Alternative Apportionment: Seeking a Fairly Apportioned Tax Base in a World of Increasing Reliance on the Sales Factor

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To make a case for the use of an alternative apportionment formula, a taxpayer must rely on a facts-based argument that shows the relationship of the factor to its income. In this article, authors Alex Meleney and Frederick H. Thomas, of Deloitte Tax LLP, discuss the standards that courts have used in determining whether relief is warranted. The authors also consider how alternative apportionment could be applied to the increasingly common single-sales factor apportionment formula and suggest that such formulas may be more susceptible to an alternative apportionment argument.

Alternative Apportionment: Seeking a Fairly Apportioned Tax Base in a World of Increasing Reliance on the Sales Factor

BY ALEX MELENEY AND FREDERICK H. THOMAS

INTRODUCTION

"Flexibility is recognized not only as desirable but an essential feature of any workable system for the allocation of income, whereas a single, rigid statutory formula would doubtless be productive of injustice in particular cases, and lead to unconstitutional results as to certain corporations, since it would be impossible to make it adaptable to different types of business . . . . Thus, the same formula which was prescribed by the Connecticut Legislature and held constitutional in *Underwood Typewriter* . . . was prescribed by the North Carolina Legislature. Its use was therefore compelled in the case of *Hans Rees'* . . . and the resulting tax in that case was held unconstitutional as a denial of due process because it taxed income derived from other states."[1]

The above language from a decision of the California Court of Appeal sums up the rationale for allowing both states and taxpayers to deviate from statutory income apportionment standards when necessary to fairly apportion the taxpayer's income to the state. Although the rationale is clear, whether pursued on constitutional grounds or under state "alternative apportionment" statutes, determining the circumstances under which a taxpayer or a state can compel a deviation from the state's standard apportionment formula has proved an

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[1] *Pacific Fruit Express Co. v. McColgan*, 153 P.2d 607, 610 (Cal. Ct. App. 1944).

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uncertain exercise. Most recent cases have tended to focus on whether the sales factor fairly represents the taxpayer's activity in the state. This emphasis on the sales factor is not surprising, as a growing number of states move to a more heavily weighted or even a single-sales factor apportionment formula for corporate income tax purposes. As such formulas put even more emphasis on sales as a measure of the income earned in a state and either reduce or eliminate the effect of the property and payroll factors, it becomes increasingly important to explore the circumstances under which negatively impacted multistate corporate taxpayers may be entitled to utilize an alternative formula to more fairly reflect income earned in the state.

In this article, we examine the standards that courts have used to determine whether a multistate corporate taxpayer is entitled to deviate from the standard apportionment formula either under the U.S. Constitution or under state statute. The goal is to identify some of the factors that courts have considered and found persuasive in concluding that relief is warranted. In a final section, we consider how alternative apportionment might be applied in the context of a single-sales factor apportionment formula.

BACKGROUND

Constitutional Standard for Relief From Statutory Apportionment Formulas

The U.S. Supreme Court has held that in order to pass constitutional muster, a tax on interstate commerce must be applied to an activity with a substantial nexus with the taxing state, *be fairly apportioned*, not discriminate against interstate commerce, and be fairly related to services provided by the state.[2] Of these four requirements, the relevant constitutional inquiry for taxpayers seeking to use an alternative apportionment formula is whether application of the standard formula results in fair apportionment.

The U.S. Supreme Court has indicated that an apportionment formula is fair—under both the Due Process and Commerce Clauses of the U.S. Constitution—if the formula satisfies standards of both internal and external consistency. Internal consistency requires that if the formula was applied by every jurisdiction, it would result in no more than 100 percent of the taxpayer's unitary business income being taxed.[3] External consistency, ''the second and more difficult requirement,'' requires that ''the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated.''[4]

In determining whether a tax is fairly apportioned, the U.S. Supreme Court has ''long realized the practical impossibility of a state's achieving a perfect apportionment of expansive, complex business activities'' and has declared that ''rough approximation rather than precision'' is sufficient.[5] As such, the U.S. Constitution does not invalidate an apportionment formula simply because it ''may result in taxation of some income that did not have its source in the taxing State'' or ''occasionally over-reflect or under-reflect income attributable to the taxing State.''[6] Instead, an apportionment formula will only be invalidated if it operates ''unreasonably and arbitrarily'' in attributing income to the state that is ''out of all appropriate proportions to the business transacted . . . in that State,'' or if it has ''led to a grossly distorted result.''[7]

However, the U.S. Supreme Court has also held that even a formula that is not arbitrary on its face can be challenged, and a taxpayer must be granted relief upon a showing that the formula operated unreasonably under the applicable facts. In *Hans Rees' Sons Inc. v. North Carolina*,[8] the taxpayer was engaged in the business of tanning, manufacturing, and selling heavy leather products, both to wholesale and retail customers. The taxpayer maintained a manufacturing facility in North Carolina and a warehouse and sales office in New York. The taxpayer's products were sold throughout North America and Continental Europe. North Carolina's apportionment statute mandated the use of a single factor formula consisting of the ratio of tangible property in North Carolina to tangible property everywhere.

Application of North Carolina's statutory apportionment formula resulted in between 66 percent and 85 percent of the taxpayer's net income being attributed to the state. The taxpayer submitted evidence that the percentage of its income attributable to North Carolina for the years in question did not exceed 21.7 percent in any given year—a difference of approximately 250 percent from the statutory formula. Under these facts, the court stated the following principle:

> The difficulty of making an exact apportionment is apparent and hence, when the State has adopted a method not intrinsically arbitrary, it will be sustained until proof is offered of an unreasonable and arbitrary application in particular cases. . . . When, as in this case, there are different taxing jurisdictions, each competent to lay a tax with respect to what lies within, and is done within, its own borders, and the question is necessarily one of apportionment, evidence may always be received which tends to show that a State has applied a method, which, albeit fair on its face, operates so as to reach profits which are in no just sense attributable to transactions within its jurisdiction.[9]

The court concluded:

> [T]he statutory method, as applied to the [taxpayer's] business for the years in question operated unreasonably and arbitrarily, in attributing to North Carolina a percentage of income out of all ap-

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[2] *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274, 279 (1977) (emphasis added).

[3] *Container Corp. of America v. California Franch. Tax Bd.*, 463 U.S. 159, 169 (1983).

[4] *Id.*

[5] *International Harvester Co. v. Evatt*, 329 U.S. 416, 422 (1947) citing *Illinois Cent. R.R. Co. v. Minnesota*, 309 U.S. 157, 161 (1940) (''That the apportionment may not result in mathematical exactitude is certainly not a constitutional defect. Rough approximation rather than precision is, as a practical matter, the norm in any such tax system.'').

[6] *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 272-73 (1978).

[7] *Hans Rees' Sons Inc. v. North Carolina*, 283 U.S. 123, 135 (1931) and *Norfolk & Western R.R. Co. v. Missouri State Tax Comn.*, 390 U.S. 317, 326 (1968).

[8] *Hans Rees' Sons Inc. v. North Carolina*, 283 U.S. 123 (1931).

[9] *Id.* at 133-4.

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> propriate proportion to the business transacted by the [taxpayer] in the State. In this view, the taxes as laid were beyond the State's authority.[10]

In *Norfolk & Western R.R. Co. v. Missouri State Tax Comn.*,[11] the taxpayer was a multistate railroad company engaged primarily in hauling coal. The Missouri Tax Commission issued a property tax assessment with respect to the taxpayer's rolling stock located in Missouri, which the commission determined by multiplying the total value of all of the taxpayer's rolling stock by the ratio of the taxpayer's track mileage in Missouri to total track mileage everywhere. Using this methodology, the commission determined that 8.2824 percent of the track controlled by the taxpayer was located in Missouri, resulting in an assessed value for the rolling stock of $19.9 million. The taxpayer challenged the assessment, arguing that it reached property not located in Missouri and therefore violated the Due Process and Commerce Clauses of the U.S. Constitution.

The taxpayer presented evidence that the actual value of its rolling stock in Missouri was $7.6 million, not $19.9 million, and that its rolling stock in Missouri constituted only 2.71 percent and 3.16 percent of its total fleet by number of units and by value, respectively (as compared to the 8.28 percent figure arrived at by the commission using the mileage formula). The taxpayer also presented evidence that much of its rolling stock was comprised of specialized coal-carrying equipment, scarcely any of which entered Missouri, and that the traffic density on its Missouri tracks was only 54 percent of the traffic density on its system as a whole.

Confronted with the evidence presented by the taxpayer, the U.S. Supreme Court reasoned that while ''it is not necessary that a State demonstrate that its use of the mileage formula has resulted in an exact measure of value. . . . [W]hen a taxpayer comes forward with strong evidence tending to prove that the mileage formula will yield a grossly distorted result in its particular case, the State is obliged to counter that evidence or to make the accommodations necessary to assure that its taxing power is confined to its constitutional limits.''[12] The court went on to conclude that the state had failed to do so in *Norfolk & Western* and that the tax therefore violated the U.S. Constitution as applied.[13]

Although the U.S. Supreme Court's jurisprudence in the area of fair apportionment is varied and sometimes difficult to reconcile, the cases discussed above clearly provide that a taxpayer has a right to challenge a state's apportionment formula as applied to the taxpayer's particular facts and receive relief if it can establish that the formula results in an unreasonable apportionment of income to the state.

State Alternative Apportionment Statutes: The UDITPA Standard

Recognizing the U.S. Supreme Court's mandate that a taxpayer is entitled to challenge an apportionment formula as applied to their particular facts and concerned that rigid formulas might actually work in some taxpayers' favor, most states have adopted apportionment statutes that allow a taxpayer to petition the tax administrator for, or for the tax administrator to require, the use of an alternative apportionment formula if the standard formula does not fairly represent the extent of the taxpayer's business activity in the state.[14] These statutes are most commonly modeled after §18 of the Uniform Division of Income for Tax Purposes Act (UDITPA), which provides:

> If the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
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> (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.

William J. Pierce, who drafted UDITPA for the National Conference of Commissioners on Uniform State Laws,[15] described §18 as:

> [A] general section which permits the tax administrator to require, or the taxpayer to petition, for some other method of allocating and apportioning the income where unreasonable results ensue from the operation of the other provisions of the act. This section necessarily must be used where the statute reaches arbitrary or unreasonable results so that its application could be attacked successfully on constitutional grounds. *Furthermore*, it gives both the tax collection agency and the taxpayer some latitude for showing that for the particular business activity, some more equitable method of allocation and apportionment could be achieved. Of course, departures from the basic formula should be avoided except where reasonableness requires. Nonetheless, some alternative method must be available to handle the constitutional problem *as well as* the unusual cases because no statutory pattern could ever resolve satisfactorily the problems for the multitude of taxpayers with individual business characteristics.[16]

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[10] *Id.* at 135-6.

[11] *Norfolk & Western R.R. Co. v. Missouri State Tax Comn.*, 390 U.S. 317 (1968).

[12] *Id.* at 329.

[13] *Id.*

[14] *See e.g.*, Cal. Rev. & Tax. Code §25137; Fla. Stat. §220.152; and 35 ILCS 5/304(f).

[15] UDITPA was approved in January 1957 by the National Conference of Commissioners on Uniform State Laws (Uniform Law Commission), which is a nonprofit unincorporated association established with the assistance of the American Bar Association to draft and propose specific statutes in areas of state law where uniformity between the states is desirable. Once a uniform act has been developed, the Uniform Law Commission works to have it enacted by state legislatures throughout the United States. More information about the Uniform Law Commission is available on its website at www.nccusl.org.

[16] William J. Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 Taxes 747, 781 (1957) (emphasis added).

While cautioning against overuse of alternative apportionment formulas, the drafter of UDITPA §18 viewed the section as permitting relief not only when application of the standard provisions ''could be attacked successfully on constitutional grounds,'' but also when ''some more equitable method of allocation and apportionment could be achieved.'' Consistent with this intent, and while the analysis generally involves the same considerations as the constitutional inquiry, many states have concluded that the standard formula does not have to produce unconstitutional results to support modification pursuant to an alternative apportionment statute.

For example, in *Union Pacific Corp. v. Idaho State Tax Comn.*,[17] the Idaho Supreme Court rejected the taxpayer's assertion that the constitutional standard should apply to determine whether modification of the standard formula was warranted under Idaho's alternative apportionment statute:

> [Taxpayer] urges the Court to accept the constitutional standard . . . as the equivalent standard by which the use of an alternative apportionment formula is justified, and to subscribe to a comparison of the percentages attributable to the state between the methodology employed by the appellant and the methodology employed by the appellee toward identifying gross distortion sufficient to invoke alternative apportionment.
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> . . .
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> To engraft a gross distortion requirement onto the application of an alternative apportionment would be to add to [Idaho's alternative apportionment statute], which we are wont to do. When the meaning of a statute is clear, the statute is to be read literally, neither by adding nor taking away anything by judicial construction.[18]

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Under Idaho's standard apportionment statute, the taxpayer in *Union Pacific* was including in its sales factor both accrued sales and the proceeds received from the subsequent sale of the related accounts receivable. The lower court held that this formula did not fairly represent the taxpayer's Idaho activity, and that excluding sales of accounts receivable from the denominator of the sales factor was ''a reasonable alternative apportionment method'' that more accurately represented the taxpayer's business activity.[19] The Idaho Supreme Court affirmed the lower court's decision, concluding that ''there is no basis for requiring a showing of gross distortion from a comparison of the standard apportionment and the alternative being proposed.''[20]

Similarly, in *Montana Dept. of Rev. v. United Parcel Svc.*, the Supreme Court of Montana concluded that the taxpayer was not required to establish distortion to successfully invoke the state's alternative apportionment statute.[21] Montana's apportionment regulations required ''freight and passenger carriers'' to determine their sales factor using a ''mileage method'' based on the ratio of miles traveled in Montana to total miles. UPS put forth what the court deemed ''substantial evidence to show that the mileage method did not fairly represent its business activity within Montana.''[22] This evidence demonstrated that UPS transported 1.71 packages per mile in Montana, as compared to between 4.68 and 9.1 packages per mile elsewhere in the region, and that UPS's Montana package drivers carried fewer packages per van than drivers in any other state and had the lowest pounds of packages transported. Based on these facts, the court concluded ''that reliable, probative, and substantial evidence existed'' to support the Montana State Tax Appeal Board's use of an alternative apportionment formula.[23]

In reaching this conclusion, the Montana Supreme Court rejected the Department of Revenue's argument that UPS was required to ''prove the 'mileage method' distorts its income prior to invoking the relief provisions of [Montana's UDITPA section 18 statute].'' The court noted that the authority cited by the department ''involved constitutional claims'' relating to a specific taxpayer, whereas UPS was arguing ''that under Montana law the mileage method utilized by the Department [did] not fairly represent the extent of its business activity within the State.'' After reviewing Montana's UDITPA §18 statute, the court found ''no authority for the State's argument that UPS must prove the mileage method distorts Montana income prior to invoking the relief provision . . . .''[24] In short, UPS was able to obtain relief by showing that its drivers drove more miles in Montana to deliver fewer packages than drivers in any other state, and that average revenue per mile varies substantially from state-to-state.

Some state courts, on the other hand, have effectively limited the availability of statutory relief to circumstances where application of the standard formula produces unconstitutional results. For example, in *Unisys Corp. v. Pennsylvania*,[25] the taxpayer challenged the statutory apportionment formula on the basis that the net worth tax component of the Pennsylvania franchise tax included the value of its subsidiaries, but the apportionment factors of these same subsidiaries were excluded from the statutory apportionment formula. The taxpayer presented evidence that if the factors of its unitary subsidiaries had been included in the three-factor apportionment formula, its tax due would have been approximately 44.5 percent less than under the standard apportionment formula. The Pennsylvania Commonwealth Court determined that the standard apportionment formula was consistent with constitutional

[17] *Union Pacific Corp. v. Idaho State Tax Comn.*, 83 P.3d 116, 122 (Idaho 2004).
[18] *Id.* at 122.
[19] *Id.* at 120.
[20] *Id.*
[21] *Montana Dept. of Rev. v. United Parcel Svc.*, 830 P.2d 1259, 1263 (Mont. 1992).
[22] *Id.* at 1262.
[23] *Id.* at 1263.
[24] *Id.* at 1262.
[25] *Unisys Corp. v. Pennsylvania*, 812 A.2d 448 (Pa. 2002).

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precepts as applied to the taxpayer, but that the taxpayer was nevertheless entitled to statutory relief under Pennsylvania's alternative apportionment provision.[26] The Supreme Court of Pennsylvania reversed. It agreed with the commonwealth court's determination on the constitutional issue, concluding that the taxpayer had failed to demonstrate that inclusion of the factors of its unitary subsidiaries in its apportionment factor was the proper baseline for measuring distortion under the constitution's external consistency requirement.[27] However, turning to the issue of relief under Pennsylvania's alternative apportionment statute, the court reasoned that:

> [R]egardless of whether statutory fair apportionment precepts sweep beyond the boundaries of constitutional fairness, we conclude that the General Assembly intended for it to be assessed, like external consistency, according to some meaningful reference point established by the taxpayer. Since we find that Unisys has failed to demonstrate the appropriateness of its proffered baseline figures, we also conclude that it has not demonstrated entitlement to relief under [Pennsylvania's alternative apportionment statute].
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> . . .
>
> Pursuant to the standards crafted by the U.S. Supreme Court, we conclude, therefore, that Unisys has failed to carry its heavy burden. For much the same reasons, we reach the same result on consideration of the statutory fair apportionment provisions.[28]

Although the court stopped short of explicitly adopting a constitutional standard for application of Pennsylvania's alternative apportionment statute, it denied relief under the statute based on the same grounds as it denied relief under the U.S. Constitution—effectively endorsing an equivalent standard.

As the cases above demonstrate, when seeking relief under a state's alternative apportionment statute, it is important to understand whether it will be necessary to establish that the standard formula produces an unconstitutional result or whether it will suffice simply to demonstrate that the standard formula operates unfairly in attributing income to the state.[29] The answer to this question can obviously have a significant impact on the availability of alternative apportionment.

EVIDENTIARY BURDEN OF PROOF

Under the U.S. Supreme Court's constitutional standard, an apportionment formula will only be invalidated if the ''taxpayer has proved by '*clear and cogent evidence*' that the income attributed to the State is in fact 'out of all appropriate proportions to the business transacted . . . in that State,' [citations omitted] or has 'led to a grossly distorted result' [citations omitted].''[30]

The burden of proof for obtaining relief under state alternative apportionment statutes varies from state to state, as demonstrated in the previous section, but has been described by the Oregon Supreme Court as requiring the moving party to prove two things. First, it must be demonstrated ''that the statutory formula as a whole does not 'fairly represent the extent of the taxpayer's business activity in [the] state.' ''[31] Second, the moving party must establish that the alternative method being advocated is ''reasonable.''[32]

Although both requirements must be satisfied, the first requirement is generally the focus of taxpayers and the courts, and will be the focus of discussion in this article. To satisfy this requirement it is necessary to establish that the formula as a whole—in the case of a multifactor formula—does not fairly represent business activity in the state, ''not merely that one factor fails to meet this standard.''[33] In the case of a three-factor formula, distortion in one factor will not necessarily result in distortion in the whole formula because the other two factors may well mitigate the distortive effect. As a result, it will generally be easier to establish that the statutory formula is distortive when that formula relies on a single factor, rather than on three factors.

INDICIA OF UNFAIR APPORTIONMENT

Use of Separate Accounting

Taxpayers' efforts to satisfy their heavy burden of proof have often been frustrated by the arguably inconsistent approach taken by the U.S. Supreme Court in accepting separate geographical accounting as a means of establishing unconstitutional distortion. In *Hans Rees'*, for example, the court invalidated North Carolina's statutory apportionment formula based on the fact that it attributed between 66 and 85 percent of the taxpayer's income to the state, while a separate accounting analysis resulted in attribution of no more than 21.7 percent in any given year.[34] Subsequently, in *Moorman Mfg.*, the court alluded several times to the fact that ''the record [did] not contain any separate accounting analysis''[35] and appeared to suggest that such evidence would have been an acceptable means of impeaching the standard formula:

> The Iowa statute afforded appellant an opportunity to demonstrate that the single-factor formula produced an arbitrary result in its case. But this record contains no such showing and therefore the Direc-

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[26] *Id.* at 451.
[27] *Id.* at 465-66.
[28] *Id.* at 465-66.
[29] Alternatively, the taxpayer might prevail by showing that the alternative apportionment method operates more fairly to apportion income to the state.
[30] *Moorman Mfg. Co.*, 437 U.S. at 274 (emphasis added) (citing *Hans Rees'*, 283 U.S. at 135 *and Norfolk & Western*, 390 U.S. at 326). *See also Container Corp.*, 463 U.S. at 169-70; *Mobil Oil Corp. v. Vermont Comr. of Taxes*, 445 U.S. 425, 453-54 (1980); and *Trinova Corp. v. Michigan Dept. of Treas.*, 498 U.S. 358, 380 (1993).
[31] *Twentieth Century-Fox Film Corp. v. Oregon Dept. of Rev.*, 700 P.2d 1035, 1042-43 (Or. 1985).
[32] *Id.* at 1043.
[33] *Id.* at 1042.
[34] *Hans Rees'*, 283 U.S. at 135-36.
[35] *Moorman*, 437 U.S. at 272 (''the record does not contain any separate accounting analysis showing what portion of appellant's profits was attributable to sales, to manufacturing, or to any other phase of the company's operations.''); *Id.* (''Indeed, a separate accounting analysis might have revealed that losses in Illinois operations prevented appellant from earning more income from exploitation of a highly favorable Iowa market.'').

tor's assessment is not subject to challenge under the Due Process Clause.[9]

9. In his concurring opinion, Justice McCormick of the Iowa Supreme Court made this point:

''In the present case, Moorman did not attempt to prove the amount of its actual net income from Iowa activities in the years involved. Therefore no basis was presented for comparison of the corporation's Iowa income and the income apportioned to Iowa under the formula. In this era of sophisticated accounting techniques, it should not be impossible for a unitary corporation to prove its actual income from activities in a particular state. . . . Having failed to establish a basis for comparison of its actual income in Iowa with the income apportioned to Iowa under the single-factor formula, Moorman did not demonstrate that the single-factor formula produced a grossly unfair result. Thus it did not prove unconstitutionality of the formula as applied.'' [Citation omitted].[36]

However, two years after *Moorman*, when the taxpayer in *Exxon Corp. v. Wisconsin Dept. of Rev.*[37] relied on *Moorman* as supporting ''the use of separate functional accounting in order to prove the extraterritorial reach of a state tax statute,'' the court dismissed the language in *Moorman* as dicta and upheld the statutory formula. The court also rejected the use of separate accounting in *Mobil*[38] and in *Container*.[39] Interestingly, in *Container Corp.*, the court described the separate accounting analysis in *Hans Rees'* as ''purposely skewed to resolve all doubts in favor of the State''—implying that an analysis prepared on such a skewed basis might be more favorably received for purposes of demonstrating that the standard formula is distortive.[40]

Persuaded by the U.S. Supreme Court's more general aversion to separate accounting, state courts and administrative tribunals have also indicated a reluctance to accept separate accounting as a means of impeaching the standard formula.[41] As explained by the California State Board of Equalization in *Appeal of Crista*:

[S]howing distortion in the standard formula is a difficult hurdle to overcome . . . . The attempted use of separate geographic accounting alone to impeach apportionment by the three-factor formula has been rejected by the United States Supreme Court because it is exactly the theoretical weaknesses of separate geographical accounting that justified resort to formula apportionment in the first place. [Citations omitted.] After considering *Container Corp*. and other United State Supreme Court cases, we indicated . . . we would not consider an argument that the standard apportionment formula could be proven inadequate solely by comparing it with internal accounting records using separate geographic accounting methods. Because most of appellant's quantitative comparisons are based solely on internal accounting records using separate geographical accounting methods, we give them limited weight in the present case as a method of impeaching the standard apportionment formula.[42]

Since taxpayers cannot generally rely on separate accounting analysis to establish distortion in the standard apportionment formula, it becomes necessary to examine other factors that courts have considered and that, when present, support a finding that the standard formula is unconstitutional as applied or unfairly attributes income to the state.

Factor Is an Inconsistent Indicator of Income

One successful approach to establishing distortion has been to demonstrate that the taxpayer's activities result in a gross disparity between a factor's contribution to the apportionment percentage and the factor's contribution to the generation of income. This analysis was undertaken in detail by the California Supreme Court in *Microsoft Corp. v. California Franch. Tax Bd.*[43]

In *Microsoft*, the taxpayer treated the entire amount received by its Washington-based treasury function from sales and redemptions of short-term securities as gross receipts and included them in the denominator of its California sales factor. An initial issue was whether gross receipts includible in the sales factor included the gross sale or redemption proceeds or only the net gains. The California Supreme Court concluded that gross receipts included the gross proceeds under California's statutes. The Franchise Tax Board then argued that including the full amount of these receipts in the sales factor denominator caused the standard apportionment formula to ''not fairly represent the extent of Microsoft's business activity in California'' and proposed an alternative formula that would ''include in the denominator of the sales factor only the net receipts from Microsoft's redemptions.''[44] The California Supreme Court agreed, concluding that it was distortive to include the entire amount of Microsoft's short-term treasury receipts in the California sales factor:

The stipulated evidence establishes that mixing the gross receipts from Microsoft's short-term investments with the gross receipts from its other business activity seriously distorts the standard formula's attribution of income to each state. These transactions generated minimal income (just under 2 percent of Microsoft's business income for 1991) but enormous receipts (approximately 73 percent of the gross receipts for 1991). Their inclusion in the standard formula would result in reducing roughly by half the estimated income attributed to California, and likely every state other than Washington, depending on

[36] *Moorman*, 437 U.S. at 275 (footnote 9 in original).

[37] *Exxon Corp. v. Wisconsin Dept. of Rev.*, 447 U.S. 207, 220-23 (1980).

[38] *Mobil Oil Corp. v. Vermont Comr. of Taxes*, 445 U.S. 425, 438 (1980).

[39] *Container Corp.*, 463 U.S. at 159, 181-183.

[40] *Id.* at 183.

[41] *See also, e.g.*, Illinois Dept. of Rev., General Information Letter IT 04-0047-GIL (Nov. 16, 2004) (denying the taxpayer's petition for alternative apportionment in part because it did not provide ''any basis for determining whether separate accounting . . . would be reasonable'').

[42] *In re Appeal of Crista Corp.* (June 20, 2002) [2002-2003 Transfer Binder] Cal. Tax Rptr. (CCH) ¶ 403-295, pp. 30,352.

[43] *Microsoft Corp. v. California Franch. Tax Bd.*, 139 P.3d 1169 (Cal. 2006).

[44] *Id.* at 1177 and 1181.

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property and payroll factors. The distortion the [Franchise Tax] Board has shown here is of both a type and size properly addressed through invocation of [California's alternative apportionment statute], application of the standard formula does not fairly represent the extent of Microsoft's business in California.[45]

The California Supreme Court in *Microsoft* concluded that the difference in the margin for Microsoft's treasury operations in Washington (0.2 percent) and Microsoft's worldwide non-treasury operations (31 percent) was significant enough that the standard apportionment formula did ''not fairly represent the extent of Microsoft's business in California.''[46]

The court's analysis in *Microsoft* raises two interrelated tensions. First, the analysis may be inconsistent with the unitary business principle. Second, the analysis arguably makes use of separate accounting analysis, which, as discussed above, has been effectively disavowed by the U.S. Supreme Court and other state courts as a means of establishing distortion. To illustrate these tensions, it is helpful to compare *Microsoft* with *Container*.

It might be argued that alternative apportionment based on substantially different profit margins is only justified when disparate businesses are being combined.

In *Container*, the taxpayer challenged the application of California's three-factor formula to its worldwide business on the basis that ''its foreign subsidiaries [were] significantly more profitable than it [was], and that the three-factor formula, by ignoring that fact and relying instead on indirect measures of income such as payroll, property, and sales, systematically distort[ed] the true allocation of income between appellant and the subsidiaries.''[47] In other words, the taxpayer argued that application of the standard apportionment formula resulted in unconstitutional distortion *due to ''significant'' variations in the margins between its geographical operations*—in this case its foreign operations and its U.S. operations—an argument essentially the same as the margins analysis underpinning the court's opinion in *Microsoft*. However, in *Container*, the U.S. Supreme Court flatly rejected this argument as being inconsistent with the unitary business principle and relying on separate accounting:

> The problem with [the taxpayer's] argument is obvious: the profit figures relied on by appellant are based on precisely the sort of formal geographical accounting whose basic theoretical weaknesses justify resort to formula apportionment in the first place. Indeed, we considered and rejected a very similar argument in *Mobil*, pointing out that whenever a unitary business exists, ''separate [geographical] 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. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable 'source.' ''[48]

Can the court's analysis in *Microsoft* be reconciled with *Container*? In *Microsoft*, the California Supreme Court appears to deal with this conflict, at least indirectly, through its conclusion that the operations of a corporate treasury function ''are qualitatively different from the rest of a corporation's business,'' and produce margins that ''may be quantitatively several orders of magnitude different from the rest of a corporation's business.''[49] The taxpayer, for example, argued that ''comparison of the income and receipts from its short-term investments in marketable securities against those from the rest of its business activities [was] a separate accounting analysis foreclosed by [the California Supreme Court] and the United States Supreme Court's previous decisions.'' In response, the California Supreme Court reasoned that its analysis

> suffers neither of the vices we and the United States Supreme Court have condemned; it involves neither a separate jurisdiction-by-jurisdiction accounting that overlooks the interdependence of operations in different jurisdictions [citations omitted] nor a separate entity-by-entity accounting that ignores the interdependence (and non-arm's-length dealing) between members of the unitary group [citations omitted]. Rather, the analysis *simply underscores the qualitative recognition that the different nature of short-term investments means that mixing short-term gross receipts with gross receipts from other types of business activity . . . may require correction*.[50]

Thus, while Microsoft's treasury operations were undoubtedly part of its unitary business, in the eyes of the *Microsoft* court, the qualitative difference between them and the rest of Microsoft's operations—as confirmed by the quantitative difference in the margins with respect to each activity—provided sufficient proof of distortion to justify application of an alternative apportionment formula.

Relying upon this rationale, it might be argued that alternative apportionment based on substantially different profit margins is only justified when disparate businesses are being combined. However, other cases allowing alternative apportionment methods based on differing profit margins cannot be so easily dismissed. In *Montana Dept. of Rev. v. United Parcel Svc.*, *above*, Montana's apportionment based on the ratio of miles

[45] *Id.* at 1181.

[46] *Id. See Sherwin-Williams Co. v. Johnson*, 989 S.W.2d 710 (Tenn. 1998) for a decision with similar facts and reaching a similar conclusion to *Microsoft*. Reg. IV.18.(c).(4) of the Multistate Tax Commission Allocation and Apportionment Regulations now provide for the inclusion of net gain from the sale of ''liquid assets'' in the sales factor. Most states have not adopted this updated model regulation.

[47] *Container Corp.*, 463 U.S. at 181.

[48] *Id.* (citing *Mobil*, 445 U.S. at 425, 438.)

[49] *Microsoft*, 139 P.3d at 1180.

[50] *Id.* (emphasis added).

traveled in Montana to total miles everywhere was found to unfairly apportion UPS's income based on evidence that UPS transported 1.71 packages per mile in Montana, as compared to between 4.68 and 9.1 packages per mile elsewhere in the region.[51] Also, UPS's Montana package drivers carried fewer packages per van than drivers in any other state and had the lowest pounds of packages transported. These facts established that UPS's profit margin was lower in Montana than elsewhere. The Montana Supreme Court found such evidence persuasive in supporting use of an alternative apportionment formula.[52]

Similarly, in *Norfolk & Western*, *above*, the taxpayer prevailed by demonstrating that there was a substantial disconnect between the item used to apportion property, track miles in Missouri, and the tax base being apportioned, the value of rail cars. The taxpayer introduced persuasive evidence that its owned rail cars were used significantly more outside Missouri relative to other states. This evidence was similar to that relied upon in both *Microsoft* and *United Parcel*. In *Microsoft*, the state proved that the relationship between the gross receipts used to produce the relatively small amount of short-term investment income were totally disproportionate to the gross receipts used to produce the taxpayer's substantial operating income. With the gross receipts used to produce the investment income concentrated in a single state, the result was that the sales factor became an unreliable indicator of where income was earned. In *United Parcel*, the taxpayer proved that the miles travelled in Montana were substantially less profitable than miles travelled in other states. As a result, miles travelled were not a reliable indicator of where income was earned, and the taxpayer was entitled to use an alternative apportionment method.

In these cases, the taxpayer did not rely on geographical accounting, although the result was to change the amount of income attributable to a given state. Instead, the prevailing party offered specific evidence as to the relationship between the apportionment factor and the tax base that proved that the apportionment factor did not reasonably approximate how or where income was earned or, in the case of *Norfolk & Western*, property was used. Having proved that the apportionment factor did not operate to reasonably apportion the tax base, the need for an alternative was sustained.

Statutory Factor Not Present Or Critical Factor Missing

Another approach to establishing distortion has been to demonstrate that one of the apportionment factors is not a significant contributor to income. For example, in *Georgia v. Coca-Cola Bottling Co.*,[53] the state challenged the taxpayer's use of Georgia's standard three-factor apportionment formula, which at that time consisted of an equally-weighted sales factor, payroll factor, and ''inventories factor'' based on the taxpayer's average monthly inventories within and without Georgia. The taxpayer did not maintain any inventories, either in Georgia or elsewhere, and its inventories factor was, therefore, zero. The Georgia Supreme Court held that the state was entitled to apply an alternative apportionment formula consisting of only the sales and payroll factors:

> [I]f a corporate taxpayer . . . does not as a matter of business practice employ tangible personal property in the form of inventories anywhere in the production of its income, then, to use the inventories factor as a zero or negative factor, as the [taxpayer] in this case did, and average it in with the other two factors, establishes a relationship between the non-use of inventories and the production of income; and such a relationship is diametrically opposed to the object of apportionment which is to apportion according to use in the production of income. . . . The object of apportionment is to fairly allocate the net income of the taxpayer, and *this is accomplished by the selection of factors which are causally related to the production of the income*, and a fair and proper allocation is obtained only when all of the factors of the formula actually exist and are used by the taxpayer in making an apportionment of its net income.[54]

Even if a factor is present, if it is a relatively insignificant contributor to income it may be ignored if it substantially distorts the income apportioned to a state. In *Stonebridge Life Insurance Co. v. Oregon Dept. of Rev.*,[55] a life insurance company contested the application of Oregon's formula that apportioned its income based on an insurance sales factor (premiums in-state divided by total premiums), a payroll factor (wages and commissions paid in Oregon divided by wages and commissions paid everywhere), and a ''property income factor'' (income derived from real and personal tangible property in the state divided by such income earned everywhere). The taxpayer earned $225 million of pre-apportionment income. All of the taxpayer's policies in Oregon were sold through direct mail or telephone solicitation, and it had no physical operation in Oregon so its payroll factor was zero. The taxpayer received $661 million of premiums, less than 1 percent of which were from Oregon customers. However, the taxpayer earned $252,000 of interest from two real estate loans in Oregon that was included in the numerator of the property income factor that had a total denominator of $1.566 million. Thus, the property income factor was 16.1179

[51] *United Parcel Svc.*, 830 P.2d at 1261-63.

[52] *Id.* at 1263. *See FedEx Ground Package System Inc. v. Pennsylvania*, 922 A.2d 978 (Pa. Commw. Ct. 2007), where the Pennsylvania revenue miles factor applicable to transportation companies was interpreted to require that the average revenue per mile *in Pennsylvania* be multiplied by miles traveled in Pennsylvania to determine the numerator of the factor. The Pennsylvania Department of Revenue had argued that average revenue per mile everywhere should be multiplied by Pennsylvania miles. The court noted that using the department's formula could lead to taxation of revenue earned outside Pennsylvania if the average revenue per mile in Pennsylvania was lower than the average revenue per mile everywhere.

[53] *Georgia v. Coca-Cola Bottling Co.*, 94 S.E.2d 708 (Ga. 1956).

[54] *Id.* (emphasis added). *See also Appeal of John Blair & Co.*, 65-SBE-009 (Cal. St. Bd. of Equal., March 4, 1965) (excluding the property factor from the taxpayer's apportionment formula based in part on the rationale that for service companies, property was not a material income-producing factor); *Appeal of Woodward*, 63-SBE-072 (Cal. St. Bd. of Equal., May 28, 1963) (holding that inclusion of a relatively small property factor, equally weighted with the sales and payroll factors, would likely result in distortion of the income allocation).

[55] *Stonebridge Life Insurance Co. v. Oregon Dept. of Rev.*, 18 Or. Tax 423 (2006), *aff'd*, 18 Or. Tax Ct. 461 (2006).

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percent and when averaged with the other factors resulted in an Oregon apportionment percentage of 5.6739 percent and an apportioned Oregon taxable income of $12.8 million. The apportioned net income was greater than the gross premium and interest income earned in Oregon. The court agreed that, as applied to the taxpayer, the statutory formula produced unconstitutional distortion:

> Ultimately, taxpayer's argument can be reduced to the claim that the sheer accident that 16% of its minuscule gross income from real and tangible property came from Oregon cannot justify Oregon's claim to almost 6% of taxpayer's total income, given that taxpayer had no Oregon wages or commissions and that less than 1% of taxpayer's insurance sales came from Oregon. The department has conceded the insignificance of the distorting factor in this case, yet it urges the court to allow that factor to attribute to Oregon a share of taxpayer's income that was generated completely outside Oregon. As the court explained in *Norfolk & Western*, ''when a taxpayer comes forward with strong evidence tending to prove that [a] formula will yield a grossly distorted result in its particular case, the State is obliged to counter that evidence or to make the accommodations necessary to assure that its taxing power is confined to its constitutional limits.'' 390 U.S. at 329. . . . [T]he court concludes that application of [Oregon's standard formula] in this case allocated to Oregon a share of taxpayer's 2003 income that was ''out of all appropriate proportion to the business transacted'' by taxpayer in Oregon. *Hans Rees' Sons*, 283 U.S. at 135. Simply put, taxpayer's low insurance sales and wage and commission factors did not balance out taxpayer's circumstantially high real estate income and interest factor. The three factors do not appropriately or permissibly reflect taxpayer's 2003 Oregon business activity; instead, the high real estate income and interest factor ''grossly distorted'' the value generated by taxpayer's Oregon operations. *Norfolk & Western*, 390 U.S. at 326.[56]

In addition to demonstrating that one of the factors is not a significant contributor to income, distortion can also be established by demonstrating that an important contributor to income is not represented in the apportionment formula. For example, in *Appeal of Farmers Underwriters Association*,[57] the California State Board of Equalization determined that ''in view of the fact that a large amount of property was used by [the taxpayer] in the production of income,'' the Franchise Tax Board was justified in modifying California's pre-UDITPA apportionment formula for service corporations, which was based solely on payroll and sales, to include a property factor.

However, taxpayers are not always successful in establishing the need to add a factor to an apportionment formula. In *Colgate-Palmolive Co. Inc. v. Bower*,[58] the taxpayer earned substantial royalty income from licensing its trademarks, trade names, and formulas to its foreign subsidiaries. This substantial income was included in the taxable income apportioned to Illinois, and the taxpayer claimed that the apportionment formula was unfair and that an intangible property factor should be added to the standard formula that included sales, payroll, and tangible property factors. The court rejected this position, noting that the payroll and tangible property used to create and maintain the intangible property were included in the standard factors and the royalty income was included in the denominator of the sales factor. Thus, the formula adequately took into account factors related to the intangible income.

Whether underrepresentation of intangible property values in an apportionment formula justifies use of an alternative formula is also at issue in another case involving Microsoft, which is currently ongoing in California Superior Court (*Microsoft II*).[59] The issue in *Microsoft II* is whether ''the value of [Microsoft's] trademarks, copyrights, patents and other intangible assets should be included in the property factor.''[60] Microsoft has argued that its intellectual property ''represents a major income producing asset that is part of [its] core business,'' and that the omission of this intellectual property from the property factor ''distorts the standard apportionment formula.''[61]

The FTB, echoing the decision in *Colgate-Palmolive*, has contended that ''excluding Microsoft's intangible property in the property factor does not significantly distort the extent of its business activity'' because ''[a]lthough the value of Microsoft's intangible property is not directly reflected in the property factor, the value attributable to researching, developing and creating the intangible property is reflected in the other factors.''[62] Specifically, ''salaries paid to Microsoft's employees responsible for creating its proprietary products are necessarily included in the payroll factor,'' and ''the value of Microsoft's tangible property, such as computers and servers, used in the development of the products are included in the property factor.''[63] As of the date this article was written, the trial court has not issued a ruling in *Microsoft II*.

Other Authorities

The new internet-based economy has proved to be a troublesome area for state tax administrators and taxpayers. A current issue is whether sales of software or information over the internet should be treated as a sale of services or an intangible asset, or as a sale of tangible personal property for purposes of sourcing the revenue

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[56] *Stonebridge*, 18 Or. Tax at 440-41. The Oregon apportionment statute applicable to insurance companies did not apparently include any provision for altering the apportionment formula and the Oregon Tax Court concluded that it did not have the power to impose a modified formula. As a result, it held the tax unconstitutional as applied and the taxpayer was only required to pay the minimum tax.

[57] *Appeal of Farmers Underwriters Association*, 53-SBE-002 (Feb. 18, 1953).

[58] *Colgate-Palmolive Co. Inc. v. Bower*, No. 01 L 50195 (Ill. Cir. Ct. Oct. 15, 2002).

[59] *Microsoft Corp. v. California Franch. Tax Bd.*, No. CGC08471260 (Cal. Super. Ct., *filed* Jan. 22, 2008) (*Microsoft II*).

[60] Franchise Tax Board Public Litigation Roster (Sept. 2010), *available at* www.ftb.ca.gov/law/litrstr/index.html.

[61] Plaintiff's Trial Brief at 25, *Microsoft II* (No. CGC08471260).

[62] Defendant's Opening Trial Brief at 24, *Microsoft II* (No. CGC08471260).

[63] *Id.* at 24-25.

under the states' apportionment formulas.[64] There appear to be few if any cases addressing the issue under claims for an alternative apportionment method.

However, one interesting case involving the delivery of information into a state without the sale of tangible personal property involves a very old economy product—the yellow pages. In *BellSouth Advertising & Publishing Corp. v. Tennessee Comr.*,[65] the taxpayer was a publisher of yellow pages phone books. The taxpayer sent salesmen into Tennessee to solicit advertisers in the yellow pages phone book directories, but the entire process of publishing and printing the various Tennessee yellow pages was conducted entirely out of state. The phone books were then distributed to phone users in Tennessee at no charge. As a result, there was no sale of tangible personal property, and the taxpayer sought to source its revenue as a sale of advertising services under the traditional income-producing activity standard that was based on the location of the greatest portion of the taxpayer's costs of performance. As these costs were outside Tennessee where the printing and publishing occurred, the taxpayer had no sales in Tennessee. The Tennessee court noted that over a five-year period, the taxpayer had delivered more than 23 million directories in Tennessee and cited history from the initial adoption of UDITPA that noted that the standard apportionment rules might not operate fairly for publishers, to conclude that apportioning none of the taxpayer's substantial advertising revenue to Tennessee resulted in an unfair apportionment.[66]

Another case for alternative apportionment involves extraordinary sales of property where a large amount of gross receipts attributable to the location of the property can overwhelm receipts from ordinary operations and skew the sales factor to one state. Arguably, the income from such sales is apportionable business income and inclusion of the gross receipts from the sale in the sales factor is appropriate.[67] The Multistate Tax Commission Allocation and Apportionment Regulations (the MTC Regulations)—which serve as model regulations for states that have adopted UDITPA—in Reg. §IV.18.(c).(1), addresses this problem by providing that:

> (1) Where substantial amounts of gross receipts arise from an incidental or occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business, those gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory or plant will be excluded.

A large number of states have adopted this regulation or a regulation similar to it. However, fixed assets do not include intangible assets, and many state formulas would appear to require the inclusion of gross receipts from sales of intangibles in the sales factor.[68] Upon the sale of the assets of a going business, the sold assets are likely to include sales of intangibles as well as fixed assets. It would seem appropriate to exclude the receipts from the sale of the intangible assets from the sales factor as well as the receipts from the sale of the fixed assets. This issue was addressed by the California Franchise Tax Board in Legal Ruling 97-1, which held:

> The exclusion from the sales factor pursuant to 18 CCR §25137(c)(1)(A) of substantial amounts of gross receipts from an incidental or occasional sale of a fixed asset is based on the rationale that such gross receipts do not fairly reflect the taxpayer's day-to-day business activity and therefore cause excessive income to be apportioned to the state where the occasional sale took place. This is especially so if the growth of built-in appreciation occurs over a substantial period of time, because taking the gross receipts into account in the year of a recognition event does not reflect the gradual effects of appreciation over several years.
>
> The same rationale can be applied to gross receipts from an incidental or occasional sale of intangible property held or used in the regular course of taxpayer's trade or business. There is no logical basis for distinguishing between fixed assets and intangibles. Accordingly, under authority of §25137 [California's alternative apportionment statute], gross receipts from an incidental or occasional sale of intangible property held or used in the regular course of taxpayer's trade or business will be excluded from the sales factor, if substantial.

Using Alternative Apportionment to Overcome Conflicting State Apportionment Formulas

One of the most common complaints of taxpayers is that more than 100 percent of their taxable income is apportioned to the states, or that more than 100 percent of one of the factors, usually the sales factor, is appor-

[64] *See American Business Information, Inc. v. Tennessee Dept. of Rev.*, No. M2008-0129-COA-R3-CV (Tenn. Ct. App. Aug. 26, 2009).

[65] *BellSouth Advertising & Publishing Corp. v. Tennessee Comr.*, 308 S.W.3d 350 (Tenn. Ct. App. 2009).

[66] *BellSouth Advertising & Publishing Corp. v. Tennessee Comr. of Rev.* 308 S.W.3d 350, 366 (Tenn. Ct. App. 2009).

[67] To the extent the gain represents depreciation recapture, the depreciation has presumably been deducted from apportionable income.

[68] Uniform Division of Income for Tax Purposes Act, in Reg. §IV.18.(c).(3) addresses the issue of receipts from intangible property under the statute's alternative apportionment authority but does not directly address the distortion that can be caused by extraordinary sales:

> (3) Where the income producing activity in respect to business income from intangible personal property can be readily identified, the income is included in the denominator of the sales factor and, if the income producing activity occurs in this state, in the numerator of the sales factor as well. For example, usually the income producing activity can be readily identified in respect to interest income received on deferred payments on sales of tangible property (Regulation IV.15.(a)(1)(A)) and income from the sale, licensing or other use of intangible personal property (Regulation IV.17.(2)(D)).
>
> Where business income from intangible property cannot readily be attributed to any particular income producing activity of the taxpayer, the income cannot be assigned to the numerator of the sales factor for any state and shall be excluded from the denominator of the sales factor. For example, where business income in the form of dividends received on stock, royalties received on patents or copyrights, or interest received on bonds, debentures or government securities results from the mere holding of the intangible personal property by the taxpayer, the dividends and interest shall be excluded from the denominator of the sales factor.

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tioned to the states. The most common example of this involves the sales factor when a taxpayer selling services is operating in some states that source sales using the traditional income producing activity/cost of performance test and in other states that use a so-called ''market sourcing'' method that sources sales to the location of the customer or where the services are received. A taxpayer that is providing services to a customer in state A that uses a market sourcing approach but does most of the actual work related to those services in state B that uses the traditional test, may find the sales included in the numerator of both states. From a taxpayer's perspective, such a situation appears ripe for alternative apportionment.

Unfortunately, just the opposite is the case. Although a taxpayer in such a situation may get a sympathetic ruling from its ''home state'' where it has substantial operations, it is doubtful that the taxpayer has a right to alternative apportionment under either constitutional principles or under state alternative apportionment statutes. Each state has a right to impose its own apportionment formula so long as the formula meets constitutional standards. The issue of double taxation is addressed under the internal consistency test that examines whether double taxation will result if every state adopted the apportionment method used by the taxing state. There is no requirement that the states conform to a consistent apportionment method. Indeed, in the above example, is it the state using market sourcing or the state using the traditional method of sourcing sales that needs to relent to avoid double taxation?

One of the most common complaints of taxpayers is that more than 100 percent of their taxable income is apportioned to the states.

The U.S. Supreme Court addressed this issue in *Moorman Mfg. Co. v. Bair*.[69] In that case, as discussed in more detail below, the taxpayer challenged Iowa's use of a single-sales factor formula under the Due Process and Commerce Clauses of the U.S. Constitution. Because most other states used a three-factor formula consisting of property, payroll, and sales factors and the taxpayer's property and payroll were substantially located outside Iowa, the result was that more than 100 percent of the taxpayer's income was apportioned to the states and subject to tax. According to the taxpayer, this was caused by Iowa's failure to have a property and payroll factor that diluted taxpayer's Iowa apportionment. The court found no constitutional issue with that result:

> Even assuming some overlap, we could not accept appellant's argument that Iowa, rather than Illinois, was necessarily at fault in a constitutional sense. It is, of course, true that if Iowa had used Illinois' three-factor formula, a risk of duplication in the figures computed by the two States might have been avoided. But the same would be true had Illinois used the Iowa formula. . . .
>
> . . .
>
> The prevention of duplicative taxation, therefore, would require national uniform rules for the division of income. Although the adoption of a uniform code would undeniably advance the policies that underlie the Commerce Clause, it would require a policy decision based on political and economic considerations that vary from State to State.
>
> . . .
>
> It is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income. It is to that body, and not this Court, that the Constitution has committed such policy decisions.[70]

ALTERNATIVE APPORTIONMENT AND THE SINGLE-SALES FACTOR

Constitutionality of Single Factor Apportionment

The U.S. Supreme Court has held that a single factor apportionment formula is presumptively valid. In *Underwood Typewriter Co. v. Chamberlain*,[71] the court sustained the constitutionality of a Connecticut statute that required the taxpayer to apportion its net income based on a single property factor. The taxpayer was engaged in the business of manufacturing and selling typewriters, which it manufactured in Connecticut and then sold and serviced at branch offices throughout the United States. Under Connecticut's statutory formula, 47 percent of the taxpayer's income was attributed to the state, despite the fact that only 3 percent of its profits were received there. The court noted that the profits of the taxpayer ''were largely earned in a series of transactions beginning with manufacture in Connecticut and ending with sale in other States.''[72] Under these circumstances, the court concluded that the formula ''reached, and was meant to reach, only the profits earned within the State,'' and that the taxpayer had failed to establish that the ''method of apportionment . . . was inherently arbitrary, or that its application . . . produced an unreasonable result.''[73]

In addition to upholding the use of a single property factor formula in *Underwood*, the U.S. Supreme Court has specifically sustained the use of a single-sales factor formula. The court first addressed the validity of a single-sales factor formula in *General Motors Corp. v. District of Columbia*,[74] but did not address whether such a formula passed constitutional muster.[75] At issue

[69] *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978).

[70] *Moorman*, 437 U.S. at 280.

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

[72] *Id.* at 120.

[73] *Id.* at 121. The U.S. Supreme Court again sustained the constitutionality of a single property factor in *Bass, Ratcliff & Gretton Ltd. v. State Tax Comn.*, 266 U.S. 271 (1924).

[74] *General Motors Corp. v. District of Columbia*, 380 U.S. 553 (1965).

[75] An earlier case, *Ford Motor Co. v. Beauchamp*, 308 U.S. 331 (1939), challenged the results under a single-sales factor

in *General Motors* was the validity of a single-sales factor regulation promulgated by the District of Columbia. While the relevant statute granted the district broad discretion to devise regulations for determining the amount of income ''fairly attributable'' to the District, in the case of a taxpayer doing business ''both within and without the District,'' the statute required that net income ''be deemed to be income from sources within and without the District.''[76] The court noted that the regulation failed to satisfy this statutory requirement under certain circumstances, such as in the case of a taxpayer with manufacturing facilities outside the district selling all of its products in the district.[77] In this example, the entire net income of a taxpayer doing business ''both within and without the District'' would be attributed to the district in violation of the statutory requirement that such a taxpayer's income ''be deemed to be income from sources within and without the District.'' The court therefore concluded that the single-sales factor regulation was not authorized by the statute and reversed the court of appeals without reaching the constitutional questions presented.[78]

While the court in *General Motors* resolved the case on nonconstitutional grounds and specifically disclaimed taking any position ''on the constitutionality of a state income tax based on the sales factor alone,'' the decision nevertheless contains some interesting dicta:

> [T]he result reached in this case is consistent with the concern which the Court has shown that state taxes imposed on net income from interstate commerce be fairly apportioned. In upholding taxes imposed on corporate income by Connecticut [in *Underwood*] and New York [in *Bass*] and apportioned in accordance with the geographical distribution of a corporation's property, this Court *carefully* inquired into the reasonableness of the apportionment formulae used.
>
> While the Court has refrained from attempting to define any single appropriate method of apportionment, it has sought to ensure that the methods used display a modicum of reasonable relation to corporate activities in the State. The Court has approved formulae based on the geographic distribution of corporate property and those based on the standard three-factor formula. *See, e.g., Underwood Typewriter Co. v. Chamberlain, supra; Butler Bros. v. McColgan*, 315 U.S. 501. The standard three-factor formula can be justified as a rough, practical approximation of the distribution of either a corporation's sources of income or the social costs which it generates. By contrast, the geographic distribution of a corporation's sales is, by itself, of dubious significance in indicating the locus of either factor . . . . In construing the District Code to prohibit the use of a sales-factor formula, we sacrifice none of the values which our scrutiny of state apportionment measures has sought to protect.[79]

Thirteen years after *General Motors*, the court in *Moorman* held, in a 6-3 decision, that a single-sales factor apportionment formula passed constitutional scrutiny.[80] The taxpayer in *Moorman* manufactured animal feed in Illinois and sold a portion of its product—approximately 20 percent—to customers located in Iowa. The taxpayer maintained warehouses and a sales force in Iowa.[81] Citing *General Motors*, the taxpayer argued that its Illinois operations were responsible for at least some portion of the income generated by its Iowa sales, and that by subjecting this income to tax in Iowa, the statutory formula resulted in extraterritorial taxation in violation of the Due Process Clause.[82]

The court described as ''speculative'' the taxpayer's contention that its Illinois operations were responsible for some of the profits generated by its Iowa sales, noting that ''the record does not contain any separate accounting analysis showing what portion of appellant's profits was attributable to sales, to manufacturing, or to any other phase of the company's operations.''[83] However, even had the taxpayer established that its Illinois manufacturing activities contributed to the profitability of its Iowa sales, the court concluded that the taxpayer was incorrect in claiming ''that the Constitution invalidates an apportionment formula whenever it *may* result in taxation of some income that did not have its source in the taxing State . . . .''[84] In holding against the taxpayer, the court noted that while the taxpayer was given an opportunity to demonstrate that the single-factor formula produced an arbitrary result in its case, the record contained no such showing.[85]

Application of Alternative Apportionment To the Single-Sales Factor

While *Moorman* establishes that a single-sales factor formula will withstand challenges based on facial con-

formula rather than the formula itself. In that case, Texas imposed franchise tax on the privilege of doing business in the state. The measure of the tax was the value of the capital stock, surplus, and undivided profits apportioned to the state using a single gross receipts factor. The formula resulted in an apportioned value of $23 million while the client showed that the actual value of its property in Texas was only $3 million. The taxpayer claimed that the Texas tax was reaching out-of-state values. The court rejected this argument, noting that the tax was not a property tax but a tax on the value of the franchise to do business in the state that was measured by capital value apportioned to the state. The value of that Texas franchise could be enhanced by property outside of Texas as evidenced by the relative amount of gross receipts in Texas.

[76] *General Motors Corp. v. District of Columbia*, 380 U.S. 553, 554 (1965).

[77] *Id.* at 557.

[78] *Id.* at 558-59.

[79] *Id.* at 561 (emphasis added).

[80] *Moorman*, 437 U.S. at 267.

[81] *Id.* at 269.

[82] *Id.* at 271-272.

[83] *Id.* at 272.

[84] *Id.* (emphasis added).

[85] *Id.* at 275. The dissenting opinion focused almost exclusively on the operation of a single-sales factor formula as discriminating against interstate commerce by failing to recognize contributors to earning income other than sales and favoring taxpayers who have property and employees in the state relative to the traditional three-factor formula. Justice Blackmun in dissent observed: ''Single-factor formulas are relics of the early days of state income taxation. The three-factor formulas were inevitable improvements and, while not perfect, reflect more accurately the realities of the business and tax world.'' 437 U.S. at 282. (Footnotes omitted.) Justice Powell in dissent argued: ''Iowa's use of single-factor sales-apportionment formula—though facially neutral—operates as a tariff on goods manufactured in other States and as a subsidy to Iowa manufacturers selling their goods outside of Iowa.'' 437 U.S. at 283.

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stitutionality, the taxpayer did not even ''suggest that a significant portion of the income attributed to Iowa in fact was generated in Illinois [manufacturing] operations,'' but instead contended that the court should ''proceed on the assumption that at least some portion of the income from Iowa sales was generated by Illinois activities.''[86] *Moorman* therefore remains a decision on the facial unconstitutionality of a single-sales factor formula, but left the door open to fact-specific challenges such as those in *Hans Rees, above,* and *Norfolk & Western, above,* both of which held that a single-factor apportionment formula was unconstitutional as applied to the specific taxpayer at issue.

A taxpayer seeking to show that a single-sales factor apportionment formula unfairly apportioned its income to a state needs to consider what type of evidence would be acceptable in light of the fact that separate accounting has been widely rejected as a means of establishing distortion. While the task may seem daunting, the U.S. Supreme Court's decisions provide some guidance. The external consistency requirement of fair apportionment requires that ''the factor or factors used in the apportionment formula *must actually reflect a reasonable sense of how income is generated.*''[87] Consistent with this requirement, ''[t]he standard three-factor formula can be justified as a rough, practical approximation of the distribution of either a corporation's sources of income or the social costs which it generates.''[88] However, as recognized by the U.S. Supreme Court in *General Motors*, ''the geographic distribution of a corporation's sales is, by itself, *of dubious significance in indicating the locus of either factor*.''[89]

If we take the example of a manufacturing company, it will have a similar problem to that confronted by the taxpayer in *Hans Rees*, *i.e.*, how to demonstrate that its income was significantly attributable to its property and payroll and not just to its sales activities. Unfortunately, the record does not reveal how the taxpayer in *Hans Rees* met its burden, although there is an indication that it used some method of geographical accounting. In *Moorman* the taxpayer urged, unsuccessfully, the court to assume that some portion of the income from Iowa sales was generated by Illinois activities.

However, it would seem that a taxpayer's ability to prove that a single-sales factor apportionment formula operates unfairly to apportion income to a state may depend on the nature of its business. If we take a manufacturer of an unpatented paper clip, it may well be that the income attributable to that product arises almost exclusively from the manufacturer's ability to efficiently sell such a low margin product. That taxpayer may not be able to show that a single-sales factor apportionment formula unfairly apportions its income.

On the other hand, consider a developer, manufacturer, and seller of a patented drug that does all of its research, development, and manufacturing in one state (the home state) but sells in all 50 states.[90] Intuitively, the profit is not entirely attributable to the taxpayer's sales function, but a substantial portion of the income is attributable to the operations in its home state. In this case, the formula does not reasonably reflect any objective determination of how the taxpayer's income is earned. As proof, the taxpayer might offer a study as to the royalty that would be received for the drug if it was licensed to an independent manufacturer and distributor. This would at least demonstrate the income earned from the research and development activity. To also capture the manufacturing profit, a study establishing the price charged an independent sales/distributing company might be a basis for isolating the income earned in its home state. If the drug is being licensed for manufacture and sale overseas, the royalty received may provide objective evidence as to income not earned from the sales function represented by the sales factor.

The *Colgate-Palmolive* case discussed above may provide support for challenging a single-sales factor apportionment formula. In that case, the taxpayer earned foreign royalties and argued that a three-factor formula did not properly apportion its income because its intangible property was not taken into account. The court rejected this position, in substantial part by noting that the payroll and tangible property used to create and maintain the intangible property were included in the standard factors.[91] How would the court respond if the state had a single-sales factor apportionment formula?[92]

A taxpayer's ability to prove that a single-sales factor apportionment formula operates unfairly to apportion income to a state may depend on the nature of its business.

The approach suggested for challenging a single factor apportionment formula does not rely on discredited geographical accounting but, instead, upon functional accounting. It is the kind of ''separate accounting analysis showing what portion of appellant's profits was attributable to sales, to manufacturing, or to any other phase of the company's operations''[93] that the U.S. Supreme Court said was lacking in *Moorman*.

In *Trinova Corp. v. Michigan Dept. of Rev.* ,[94] the taxpayer challenged the constitutionality of the apportioned Michigan Single Business Tax (SBT) as applied to its facts. The SBT was a value-added tax measured by federal taxable income with compensation and depreciation deductions added back. That base was apportioned to Michigan using a three-factor formula consisting of property, payroll, and sales factors. Under the taxpayer's particular facts, its taxable income was a loss and its Michigan tax base consisted entirely of the com-

[86] *Moorman*, 437 U.S. at 272.
[87] *Container Corp.*, 463 U.S. at 169 (emphasis added).
[88] *General Motors*, 380 U.S. at 561.
[89] *Id.* (emphasis added).
[90] For purposes of discussion we will assume that the taxpayer has nexus in all 50 states and is not protected by Pub. L. No. 86-272.
[91] *Colgate-Palmolive Co. Inc. v. Bower*, No. 01 L 50195 (Ill. Cir. Ct. Oct. 15, 2002).
[92] *Colgate-Palmolive* was an Illinois case. Interestingly, Illinois now has a single-sales factor apportionment formula. *See* 35 ILCS 5/304. One wonders how the court would address the issue now.
[93] *Moorman*, 437 U.S. at 272.
[94] *Trinova Corp. v. Michigan Dept. of Rev.* 498 U.S. 358 (1991).

pensation and depreciation add-back. The taxpayer's Michigan property factor was .0930 percent, its payroll factor was .2328 percent, and its sales factor was 26.5892 percent, for an overall Michigan apportionment percentage of 8.9717 percent. The taxpayer argued that because the location of its property and payroll were known and were almost entirely outside of Michigan, adding its compensation and depreciation into the tax base and then apportioning it using a percentage that was greatly in excess of the portion of the property and payroll in Michigan resulted in a taxation of extraterritorial value by Michigan.

The court rejected the taxpayer's challenge, noting that the SBT was not three separate taxes on property, payroll, and sales but a value-added tax. Value added was a function of all the taxpayer's operations, and compensation, depreciation, and revenues are codependent variables in arriving at value added. Although it was clear that the taxpayer did not perform any manufacturing operations in Michigan, the court noted that there was no evidence as to how much value was added by taxpayer's different operations; that is, its sales offices in Michigan relative to its manufacturing plants and payroll located outside Michigan.[95] In reaching its conclusion, the court noted that the current record, like the record in *Moorman*, did not contain evidence as to the income attributable to different phases of the taxpayer's operations.[96] The question remains, would a different result have been achieved if, as suggested above, convincing evidence was introduced to show what portion of income was attributable to the sales function as opposed to the manufacturing function? Where apportionment is tied to a single factor, such evidence could be compelling in demonstrating that, under the taxpayer's particular facts, the formula inappropriately reached income earned outside the state.

In *Trinova*, the taxpayer argued that the sales function was not a contributor to value added and its tax base should be apportioned on a two-factor formula consisting of property and payroll. The court responded:

> We have . . . already concluded that sales (as a measure of market demand) do have a profound impact upon the amount of an enterprise's value added, and therefore reject the complete exclusion of sales as somehow resulting in more accurate apportionment.[97]

Conversely, at least under some facts, can the complete exclusion of property and payroll from the apportionment factor result in an accurate apportionment of income?

Of course, the home state, if it had single-sales factor apportionment in the above example, could argue for a larger apportionment of income to the state under the same arguments suggested above. However, assuming a state consciously adopted single-sales factor apportionment in order to encourage development in the state (that is, to promote the location of taxpayer's research, development, and manufacturing facilities in the state), it would be surprising for the home state to take that position. If it routinely took that position, it would undermine the goal of adopting a single-sales factor apportionment formula.

Admittedly, the burden for the taxpayer may be high for sustaining a challenge to the application of single-sales factor apportionment. Beyond developing the needed facts about where income is earned, will a state court be willing to hold its state's apportionment formula unconstitutional as applied in circumstances that might affect a large number of taxpayers? Would the current U.S. Supreme Court grant certiorari for such a case? Nevertheless, as more states adopt single-sales factor apportionment, it seems likely that this issue will reach the courts at some point.

CONCLUSION

Taxpayers as well as the states have the ability to challenge the result of a statutory apportionment formula under both the U.S. Constitution and state statutes if application of the formula results in an unfair apportionment of income to the state. Where taxpayers feel that their income is over apportioned to a particular state, it may be time to investigate whether a remedy is available.

The availability of a remedy may depend on whether state law requires a showing of ''constitutional distortion'' or merely that the formula results in a demonstrably unfair apportionment of income to the state. In either case, the taxpayer will need to provide clear and convincing evidence supporting the claim of unfair apportionment. While a wide range of facts and circumstances might support a taxpayer's claim to alternative apportionment, two approaches that have had success are (i) the presentation of convincing evidence demonstrating that the factor is an unreliable and inconsistent indicator of income earned in the state, and (ii) a showing that the factor does not contribute significantly to income and that the factor disproportionately apportions income to the state. Probative evidence is not likely to be derived from separate company or geographic accounting records but from evidence showing the relationship of the factor to income (or the lack of such relationship) and how that relationship operates to distort the income apportioned to the state.

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In addition, with respect to the single-sales factor formula that is becoming more commonly used by the states, that formula would seem to focus on a single element of a taxpayer's income producing activities to the exclusion of other contributors to taxpayer's profitable operations. There appears to be support in both case law and in reason that a single-factor formula is more likely to unfairly apportion income than a multiple-factor formula. Although the U.S. Supreme Court has

[95] *Id. at* 375-76.
[96] *Id.* at 375.
[97] *Id.* at 382.

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upheld the general validity of a single-sales factor apportionment formula in *Moorman*, in that case the taxpayer did not attempt to show that the formula was unconstitutional as applied to its facts. Since *Moorman*, it does not appear that taxpayers have seriously challenged the application of a single-sales factor apportionment formula to particular fact situations where such a formula could operate unfairly. However, in an economy where intellectual property plays such a significant role, it seems inevitable that a single-sales factor apportionment formula will be challenged as violating the external consistency test established in *Container Corp.* because, under the taxpayer's particular facts, a formula based on a single-sales factor fails to ''reflect a reasonable sense of how income is generated.''[98]

[98] *Container Corp.*, 463 U.S. at 169.