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Unfair Apportionment: Consider the Alternatives

The taxpayer's task is to assess both constitutional and statute-based options

By Craig B. Fields, Mitchell A. Newmark, and Eugene J. Gibilaro

When must state apportionment be fair? Always. If a state's normal apportionment formula is operating unfairly with respect to your company, you need to consider the alternatives. The United States Supreme Court has articulated a four-part test for determining whether a state tax burdens interstate commerce in violation of the Commerce Clause of the United States Constitution. Pursuant to one part of that test, a state tax is constitutional when the tax is "fairly apportioned."[1] What is fair apportionment? To be fairly apportioned, a state tax must be both "internally consistent" and "externally consistent."[2]

The internal consistency test looks to the overall structure of the tax at issue and asks whether the tax would necessarily disadvantage interstate commerce when compared with intrastate commerce if every state enacted an identical taxing scheme.[3] Inasmuch as an internally inconsistent tax impermissibly burdens interstate commerce on its face, the tax is per se invalid in all cases, without the need for further consideration of the economic reality of how the tax applies.

The external consistency test looks to the specific economic realities of how the tax applies in order to determine whether the tax impermissibly "reaches beyond that portion of value that is fairly attributable to economic activity within the taxing State."[4] Inasmuch as the external consistency test is concerned with the underlying economic realities of how the tax applies in practice, the analysis is undertaken on a case-by-case basis to determine whether a tax is fairly apportioned as applied to particular taxpayers. A state's statutory apportionment formula may be externally consistent as applied to one taxpayer but externally inconsistent as applied to another, depending on the economic realities of their respective business activities in the state. If it is determined that a normal statutory apportionment formula is externally inconsistent as applied to a particular taxpayer, then the U. S. Constitution requires an alternative method of apportionment to be applied that more fairly reflects the extent of that taxpayer's business activities within the taxing state.

Distinct from U.S. Constitution considerations, states have enacted statutory alternative apportionment provisions to address situations where the normal statutory apportionment formula does not fairly represent in-state business activities or income. Pursuant to these alternative apportionment statutes, typically either the state or the taxpayer may assert that the statutory apportionment formula does not fairly represent the in-state business activities or income and may propose that an alternative method of apportionment be used to fairly reflect in-state activities. Such provisions aim to provide an additional safeguard to ensure fair apportionment in cases where the normal statutory apportionment formula yields a result that does not fairly represent in-state business activities but is not so manifestly unfair as to rise to the level of a constitutional violation. However, it is important to note that whereas all state apportionment formulas are required to be internally and externally consistent in accord with the U.S. Constitution, statutory alternative apportionment provisions are state-made laws and therefore tend to vary by state.

We will consider constitutionally required and statute-based alternative apportionment in turn.

Constitutional Aspects of Alternative Apportionment

The U.S. Supreme Court has stated that a statutory apportionment formula that is "not intrinsically arbitrary … will be sustained until proof is offered of an unreasonable and arbitrary application in particular cases."[5] A normal statutory apportionment formula will be invalidated when the taxpayer demonstrates that the formula operates in a way that attributes to the taxing state "a percentage of income out of all appropriate proportion to the business transacted" within the state.[6]

For example, in *Hans Rees' Sons, Inc. v. North Carolina Ex Rel. Maxwell,* North Carolina's normal statutory apportionment formula was a single property factor based on real and personal property located within the state. The taxpayer was in the business of tanning, manufacturing, and selling belting and other leather products, was incorporated in New York, and owned a manufacturing plant in North Carolina. A sales office and a warehouse were located in New York. Sales were made throughout the United States, including to customers in North Carolina. All sales originated in New York, with approximately forty percent of orders shipped to customers from the New York warehouse and approximately sixty percent of orders shipped directly from the North Carolina plant. The taxpayer demonstrated that around seventeen percent of its net income had a North Carolina source; in contrast, the state's single property factor formula yielded a North Carolina apportionment percentage of between approximately sixty-six and eighty percent during the tax years in question, proving a distortion of between approximately 270 percent and 370 percent. The Supreme Court concluded that the state's formula was out of all appropriate proportion to the activities transacted by the taxpayer in the state.[7]

Similarly, in *Norfolk & Western Railway Co. et al. v. Missouri State Tax Commission*, Missouri's normal formula required that railroad rolling stock be apportioned to the state for property tax purposes based on the proportion of the taxpayer's railroad track miles in Missouri relative to the taxpayer's railroad track miles everywhere.[8] The taxpayer maintained much of its equipment in the coal regions of Virginia, West Virginia, and Kentucky. The taxpayer leased all of the property of another railroad company that engaged in a substantial amount of business in Missouri. Using the normal statutory apportionment methodology, the state determined that the taxpayer owed property tax on approximately eight percent of the assessed value of all its rolling stock. However, the taxpayer submitted evidence that the value of rolling stock in Missouri on the assessment date amounted to approximately three percent of all the taxpayer's rolling stock, proving a distortion of approximately 165 percent. The Court was persuaded that the statutory apportionment formula yielded "a grossly distorted result" and that the state was required to "make the accommodations necessary to assure that its taxing power is confined to its constitutional limits."[9]

Conversely, in *Moorman Manufacturing Co. v. Bair, Director of Revenue of Iowa*, the Supreme Court found that Iowa's single sales factor apportionment formula was not per se invalid and that, as to fair apportionment, the taxpayer failed to produce evidence that a significant portion of its income had been improperly attributed to Iowa.[10] Moorman manufactured and sold animal feed. Although all products were manufactured in Illinois, the taxpayer maintained 500 salespeople in Iowa and owned six warehouses in the state. Moreover, Iowa sales accounted for approximately twenty percent of the taxpayer's total sales. Inasmuch as all products sold in Iowa were manufactured outside the state, the taxpayer argued that it should have been permitted to use an alternative apportionment method (i.e., equally weighted property, payroll, and sales factors). The distortion between Iowa's statutory single sales factor formula and the alternative three-factor formula ranged from between approximately forty percent and sixty percent during the tax years in question. The Court concluded that while Iowa law permitted the taxpayer an opportunity to demonstrate that the statutory formula was arbitrary as applied to it,

"this record contains no such showing and therefore the Director's assessment is not subject to [constitutional] challenge."[11] Effectively the purported distortion was the mathematical difference between a single factor and the three-factor formula.

When a taxpayer challenges a state's statutory apportionment formula on the grounds that it violates the U.S. Constitution, the burden is on the taxpayer to put forth evidence demonstrating that an alternative apportionment method is required to reasonably reflect in-state business activities. Moreover, the cases show that the distortion must be substantial. The Supreme Court has observed that states' apportionment formulas occasionally over-reflect or under-reflect income attributable to the taxing state. "Yet despite this imprecision, the Court has refused to impose strict constitutional restraints on a State's selection of a particular formula."[12] Statutory alternative apportionment provisions have therefore been enacted, in part, to alleviate the effects of distortive apportionment in cases where such distortion does not rise to the level of a constitutional violation.

Statutory Aspects of Alternative Apportionment

State statutory provisions have long authorized state tax administrators to vary the statutory apportionment formula if that formula does not fairly represent the extent of a taxpayer's business activity within the state. The model alternative apportionment provision outlined in the Uniform Division of Income for Tax Purposes Act ("UDITPA") states:

> If the allocation or apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the [tax administrator] may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> a. separate accounting;
> b. the exclusion of any one or more of the factors;
> c. the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
> d. the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.[13]

Many states have adopted the UDITPA alternative apportionment formulation, either with identical language or minor modifications, into their own tax codes.[14] Moreover, other states that have not adopted the UDITPA scheme have nonetheless adopted their own alternative apportionment provisions. For example, New Jersey law states:

> If it shall appear to the commissioner that an allocation factor determined pursuant to section 6 does not properly reflect the activity, business, receipts capital, entire net worth or entire net income of a taxpayer reasonably attributable to the state, he may adjust it by:
>
> a. excluding one or more of the factors therein;
> b. including one or more other factors, such as expenses, purchases, contract values (minus subcontract values);
> c. excluding one or more assets in computing entire net worth; or
> d. excluding one or more assets in computing an allocation percentage; or
> e. applying any other similar or different method calculated to effect a fair and proper allocation of the entire net income and the entire net worth reasonably attributable to the state.[15]

Although the language in state alternative apportionment provisions is typically similar, states have taken different approaches to interpreting and applying those provisions. For example, California courts ruled that an alternative apportionment provision may be triggered "if the challenged activity both qualitatively differs from the taxpayer's principal business and quantitatively distorts the formula by a substantial amount."[16] In *Microsoft Corp. v. Franchise Tax Board*, the California Franchise Tax Board invoked the state's alternative apportionment provision to include in Microsoft's sales factor only its net gain, rather than the company's gross receipts, from the redemption of securities held as part of Microsoft's treasury function.[17] In ruling in favor of the Franchise Tax Board, the court found Microsoft's redemption of securities in connection with its treasury function to be incidental investment activity. Moreover, the court found the distortion to the sales factor to be substantial in that "Microsoft's short-term investments produced less than 2 percent of the company's income, but 73 percent of its gross receipts" (i.e., increasing the sales factor denominator and diluting the factor overall).[18]

In *General Mills v. Franchise Tax Board*, amounts received in connection with commodity futures sales that were made to hedge against price fluctuations were held to distort the sales factor. *General Mills* was distinguishable from *Microsoft* on the grounds that General Mills' hedging activities were not short-term investment activities, but rather were "a support activity integral to the company's main line of business."[19] Nonetheless, the

California Court of Appeals found that the "qualitative" and "quantitative" tests are not independent and separate requirements and that General Mills' sales factor was distorted because, among other reasons, "hedging activities produced at most 2 percent of [General Mills'] income (and in two of six years operated at a loss) while it generated between 8 and 30 percent of [General Mills'] gross receipts."[20] California courts have struggled to articulate clear explanations of the "qualitative" and "quantitative" tests and the extent to which each test matters in determining whether the apportionment formula fairly represents in-state activities.

Inasmuch as the external consistency test is concerned with the underlying economic realities of how the tax applies in practice, the analysis is undertaken on a case-by-case basis to determine whether a tax is fairly apportioned as applied to particular taxpayers.

A previous iteration of the Multistate Tax Commission's (MTC) model alternative apportionment regulations permitted alternative apportionment in unusual circumstances. State courts have struggled to determine when a taxpayer's business activities present an "unusual fact situation" and the extent to which that factor is relevant to an alternative apportionment analysis. For example, the Tennessee Supreme Court held that the state commissioner of revenue properly exercised his discretion under the state's alternative apportionment statute in requiring a wireless telecommunication service provider to source its receipts based on customer billing addresses rather than the normal statutory costs-of-performance method.[21] Tennessee had previously adopted the model regulation that permitted alternative apportionment "only in limited and specific cases" in which "unusual fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results."[22] Although the court acknowledged that wireless telecommunication activities are neither unusual nor nonrecurring, the court found that it was unusual for "millions of dollars in receipts from Vodafone's Tennessee customers to vanish, for tax purposes."[23] That, of course, was outcome-determinative reasoning with no foundation in the facts or the law. The court also found that this was an unusual fact situation, because the commissioner would be unable to verify the location for the greater portion of Vodafone's costs. The court gave no explanation for why the situs of costs associated with wireless telecommunications services are uniquely difficult to verify in comparison to any other service business.[24]

The "any other method" alternative apportionment language has been broadly construed as to whether an alternative apportionment method is appropriate in a particular situation. The South Carolina Supreme Court interpreted the "any other method" language of its alternative apportionment provision to include combined reporting (the normal method of reporting in South Carolina was separate company reporting).[25] The court reasoned that the state's alternative apportionment provision "clearly authorizes the Department to use 'any other method' to effectuate an equitable apportionment of the taxpayer's income, including the combined entity apportionment method."[26] Therefore, in both Tennessee and South Carolina, courts have permitted the use of alternative apportionment methods that fundamentally conflict with legislative preferences regarding the states' apportionment methodology (i.e., cost of performance sales sourcing in Tennessee and separate company reporting in South Carolina).

Finally, one area relevant to alternative apportionment where taxpayers have had significant success is the burden of proof. Unlike Constitution-based alternative apportionment where it is always the taxpayer who claims constitutional protection and bears the burden of proving that the state has applied its normal apportionment formula unconstitutionally, typically both states and taxpayers may invoke alternative apportionment under state statutes. The question then arises whether it is the state or the taxpayer that bears the burden of proof when the state is the one asserting alternative apportionment. In *CarMax Auto Superstores West Coast, Inc. v. South Carolina Department of Revenue*, the South Carolina Supreme Court found that there are two burdens of proof in alternative apportionment cases.[27] The party seeking alternative apportionment (i.e., either the state or the taxpayer) bears the burden of proving that the statutory apportionment formula does not fairly represent the taxpayer's business activity in the state. If that burden is met, the party seeking alternative apportionment then must prove that its alternative method of apportionment is reasonable. Significantly, in both *CarMax* as well as a subsequent decision from the Court of Appeals of South Carolina, the courts found that the state department of revenue had failed to produce sufficient evidence that the normal statutory method did not fairly represent the taxpayer's business activities in the state and, therefore, the state could not force alternative apportionment.[28] States have nearly uniformly concluded

that the state tax administrator bears the burden of proof when it is the state tax administrator that asserts alternative apportionment.[29]

Taxpayer Considerations

Simple examples are: 1) a manufacturer whose headquarters and plant are in one state, with sales in all fifty states, and 2) a service provider whose headquarters and idea-generating employees are in one state, with sales in all fifty states. With respect to both Constitution-based and statutory alternative apportionment, the critical threshold question is whether the statutory apportionment formula fails to yield an apportionment factor that accurately reflects the taxpayer's in-state activities. If the distortion is substantial enough, then the taxpayer has a constitutional basis for asserting an alternative apportionment method. If the distortion is not substantial enough to raise constitutional issues but is nonetheless meaningful, then statutory alternative apportionment comes into play.

The question of whether the statutory apportionment formula fails to reflect the taxpayer's in-state activities ultimately depends upon how the taxpayer generates its income. The sales factor should reflect the economic reality of where revenue is generated, whereas the property factor and payroll factor should reflect the economic reality of where expenses are incurred to generate the income. The absence of one of these factors (or the use of a single factor) could result in a formula that apportions either according to revenue or to expenses alone. Furthermore, a sales factor may better reflect economic reality for a high-profit-margin business with relatively minimal expenses. In contrast, a property factor or a payroll factor may better reflect economic reality for low-profit-margin businesses with relatively large expenses.

Moreover, it should also be considered whether the methodology for computing a factor accurately reflects the underlying economics of the taxpayer's in-state activities with respect to that factor. For example, a software company outsourced most of its development work to employees in India. The company had many employees located in India, whereas it had only a few (though highly paid) employees in New York. Due to wage discrepancies between employees in New York and employees in India, the New York payroll factor was distortedly high. The software company applied for alternative apportionment, and an administrative law judge (and, on appeal, the Tax Appeals Tribunal) agreed that alternative apportionment was warranted and that the payroll factor should be alternatively computed as what percentage the headcount of New York billable employees constituted of the total headcount of billable employees everywhere, including India.[30] This is just one example of methodologies that might sway a state taxing authority or a court to agree to an alternative apportionment method when a taxpayer believes that the statutory method does not fairly reflect in-state activities.

Taxpayers should also consider the possible reactionary positions that the state could take with respect to alternative apportionment. For example, consideration should be given to the risk that the state may assert alternative apportionment in a situation where the taxpayer believes that the statutory formula does accurately reflect in-state activities. Moreover, a taxpayer who asserts alternative apportionment should consider what potential alternative methods the state may counter with and whether such alternative methods fairly reflect activity but are worse than the normal statutory method.

Ultimately, if a taxpayer believes that the statutory method of apportionment does not accurately reflect in-state business activities, a number of options are available. Procedurally speaking, no special requirements are necessary to assert that the application of a normal apportionment formula is unconstitutional (i.e., the taxpayer takes the position, and if the state disagrees and issues an assessment, the taxpayer may challenge that assessment on constitutional grounds in court). Conversely, states may require that certain special procedural rules be followed to assert statutory alternative apportionment (e.g., filing a specific form or making the request to use alternative apportionment by a specified deadline), and, if those requirements are not met, the taxpayer may be precluded from asserting statutory alternative apportionment.

A taxpayer could consider whether it could use an alternative method of apportionment on its originally filed return. It is important to note that state statutes may bar taking a statutory alternative apportionment position on an original return without prior state approval, in which case the taxpayer may be limited to arguing that the standard apportionment method is unconstitutional. Taxpayers could also formally request, in accordance with any special state procedural rules, that the state permit the taxpayer to use an alternative apportionment method on its return. In lieu of seeking to take the position on an original return, taxpayers could take the alternative apportionment position on an amended return and seek a refund. Taxpayers could also consider taking an alternative apportionment position to counter unfavorable audit work papers. However, special state procedural rules may bar the taxpayer from asserting statutory alternative apportionment as late as during an audit of the return. In this case, the taxpayer may have only a constitutional alternative apportionment argument available.

Finally, if the state asserts alternative apportionment, the taxpayer needs to think about what the state's basis is for doing so and whether it is justified. Does the statutory apportionment formula actually fail to represent in-state activities fairly, or is the state overreaching? If the taxpayer agrees that the statutory formula is incorrect, then the taxpayer should consider whether there is a better alternative apportionment method available other than the method the state is asserting. If so, the taxpayer can counter the state's assertion with its own alternative method.

Although there is much to consider with respect to alternative apportionment, and many issues may arise, alternative apportionment is ultimately concerned with ensuring fair apportionment. As a result, when we think about apportionment in general and alternative apportionment in particular, the most important question to ask is, simply, "Is it fair?"

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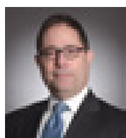
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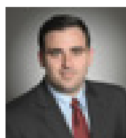
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Endnotes

1 *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977) (holding also that a state tax passes constitutional muster only when "the tax is applied to an activity with a substantial nexus with the taxing State,…does not discriminate against interstate commerce, and is fairly related to the services provided by the State").

2 *Oklahoma Tax Comm'n v. Jefferson Lines*, 514 U.S. 175, 185 (1995).

3 *Id.*

4 *Id.*

5 *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell, Comm'r of Revenue*, 283 U.S. 123, 133 (1931).

6 *Id.* at 135.

7 *Id.*

8 390 U.S. 317, 320-321 (1968).

9 *Id.* at 329.

10 437 U.S. 267, 272-273 (1978).

11 *Id.* at 275.

12 *Id.* at 273.

13 UDITPA § 18.

14 *See, e.g.,* Cal. Rev. & Tax. Code § 25137; S.C. Code Ann. § 12-6-2320; Tenn. Code Ann. § 67-4-2014.

15 N.J. Stat. Ann. § 54:10A-8.

16 *Gen. Mills v. Franchise Tax Bd.*, 92 Cal. Rptr. 3d 208, 218 (Cal. Ct. App. 2009).

17 17139 P.3d 1169 (Cal. 2006).

18 *Id.* at 1178, n. 17.

19 *Gen. Mills v. Franchise Tax Bd.,* 146 Cal. Rptr. 3d 475, 484 (Cal. Ct. App. 2012).

20 *Id.* at 491.

21 *Vodafone Ams. Holdings, Inc. & Subsidiaries v. Roberts*, 486 S.W.3d 496 (Tenn. 2016).

22 Former Tenn. Comp. R. & Regs. R. 1320-06-01-.35(1)(a)(4) (2015).

23 *Vodafone Ams. Holdings*, *supra*, 486 S.W.3d at 529.

24 In 2010, the MTC revised the model regulation to eliminate the "unusual fact situations (which ordinarily will be unique and nonrecurring)" language. Moreover, in 2014, the MTC adopted a proposed revision to the UDITPA alternative apportionment provision which added new language permitting state tax administrators to establish regulations determining alternative apportionment methodologies for particular industries if it is determined that the statutory apportionment formula does not fairly represent the business activity in the state of taxpayers engaged in that industry. Multistate Tax Commission, Suggested Revisions to the Hearing Officer's Section 18 Proposed Amendments, as approved by the Uniformity Committee (July 28, 2014).

25 *Media Gen. Commc'n, Inc., & Media Gen. Broad. of S.C. Holdings, Inc. v. South Carolina Dep't of Revenue*, 694 S.E.2d 525 (S.C. 2010).

26 *Id.* at 531.

27 767 S.E.2d 195 (S.C. 2014).

28 *See id.*; *see also*, *Rent-A-Center West Inc. v. South Carolina Dep't of Revenue*, 792 S.E.2d 260 (S.C. Ct. App. 2016).

29 *But see, Equifax, Inc. v. Mississippi Dep't of Revenue*, 125 So. 3d 36 (Miss. 2013) (finding that the taxpayer bears the burden of proof when the Department asserts alternative apportionment). However, in the wake of the *Equifax* decision, the Mississippi legislature amended its statute to expressly place the burden of proof on the party requesting or requiring alternative apportionment. *See* Miss. Code Ann. § 27-7-24.

30 *In re Infosys Technologies Limited*, DTA No. 820669 (N.Y.S. Div. of Tax App., Feb. 15, 2007), *aff'd*, (N.Y.S. Tax App. Trib., Feb. 21, 2008).