables, sales, manufacturing costs, wages, salaries and purchases . . . . By 1928, the 17 states then taxing company income used nine different formulas . . . . the most common formulas apportioned income on the basis of either property or sales.

"The NTA [National Tax Association] then gave the states what the political situation seemed to demand: a three-factor formula . . . the NTA shifted its efforts toward defining a formula that would require the fewest changes in state tax practices. After examining state practices, the NTA concluded that a property, payroll and sales formula, with each factor accounting for one-third of the total weight, would be the most acceptable formula to the states.

"The NTA chose [this formula] not because this particular formula apportioned income more accurately than any other formula, but because ‘uniformity is preferable to scientific accuracy’ in apportioning multistate income. Furthermore, the NTA noted that the formula: (i) is simple and well-balanced; (ii) leads to a fair allocation that requires fewer departures from the standard; and (iii) is based on 10 years of experience in Massachusetts that has been satisfactory to both taxpayers and tax administrators. By 1948, nearly 45% of taxing states, compared with 12% two decades earlier, used the three-factor formula.” Ferdinand P. Schoettle, State and Local Taxation: The Law and Policy of Multi-Jurisdictional Taxation 581 (2003), drawing on JoAnn E. Weiner, Tax Coordination and Competition in the United States of America, Report of the Committee on Independent Experts on Company Taxation, 92 TNI 36-15, Sept. 2, 1992 (ellipses added).
Chapter 10

B. Sales v. Receipts

The sales factor is sometimes referred to as a receipts factor. “Receipts” has a broader connotation than “sales,” encompassing compensation for services, rents, dividends, royalties, interest and other types of revenue generated by the exploitation of property or labor, which might not fall within the common meaning of “sale.” To be sure, some states that use the designation “receipts factor” may include only sales receipts; other states, however, use the label because they include a broader category of revenue. Special rules often apply to income generated by intangibles or services. However labeled, the receipts or sales factor includes only those receipts that enter into the calculation of a corporation’s apportionable income, but not necessarily all such receipts.91

C. Traditional Evenly-Weighted, Three-Factor Formula

The Court has refused to impose a particular type of apportionment formula on the states,92 but nevertheless has described the three-factor formula in Container,93 a well-known case involving a manufacturer, as “something of a benchmark against which other apportionment formulas are judged.”94 The Court has not had an opportunity to revisit its comment in the ensuing three decades.

The traditional three-factor, evenly-weighted property, payroll, and sales apportionment formula, which is now used by only a minority of states notwithstanding that it is the heart of UDITPA, evolved at a time when the economy was basically manufacturing- and mercantile-oriented. In that context, the formula tended to work satisfactorily. The states, however, have long used specially developed formulas tailored to the activities of non-manufacturing businesses, such as banking, insurance, financial services,95 mutual funds, communications, pipelines, publishing, broadcasting, natural resources, construction, airlines, railroads, trucking, utilities, and so forth.96 Indeed, one of the reasons the corporate income tax has proven to be so

91. For example, MTC Reg. §IV.18(c), see Appendix, excludes from the receipts factor, but not from calculating apportionable income, gross receipts from the incidental or occasional sale of a fixed asset used in the regular course of the taxpayer’s trade or business.

UDITPA §17 provides that receipts from services or intangible property are included in the numerator of a state’s receipts factor if either the income-producing activity is performed in that state or, in the case of services performed in more than one state, if a greater proportion of the income-producing activity is performed in that state than in any other state. “Proportion” is measured by costs of performance and the MTC initially excluded payments to independent contractors and indirect costs. See As the Supreme Court has stated, “separate accounting, while it purports to isolate portions of income received in various states, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale.” Nonetheless, separate accounting is available as a potential alternative if allocation and apportionment do not fairly represent the extent of the taxpayer’s business activity in the taxing state. §IV(C)(4)(a), (b) infra. The MTC has recently developed rules dealing with independent contractors. MTC Reg. IV.17(4)(C).

If a combined or consolidated return is filed, see infra §XII, intercorporate sales are excluded from the receipts factor.

92. See Moorman, supra note 61.

93. Container, supra note 61.

94. Container, supra note 61, at 170.

95. In Crocker Equipment Leasing, Inc. v. Dept. of Rev., 838 P.2d 552 (Or. 1992), a financial organization was allowed to include intangible property in the Oregon property factor. For a relatively recent case distinguishing Crocker, see US Bancorp v. Dep’t of Revenue, 2007 Ore. Tax LEXIS 41, 68-69, n.23 (Or. T.C. Mar. 13, 2007) (“Crocker was decided solely on statutory bases and did not purport to announce a constitutional test for apportionment at issue there”). But see Lehman Bros. Bank, FSB v. State Bank Comm’r, 937 A.2d 95 (Del. 2007), cert. den., 553 U.S. 1018 (2008) (upholding Delaware bank franchise tax statute taxing 100% of bank’s net income despite substantial activities outside that State).


Because activities subject to special formulas are more significant in many states than manufacturing activities, the traditional three-factor formula, even where used, is no longer the dominant formula it once was. Moreover, even in the case of manufacturing companies, states have replaced the evenly-weighted three-factor formula with a double-weighted sales factor.
resilient in light of the considerable structural changes in the nature of the economy has been the
development of these alternative formulas.

D. The Move to More Heavily Weighting the Sales Factor

For many years, the majority of states weighted the three factors equally. Today, a large majority weight
the sales factor more heavily than the property or payroll factors. The two most common methods are to
double-weight the sales factor, or to use only sales.

Compared with an equally-weighted, three-factor formula, a double-weighted sales factor may increase that
state’s tax on some corporations, decrease it on others, and have no effect on corporations that conduct all
of their activities in the state. The exact pattern of effects depends on the mathematical relationship
between the sales factor and the property and payroll factors. More specifically, corporations whose sales
factors in the state are lower than the average of their in-state property and payroll factors benefit from a
double-weighted sales factor; corporations whose sales factors are greater than the average of their property
and payroll factors will apportion more income to that state.

Replacing an equally-weighted apportionment formula with one that double-weights the sales factor (or uses
only a sales factor) may be attractive to a state because the tax is reduced on corporations that have most of
their production activities in-state, but have most of their sales outside the state. Legislators may view this

or a single sales factor.

At least one state allows its revenue commissioner to negotiate the formula for taxpayers planning new or expanded

For a general discussion of specialized apportionment formulas, see Multistate Guide, supra note 35, at I-5031.

97. Some states eliminate a factor from the formula if its denominator is zero. Some states eliminate a factor from the formula
if it is deemed insignificant in generating the corporation’s apportionable income. See, e.g., Mass. Regs. 830 C.M.R.
63.38.1(11)(2008).

98. As of January 2015, states weighting the sales factor more than one-third but less than 100% for some or all taxpayers
include Alabama, Arizona, Arkansas, Connecticut, Florida, Georgia, Idaho, Kansas, Kentucky, Maryland, Massachusetts,
Mississippi, New Hampshire, New Mexico, North Carolina, Ohio, Oklahoma, Tennessee, Utah, Vermont, Virginia, and West
Virginia. Survey by the Federation of Tax Administrators. This survey does not reflect special formulas that might apply to
special industries.

99. As of January 2015, jurisdictions using only a sales factor for some or all taxpayers include California, Colorado,
Connecticut, District of Columbia, Georgia, Illinois, Indiana, Iowa, Kansas, Louisiana, Maine, Maryland, Massachusetts,
Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, New Mexico, New York, Oregon, Pennsylvania, Rhode Island,
South Carolina, Texas, Utah, Virginia, and Wisconsin. Survey by the Federation of Tax Administrators. This survey does not
reflect special formulas that might apply to special industries. For a devastating critique of the single-weighted sales factor, see
Michael Mazerov, The “Single Sales Factor” Formula for State Corporate Taxes: A Boon to Economic Development or a Costly
Giveaway?, Center on Budget and Priorities, (2001), excerpted infra Chapter Eleven. Massachusetts adopted a single-factor sales
formula in 1996 for certain industries. Mass. Gen. L. ch. 63, §38 (1996). This change was made in response to urgings by
Raytheon Corporation, a defense contractor and a major employer based in Massachusetts, and was strongly supported by
then-Governor Weld. For a Massachusetts-based manufacturer that sells out-of-state, such as a typical defense contractor, a
single-factor sales formula will substantially reduce its Massachusetts tax without reducing the state’s nominal tax rate
(assuming no throwback rule applies). For out-of-state manufacturers whose only activities in Massachusetts are sales, the
change will increase their taxes, assuming they are not protected by P.L. 86-272. For a discussion of whether legislators should
view a single-factor receipts formula as an effective tax incentive, see Pomp, supra note 7, at 393-409, 570-87; Mazerov, supra.

100. See Pomp, supra note 7, at 571-77. Because of this mathematical relationship, determining whether double-weighting the
sales factor will increase state tax revenue requires an empirical analysis.

101. The same mathematical relationship describes which corporations would benefit from a single sales-factor apportionment
formula. Instead of the more accurate mathematical statement in the text, some commentators describe double-weighting the
sales factor as increasing taxes on out-of-state corporations, a statement that illustrates the ambiguity in the definition of “out-
of-state” corporations. See text following supra note 52. For a fuller discussion, see Pomp, supra note 7, at 570-87.
change as an incentive for such corporations to expand, or locate, their operations in the state. Conversely, the tax is increased on corporations that manufacture outside the state and sell in the state without the protection of P.L. 86-272. These corporations now have an incentive to shift their production activities to the state.

But there can also be a perverse locational disincentive to more heavily weighting the sales factor. A corporation that only sells in a state may be immunized from taxation by P.L. 86-272. For such a corporation, a double-weighted sales factor will be more of a disincentive for the corporation to engage in nexus-creating activities in that state than would an evenly-weighted receipts factor. The disincentive effects are even greater under a single-factor sales formula.

E. Virtue of an Apportionment Formula

One major virtue of apportionment is that a formula is used to divide something that cannot be easily assigned geographically—income—using factors that can be located geographically: property, payroll, and sales. The Court has recognized that for "more-or-less integrated business[es] . . . arriving at precise territorial allocations of 'value' is often an elusive goal, both in theory and in practice." The Court has described dividing up the tax base as bearing "some resemblance . . . to slicing a shadow."

Another virtue of the UDITPA formula is that it has proven to be a politically acceptable manner of dividing the tax base. By utilizing property, payroll, and sales, the formula recognizes the claims of the states where production occurs and the claims of the states that provide a market. The payroll, property, and sales factors can be viewed as a proxy for some of the activities by which income is generated, although some economists might argue that income has already been realized prior to a sale, and that all a sale does is convert an asset (e.g., inventory) from one form (e.g., tangible personal property) into another (e.g., cash or its equivalent).

The three factor formula can also be viewed as assigning tax revenue as a quid pro quo to those states that provide benefits, opportunities, services, and protections to a corporation. Through the provision of highways, police, fire, schools, waste disposal, a legal infrastructure, and other public sector goods and services, a state facilitates the earning of corporate income for which it is entitled to a return on its investment. In addition, the formula generates tax revenue for states incurring the costs of providing services.

102. While there may not be a neat cause and effect, the following industries and corporations are understood to have supported or initiated efforts to double weight the sales factor in their states: the paper industry in Maine; Coca Cola, Georgia-Pacific and the automobile industry in Georgia; military contractors in Florida; the mining industry in West Virginia; Intel Corporation in New Mexico; and Kraft, Motorola, and Abbott Labs in Illinois. Iowa's adoption of a single-weighted sales factor in the 1930's is widely believed to have been in response to pressure by John Deere and Maytag.

103. For a corporation that makes all of its sales in State A and conducts all of its other activities in State B, a double-weighted sales factor would divide the income equally between the two states, a normatively defensible result. The federal rules reach this 50-50 split for certain types of income. See Int. Rev. Code §863(c), (e). The MTC recommends this formula as part of its reform of UDITPA, but does not require it.

104. See infra §IX(A); Wrigley, supra note 61 and infra Chapter Eleven.

105. For a full discussion, see Mazerov, supra note 99.

106. Container, supra note 61, at 164.

107. Id. at 192.

108. See infra note 111.

and facilities to the corporation,\textsuperscript{110} for which the factors serve as a rough proxy. The recent trend to using only a sales factor is inconsistent with the above defense of the three factor formula.

As the following excerpt indicates, the MTC has accepted the reality that the evenly-weighted three factor formula has been overtaken by current practices, and has recommended that UDITPA no longer require any specific weighting of the factors. Nonetheless, the MTC has recommended, without requiring, a double-weighted sales factor.

* * * * *

F. MTC Report on Factor Weighting

“Most states have moved away from the Act’s evenly-weighted, three-factor formula, replacing it with approaches that more heavily weight the sales factor. Today, only a small number of states unconditionally follow the Act’s formula. Most either double weight the sales factor or use it exclusively.

“[T]he Uniformity Committee considered five options: (1) retain the current, three-factor equal weighting, (2) double weight the sales factor, (3) use only a single sales factor, (4) indicate that the weighting is each state’s choice (this approach lacks a uniformity focus, but would acknowledge states’ differing tax policies and the point that states are, in fact, moving in a uniform direction), and (5) allow taxpayers to elect a weighting which will allow it to file uniformly in all or some threshold percentage of states (unlike the taxpayer apportionment election that exists now in Compact Article III.1, this election would be limited to factor weighting and would require a consistent election in some number of other states) . . . [T]he Uniformity Committee determined that the double-weighted sales formula had the most support among the states.”

Without much explanation, the MTC’s Executive Committee voted to allow each state to define its own factor weighting, but recommended double weighting the sales factor.

G. Comments by the Hearing Officer

“Despite the political attractiveness of the evenly-weighted, three factor formula, a Nobel Prize winning economist described the formula as: ‘[t]his simple but arbitrary and capricious formula has all the earmarks of having been concocted by a committee of lawyers who had forgotten anything they ever were taught about statistics or economics.’\textsuperscript{111} This criticism ignores a major virtue of the formula: it divides something that cannot be easily assigned geographically–income–using factors that can be located geographically–property, payroll, and sales. But as the discussion of Art. IV.17 suggests, the sales factor might be less able to deal with the receipts from services and intangibles than the receipts from tangible property.

“Because of the lack of any scientific or economic model upon which the evenly-weighted, three-factors were based, the formula could not resist attempts by states, at the urging of business, to use it to encourage economic development. Around the 1970’s, a few states started to double weight the sales factor with many more doing so over the next few decades.

. . . .

\textsuperscript{110} No correlation necessarily exists—or has to exist—between the benefits a state provides to a corporation and the cost of providing such benefits. For example, the benefits to a business of allowing it to operate as a corporation do not have any logical relationship to the costs a state incurs by adopting incorporation statutes.

\textsuperscript{111} William Vickrey, The Corporate Income Tax in the U.S. Tax System, 73 Tax Notes 597, 602 (1996). (Vickrey also thought a sales factor had no role to play in an apportionment formula, a common opinion among economists when UDITPA was being debated and one shared by the Willis Committee, which recommended only property and payroll factors.)
"Legislators typically view the shift from an evenly-weighted to a double-weighted sales factor (or sales only) as an incentive for in-state corporations to expand their operations in the state and for out-of-state corporations to locate in the state. States have emphasized the incentive effects of the shift over the disincentive effects.

"A state that finds double weighting attractive will be drawn to using only a sales factor. Mathematically, this is equivalent to placing an infinite weight on the sales factor in any formula using a property or payroll factor. A single sales factor provides the greatest benefit to corporations that are primarily producing inside the taxing state and selling outside that state, and provides the greatest detriment to those primarily producing outside the state and selling in the state. Many commentators challenge the benefits of using a single sales factor (or double-weighted sales factor) to influence economic development. Even if there are benefits, they will be neutralized as other states adopt similar measures.

"From a tax policy perspective, the single sales factor is virtually indefensible. It is hard to think of situations where an interstate taxpayer generates income without the use of capital or labor. Moreover, under the right fact pattern, a single sales factor might produce results that violate the external consistency prong of the fair apportionment requirement under the Commerce Clause, results raising the possibility of alternative apportionment. In addition, using only sales to apportion income places a great burden on the rules used for assigning receipts to a state. As the discussion of Art. IV.17 suggests, the Hearing Officer is concerned whether the various existing state rules or those proposed in the Draft can meaningfully bear that burden (at least for interstate business-to-business transactions).

"Politically, corporations prefer a tax reduction implemented by changes to the apportionment formula, as opposed to a visible reduction in the tax rate or an increase in grants or credits. Compared to these other ways of benefitting corporate investment and activities, a change in the apportionment formula is more opaque and non-transparent, and more likely to escape notice and debate.

1. Double Weighting as a Fair Compromise

"There is no science, economic theory, or model that determines the normative weighting of the factors, or for that matter, what the factors should even be. At the least, a double-weighted sales factor has the advantage of sharing the tax base equally between the origin (or production states) and the destination (or market states), assuming sales are assigned to the latter. There are no strong normative reasons for favoring the origin states over the destination states or vice versa so that double-weighting is a reasonable and fair compromise. If the payroll and property factors are viewed as double-weighting the origin states, that is balanced by double-weighting the sales factor.

"The states did not adopt a double-weighted sales factor, however, because they thought it was a fair compromise. The overriding reason was economic development—the same reason motivating the movement to a single sales factor.

2. The Recommendation of Double Weighting is Unlikely to have any Significant Effect

"The Executive Committee’s proposal to allow states to define the factor weighting fraction is a concession to reality. The states have long deviated from the Act’s three-factor, evenly-weighted formula. The proposal merely reflects the current state of affairs.

"The recommendation of double weighting is unlikely to have much effect. A substantial number of states currently double weight; the only effect of the recommendation will be if it discourages some of them from moving in the direction of a single sales factor. States that have already made that change are hardly going to abandon it because of the Draft, unless they are unhappy with a single sales factor for other reasons, perhaps because a loss in tax revenue is not offset by increased economic activity. The group that might be affected will be the small number of states currently conforming to the Act. The Draft will release them from the
obligation of using a three-factor, evenly-weighted formula, although some of these states may move directly to using only sales and skip double weighting entirely.

“The Act’s evenly-weighted, three-factor formula did little to stop the movement to double weighting or to the single sales factor. Double weighting may be sound tax policy, but considerations of economic development will typically prevail.

3. The Effect on Uniformity

“The recommendation that states can do what they want with the formula will probably be criticized by some as a major setback for uniformity. When the Hearing Officer was a co-reporter for the ULC project, he was often told that if no agreement could be reached on the formula, there was no reason to continue with the project.

“The Hearing Officer dismisses this view. Even back in 1957, when UDITPA was proposed, uniformity never quite existed. Long before the evenly-weighted, three-factor formula emerged as the consensus approach, specialized formulas were used for specialized industries—and these were often quite different from the three-factor formula. (The Hearing Officer has not attempted to determine whether the states used similar industry-specific formulas; some similarity no doubt existed.) These specialized formulas co-exist today with the Act’s formula. The MTC, which has labored mightily to develop industry-specific formulas, has not been criticized (nor should it have been) on the grounds that these efforts have thwarted uniformity. To the contrary, one of the reasons the corporate income tax has proven to be so resilient in light of the considerable structural changes in the economy has been the development of these alternative formulas.

“In 1957, the Act’s evenly-weighted, three-factor formula applied primarily to manufacturing and mercantile activities, which at that time represented a significant percentage of the country’s gross domestic product (GDP). With the rise of interstate activities subject to specialized formulas, which do not incorporate an evenly-weighted, three-factor formula, such as those covering financial services, telecommunications, broadcasting, and advertising, combined with the country’s loss in manufacturing, the Act’s apportionment formula has come to cover less of the country’s GDP. This suggests that the movement away from the 1957 formula was less a threat to uniformity than is sometimes asserted. Furthermore, given the specialized formulas that always existed, the uniformity in the apportionment formulas that prevailed in 1957 is probably overstated. Finally, the MTC industry-specific regulations that do not adopt the evenly-weighted, three-factor formula cover major sectors of the service economy.

“More fundamentally, perhaps uniformity should be viewed on an industry basis, rather than on a more general level. The lack of criticism of the MTC industry regulations as undercutting uniformity may be an implicit endorsement of this view. If so, the MTC’s regulations covering the apportionment of specialized industries such as financial institutions, telecommunications, airlines, railroads, trucking companies, and television and radio broadcasting have done more to promote uniformity than the movement away from the three-factor formula has done to undercut uniformity.

“Even these detailed industry-specific regulations cannot respond to what some might argue the concept of uniformity requires: identical tax rules on taxable income and nexus; identical interpretation of terms and concepts; and identical rates. To take those goals seriously, however, would paralyze legitimate efforts at harmonizing the rules on apportionment.

4. Concluding Observation

“The Hearing Officer endorses the Executive Committee’s Proposal. Notwithstanding the recommendation for double weighting, the march to a single sales factor can still be expected to continue. The Hearing Officer believes that the most useful role for the MTC is to continue its cooperative efforts with the private sector to formulate industry-specific rules of apportionment. The MTC has a track record in being able to bring
interested parties together in a spirit of cooperation and formulating workable model regulations.”

IV. Composition of the Factors of the Apportionment Formula

A. The Property Factor

State practice differs not only on the weight assigned to the factors in the apportionment formula, but also with respect to the details regarding each factor. Consider, for example, the property factor, which superficially would seem to raise few questions. But policy questions immediately arise. What types of property should be included within that factor? Real, tangible, or intangible property? Leased property? Property in transit? Property under construction? Inventory? Spare parts? Property available or capable of being used in the business even if it is not used? What if property is no longer used in the business? How should property be treated if it is partially used to generate allocable, rather than apportionable, income?

How should property be valued? Original cost? Current fair market value? Original cost less financial depreciation? Original cost less tax depreciation? Assessed value for property tax purposes? Should different rules be used for different types of assets? What about property that is in outer space, such as communication satellites, or property on the high seas? Should a throwback (or throwout) rule be used?

When should the property be valued? At the beginning of the year or at the end of the year? Should an average value be used?

To which states should property be assigned? While this is a trivial question for real estate because the state where the property is located is the only logical candidate, what should the rules be for moveable property? If intangible property is included in the denominator of the property factor, in which state’s numerator should it be included?UDITPA, Section 10 provides that the property factor is a fraction, the numerator of which is the average value of the taxpayer’s real and tangible personal property owned or rented and used in this state during the tax period, and the denominator of which is the average value of all the taxpayer’s real and tangible personal property owned or rented and used during the tax period. Property is valued at its original cost. Property rented by the taxpayer is valued at eight times the net annual rental rate. The average value of property is determined by averaging the values at the beginning and ending of the tax period, but the tax administrator may require the averaging of monthly values during the tax period if reasonably required to reflect properly the average value of the taxpayer’s property. All of the other issues raised above are unaddressed by UDITPA.

The MTC’s Report did not cover the property factor.

B. The Payroll Factor

The payroll factor raises its own set of issues. For example, should the payroll factor include tax-free fringe benefits or payments to a deferred compensation plan or pension plan? How should the payroll factor treat employees who spend part of their time generating non-apportionable income? How should management fees paid to a related corporation be treated? How should the payroll of an employee who travels for most of

112. See, e.g., Alaska v. Amoco, 676 P.2d 595 (Alaska 1984); Mass. v. Exxon Corp., 551 N.E.2d 36 (Mass. 1990); MTC Reg. IV.10.(b). Is it improper to include inventory in the property factor and include the sale of such inventory in the sales factor?

113. For a general discussion of the property factor, see Multistate Guide, supra note 35, at I-5173. Historically, income from intangible property was typically not apportioned. It was commonly allocated to the state of legal or commercial domicile, or to the state of its business situs. Under this approach, the property factor was not implicated.
Chapter 11

protected under P.L. 86-272 or this Statement, no sales in this state or income earned by the company attributed to this state during any part of said tax year shall be protected from taxation under said Public Law or this Statement.

E. Application of the Joyce Rule.

In determining whether the activities of any company have been conducted within this state beyond the protection of P.L. 86-272 or paragraph IV.B. of this Statement, the principle established in Appeal of Joyce, Inc., Cal. St. Bd. of Equal. (11/23/66), commonly known as the “Joyce Rule”, shall apply. Therefore, only those in-state activities that are conducted by or on behalf of said company shall be considered for this purpose. Activities that are conducted by any other person or business entity, whether or not said person or business entity is affiliated with said company, shall not be considered attributable to said company, unless such other person or business entity was acting in a representative capacity on behalf of said company.


B. Apportionment and Allocation of Income

Underwood Typewriter Company v. Chamberlain, Treasurer of the State of Connecticut

Supreme Court of the United States, 1920.
254 U.S. 113, 41 S. Ct. 45, 65 L. Ed. 165.

MR. JUSTICE BRANDEIS delivered the opinion of the court.

... The Underwood Typewriter Company is engaged in the business of manufacturing typewriters and kindred articles; in selling its product and also certain accessories and supplies which it purchases; and in repairing and renting such machines. Its main office is in New York City. All its manufacturing is done in Connecticut. It has branch offices in other States for the sale, lease and repair of machines and the sale of supplies; and it has one such branch office in Connecticut. All articles made by it—and some which it purchases—are stored in Connecticut until shipped direct to the branch offices, purchasers or lessees. In its return to the tax commissioner of Connecticut, made in 1916 under the above law, the company declared that its net profits during the preceding year had been derived principally from tangible personal property; that these profits amounted to $1,336,586.13; that the fair cash value of the real estate and tangible personal property in Connecticut was $2,977,827.67, and the fair cash value of the real estate and tangible personal property outside that State was $3,343,155.11. The proportion of the real estate and tangible personal property within the State was thus 47%. The tax commissioner apportioned that percentage of the net profits, namely
$629,668.50, as having been earned from the business done within the State, and assessed thereon a tax of $12,593.37, being at the rate of 2% . . . .

. . . .

[I]t is contended that the tax violates the Fourteenth Amendment because, directly or indirectly, it is imposed on income arising from business conducted beyond the boundaries of the State. In considering this objection we may lay on one side the question whether this is an excise tax purporting to be measured by the income accruing from business within the State or a direct tax upon that income; for the “argument, upon analysis, resolves itself into a mere question of definitions, and has no legitimate bearing upon any question raised under the Federal Constitution.” Shaffer v. Carter, 252 U.S. 37, 55. In support of its objection that business outside the State is taxed plaintiff rests solely upon the showing that of its net profits $1,293,643.95 was received in other States and $42,942.18 in Connecticut, while under the method of apportionment of net income required by the statute 47 per cent. of its net income is attributable to operations in Connecticut. But this showing wholly fails to sustain the objection. The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sale in other States. In this it was typical of a large part of the manufacturing business conducted in the State. The legislature in attempting to put upon this business its fair share of the burden of taxation was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders. It, therefore, adopted a method of apportionment which, for all that appears in this record, reached, and was meant to reach, only the profits earned within the State. “The plaintiff’s argument on this branch of the case,” as stated by the Supreme Court of Errors, “carries the burden of showing that 47 per cent. of its net income is not reasonably attributable, for purposes of taxation, to the manufacture of products from the sale of which 80 per cent. of its gross earnings was derived after paying manufacturing costs.” The corporation has not even attempted to show this; and for aught that appears the percentage of net profits earned in Connecticut may have been much larger than 47 per cent. There is, consequently, nothing in this record to show that the method of apportionment adopted by the State was inherently arbitrary, or that its application to this corporation produced an unreasonable result.

. . . .

Questions and Comments

1. The theory underlying the unitary business concept applied by the Court has its roots in the property taxation of railroads. The issue there was how to value track that ran through a state. The Court recognized that the track might be near valueless if viewed in isolation but very valuable as part of a functioning railroad. The Court approved a methodology whereby a jurisdiction could value the track by multiplying the value of the railroad by the percentage of track that was in the jurisdiction. Union Pacific R.R. Co. v. Ryan, 113 U.S. 516 (1884). Underwood represents the first time the Court applied this approach in the context of an income tax.

2. Was the taxpayer challenging the constitutionality of the Connecticut formula on its face or only the application of the formula to its particular situation?

3. How did the taxpayer prove the amount of its net profits that were received in Connecticut? The Court
Chapter 11

says “plaintiff rests solely upon the showing. . .” What was that “showing” based on?

4. What kind of proof would have been sufficient to invalidate the Connecticut assessment?

5. Suppose that all of Underwood’s property was in Connecticut, that all of its sales and sales activities took place in other states, and that it was not protected by P.L. 86-272 in those other states. What percentage of its net income would be taxed by Connecticut? Does that seem unreasonable? Cf. Treasury Reg. §1.863-3AT.

6. Does the Court view the task of specifically allocating profits as impossible?

Is it inconsistent for the Court to speak of “the impossibility of allocating specifically the profits earned by the processes conducted within its borders” but to entertain the possibility that a taxpayer could show that the formula produced an unreasonable result?

7. The Connecticut Supreme Court of Errors stated that 80 per cent of Underwood’s gross earnings was derived from manufacturing. Is that statement inconsistent with the U.S. Supreme Court’s opinion?

8. Does the case support the proposition that a state can tax interstate commerce?

9. Where was Underwood commercially domiciled? Does it matter to the Court?

10. Is the Court upholding the constitutionality of a single-factor apportionment formula? See Moorman, infra.

Bass, Ratcliff & Gretton, Limited v. State Tax Commission
Supreme Court of the United States, 1924.
266 U.S. 271, 45 S. Ct. 82, 69 L. Ed. 282.

MR. JUSTICE SANFORD delivered the opinion of the Court.

[The Tax Law of New York] provides that for the privilege of doing business in the State a foreign manufacturing and mercantile corporation shall pay, in advance, an annual franchise tax, to be computed by the State Tax Commission, at the rate of three per centum, upon the net income of the corporation for the preceding year. This net income is "presumably the same" as that upon which the corporation is required to pay a tax to the United States; but the amount thereof as returned to the United States is subject to any correction for fraud, evasion or errors, ascertained by the Commission. If the entire business of the corporation is not transacted within the State, the tax is to be based upon the portion of such ascertained net income determined by the proportion which the aggregate value of specified classes of the assets of the corporation within the State bears to the aggregate value of all such classes of assets wherever located. The classes of assets which are to enter into this ratio—hereinafter termed the segregated assets—are: real property and tangible personal property; bills and accounts receivable resulting from the manufacture and sale of merchandise and services performed; and shares of stock owned in other corporations, not exceeding ten per centum of the real and tangible personal property, which are to be allocated according to the location of the physical property representing such stock. The corporation is to be exempt from any personal property tax.

....

Bass, Ratcliff & Gretton is a British corporation, engaged in brewing and selling ale. All its brewing is done