Testimony

of

Daniel B. De Jong
Tax Counsel
Tax Executives Institute, Inc.

before the

Subcommittee on Commercial and Administrative Law
Committee on the Judiciary
United States House of Representatives

on

State Taxation: The Role of Congress in Developing Apportionment Standards

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Chairman Cohen, Ranking Member Franks, and Members of the Subcommittee, thank you for your invitation to Tax Executives Institute to provide the business perspective on issues related to the apportionment of income for state corporate tax purposes. TEI is the preeminent worldwide association of in-house tax professionals, with more than 7,000 members representing 3,000 of the largest companies in the United States, Canada, Europe, and Asia. As a member of TEI's legal staff, I concentrate on state and local tax matters.

TEI members represent a broad cross-section of the business community whose U.S. employers are, almost without exception, engaged in interstate commerce. The multijurisdictional companies represented by the Institute's membership are directly and

materially affected by the rules governing allocation and apportionment of income among the various states.

The subject of today's hearing, multistate apportionment, challenges even the most seasoned state tax practitioner. When a business operates in multiple jurisdictions, it is necessary to determine which of the business's activities and investments (and how much of the income derived from those activities and investments) should be attributed to each jurisdiction. Understandably, it is not an easy task, and there is no single, simple, correct answer. Supreme Court Justice William Brennan aptly noted in a seminal 1983 case that dividing income among the several states bears some resemblance to "slicing a shadow."[1]

These challenges are not confined to the United States and the domestic multijurisdictional tax context. Other countries also struggle to fashion rules that ameliorate double taxation of income earned overseas. Here in the United States, where taxpayers are subject to a system that taxes their worldwide income, double taxation at the federal level is ameliorated – but not entirely eliminated – through a complex foreign tax credit mechanism and a broad network of bilateral income tax treaties.

In recent years, the countries of the European Union (EU) have considered establishing a common consolidated corporate tax base for their EU-wide activities.[2] Even if the EU achieves a common tax base, the member states will need to grapple with the politically delicate balancing

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[1] *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 192 (1983).

[2] "The European Commission believes that the only systematic way to address the underlying tax obstacles which exist for companies operating in more than one Member State in the Internal Market is to provide companies with a consolidated corporate tax base for their EU-wide activities. Targeted solutions have many merits and would go some way towards remedying the tax obstacles. However, even if all of them were implemented, they would not address the fundamental problem of dealing with up to 27 different tax systems." Available at http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm (last visited March 3, 2010).

necessary to establish a system for apportioning that base.[3] This underscores the complexity associated with attempting to achieve consistency and uniformity in the allocation and apportionment of income across multiple jurisdictions.

My testimony today will focus on (1) the practical effect of the current patchwork of apportionment rules among the states, *i.e.,* how they affect multistate businesses, and (2) the challenges that exist to achieving consensus on how to "slice the shadow."

A. DETERMINING THE APPORTIONABLE TAX BASE

Last month, the Subcommittee heard testimony on the issue of state tax nexus. Because the concept of nexus limits the states' right to tax a multistate business, it acts as a toggle on the requirement to file a tax return in a state and to perform the calculations necessary to determine the ultimate tax due to the state, including the rules governing the apportionment of a taxpayer's income to the state.

Before applying an apportionment ratio, however, multistate businesses must determine the tax base that will be apportioned among the states with which they have nexus. In most states, the calculation of state taxable income begins with federal taxable income, which provides an initial degree of uniformity. From that point, the amount of uniformity among the states decreases dramatically. For instance, some states require taxpayers to add back certain items of income or deduction while others require subtraction of certain items. The differences often derive from individual, state-specific policy considerations; others may be attributable to a state decision to avoid a revenue loss caused by retaining existing conformity with the Internal Revenue Code. For example, many states require taxpayers to "add back" the federal domestic

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[3] *The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-jurisdictional Corporate Income Taxation: a Review of Issues and Options*, Working Paper No. 9/2006, available at http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_09_complete_en.pdf (last visited March 3, 2010).

manufacturing deduction permitted under section 199 of the Internal Revenue Code in computing their state taxable income. Thus, even if a uniform standard for apportionment could be achieved, the tax base would continue to differ from state to state.

B. CONSTITUTIONAL LIMITATIONS ON APPORTIONABILITY

The U.S. Constitution limits the states' ability to tax income from transactions that bear no, or only a marginal, connection – or nexus – with the taxpayer's activities in the state.[4] Permitting states to apportion that income would result in the state's taxing value earned wholly outside its borders. Accordingly, income that falls into this category must be removed from the income subject to formulary apportionment and instead allocated in full to the state in which it was earned.

More than a century ago, the Supreme Court first addressed the question of what connection must exist between a state and a nondomiciliary taxpayer's income from out-of-state sources or activities. That connection ultimately became known as the unitary business principle, which has since been described as "the linchpin of apportionability in the field of state income taxation."[5] The Court's jurisprudence mandates an inquiry into whether the out-of-state item that the state seeks to tax is "unitary" with, or functionally related to, the taxpayer's in-state

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[4] As explained in more detail later in this testimony, in apportioning the income of multistate unitary corporations, some states use the apportionment formula set forth in the Uniform Division of Income for Tax Purposes Act (UDITPA), which requires a corporation to "separate its income into business income which is subject to apportionment among the various States, and non-business income, which is allocated to a single State." Sanjay Gupta & Lillian Mills, *How Do Differences in State Corporate Income Tax Systems Affect Compliance Cost Burdens?* (2002). UDITPA divides income into business income, which is apportioned by means of a three-factor formula, and nonbusiness income, which is allocated according to the type of income and the type of property giving rise to the income. Some states have also adopted special allocation rules for certain industries such as pipelines and telecommunications companies.

[5] *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 439 (1980).

activities;[6] the Court has described a unitary business relationship as one marked by "functional integration, centralization of management, and economies of scale."[7]

Often the question whether an item of income satisfies the unitary business test arises in the context of intangible income derived from a business's investment in subsidiaries. In one case, the taxpayer received a dividend from a foreign subsidiary and claimed the income was "earned in the course of activities unrelated to" its business activities in the state.[8] In analyzing that transaction, the Supreme Court explained that "[w]here the business activities of the dividend payor have nothing to do with the activities of the recipient in the taxing State, due process considerations might well preclude apportionability because there would be no underlying unitary business."[9] Ultimately, the Court in that case found that the relationship between the in-state taxpayer and its foreign subsidiary met the unitary business test forcing the taxpayer to include the dividend in its apportionable tax base. Because the determination of a unitary relationship is so fact-intensive, businesses and the states continue to struggle with its application, and the result has been a steady stream of litigation. The ensuing uncertainty exacts a cost on business – over and above any tax that might ultimately be due – impeding economic growth at a time when global competition pressures them to reduce costs and streamline their operations.

C. WHICH ENTITIES TO INCLUDE?

Business enterprises composed of multiple entities confront an additional hurdle in determining their tax base: They must identify the entities properly included in their state tax return filing. Not surprisingly, there is no uniformity among the states. Some states disregard

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[6] *Connecticut General Life Ins. Co. v. Johnson*, 303 U.S. 77, 80-81 (1938).
[7] *Mobil Oil Corp.,* 445 U.S. at 438.
[8] *Id.* at 439.
[9] *Id.* at 441-42.

the interrelationships between affiliated corporations and require each corporation doing business in the state to file a separate tax return and to compute its tax liability using its own separate company income and apportionment factors, whereas other states require that all such corporations be combined in a single return.

Currently, 45 states impose a corporate income tax (or a similar business tax). Of those, 23 require groups of related entities to file as a group when those entities constitute a unitary business. The goal of including all entities in the same tax filing is to better capture "the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise."[10] To be unitary, corporations must meet an ownership test (usually direct or constructive ownership of more than 50% or 80% – depending on the state), and exhibit characteristics of interdependence "to form one integral business rather than several business entities."[11] The Supreme Court has permitted the use of mandatory unitary combined reporting in a number of cases.[12]

The use of unitary combined reporting highlights the importance of nexus as a threshold issue in the state taxation of multistate businesses. Even when only one entity in a group has nexus in a state, all other unitary entities must be included in the return. Some states treat the entire unitary group as a single taxpayer, while others recognize the independent existence of each corporation in the group. In states that respect the separate legal existence of group members, determinations of nexus remain important. For example, some states exclude from the group's sales factor numerator sales made into the state by entities within the group that do not

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[10] *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 164-65 (1983).
[11] *Pioneer Container Corporation v. Beshears*, 684 P.2d 396, 399 (Kan. 1984).
[12] *See e.g., Container Corp., supra*, and *Barclays Bank PLC v. Franchise Tax Board*, 512 U.S. 298 (1994).

individually have nexus there.[13] In some cases, the exclusion of those amounts from the sales factor can significantly lessen the tax liability of the group in that state. On the other hand, some states attribute the nexus of one group member to all members of the group and thus do not permit the exclusion of sales into the state by "no-nexus" members from the numerator of the sales factor.[14]

For businesses with international operations, the identification of the entities included in its "unitary group" may include foreign entities. During the 1980s and early 1990s, a number of states began requiring the inclusion of the international operations of multinational businesses in their apportionment calculations – even where those international operations were conducted through separate legal entities. When the Supreme Court permitted the application of these principles to the international operations of multinational business groups – even those headquartered outside of the United States[15] – "a number of states began to show interest in worldwide combined reporting."[16] Ultimately, the extreme unpopularity of the worldwide combined reporting concept (not only among taxpayers but with foreign governments as well) and the threat of federal intervention prompted the states to back away from requiring its use.[17]

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[13] This approach is often referred to as the *Joyce* rule named for a decision by the California State Board of Equalization. *See Appeal of Joyce, Inc*., No. 66 SBE 069 (Cal. SBE Nov. 11, 1966).

[14] This approach is commonly referred to as the *Finnigan* rule named for another decision by the California State Board of Equalization. *See Appeal of Finnigan Corp.*, No. 88-SBE-022 (Cal. SBE Aug. 25, 1988) (*Finnigan I*); Opinion on Petition for Rehearing, No. 88-SBE-022-A (Cal. SBE, Jan. 24, 1990) (*Finnigan II*).

[15] *Barclays Bank PLC*, *supra*.

[16] Joe Huddleston & Shirley Sicilian, *History and Considerations for Combined Reporting: Will States Adopt a Model Combined Reporting Statute?*, available at http://www.ncleg.net/DocumentSites/committees/revenuelaws/2007-2008/Meeting%20Documents/Meetings%20for%20Report%20to%202009%20Session/19%20November%202008/History%20and%20Considerations%20for%20Combined%20Reporting%20-%20MTC.pdf (last visited March 3, 2010).

[17] "The international business community and foreign governments became concerned, in part because unitary apportionment was not the standard for United States' or foreign governments' taxation of international income at the national level. The U.S. Treasury formed a Working Group, with state, federal, and business community representatives. The 20 members of this Working Group included chairs of large corporations (Ford, Exxon, IBM, and others) State legislators (such as the house speakers from Florida and New Hampshire), Governors (from Utah, Illinois, and California) and high level federal staff (including the U.S. Secretary of the Treasury and an Under Secretary of State). Although no agreement was reached, the Working Group Chairman's Report ultimately

Most states today employ a "water's-edge" approach to mandatory combined reporting. Under this method, unitary businesses generally include only domestic entities in the group return. More recently, however, states have begun including an apportioned amount of the income of foreign affiliates in an otherwise water's-edge return where the foreign affiliate either (1) earns income attributable to sources within the United States, or (2) earns more than a threshold amount of its income from the sale or license of intangibles or services to other domestic members of the unitary business.[18] Including these entities in a water's-edge return often places an increased tax burden on multinational enterprises because it results in state taxation of income excluded from the federal income tax base and engrafts another layer of complexity – and attendant burden – on the determination of their tax base. Federal income tax treaties do not apply to state taxes further inhibiting the ability to conform the tax base of foreign entities included in a combined return to federal taxable income. This disconnect, and the lack of a state-level foreign tax credit, exposes foreign multinationals to double taxation in the states and the countries where they are subject to tax.

D. CALCULATING AND APPLYING APPORTIONMENT FORMULAS

The identification of the entities to be included in each state tax return and the unitary business income of those entities provides the pool of income to be divided and ultimately taxed by the various states in which a business has nexus. The Supreme Court has confirmed that "the entire net income of a corporation, generated by interstate as well as intrastate activities, may be fairly apportioned among the States for tax purposes by formulas utilizing in-state aspects of

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recommended States adopt water's-edge combination that includes only those foreign entities doing business in a tax haven. As a result of the report and the extreme unpopularity of the concept, the States stepped away from worldwide combined reporting." *Id*. at 15.

[18] *See e.g.*, MTC Model Statute for Combined Reporting §§ 5.A.iv & vi (2006).

interstate affairs."[19] Hence, apportionment formulas are used to determine what part of a taxpayer's unitary income may be properly taxed by respective states. For example, under the Uniform Division of Income for Tax Purposes Act (UDITPA), the apportionment formula compares (i) the taxpayer's property, payroll, and sales (receipts) within the taxing state to (ii) the taxpayer's total property, payroll, and sales everywhere.[20] At the height of its popularity, 34 states had adopted the statute verbatim or had embraced significant segments of the uniform statute.

States began to move away from a standard formula, however, after the Supreme Court's 1978 decision in *Moorman Mfg. Co. v. Bair*,[21] which allowed the use of a single-sales factor to apportion multistate business income. Since then, states designed their formulas to benefit and encourage in-state investment. For example, by removing the payroll and property factors from the apportionment calculation as in *Moorman*, the state can benefit in-state businesses by eliminating the ratios tied to the production of a taxpayer's goods and services (allowing in-state businesses to increase their payroll and property in the state without causing an increase in their state corporate income tax liability). This type of formula is especially beneficial for producers that sell the majority of their products and services to customers located outside their state of production. The reciprocal is also true: These formulas disadvantage out-of-state companies.

Since *Moorman*, a steady migration away from the equally weighted three-factor standard in UDITPA has contributed to the shift of the state corporate income tax base from one jurisdiction to another with a concomitant increase in complexity, as businesses have had to cope

[19] *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 460 (1959).
[20] UDITPA was developed by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in 1957.
[21] *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978).

with disparate rules among the states.[22] At the same time, there is disagreement among state taxing authorities and taxpayers (and sometimes between taxpayers themselves) on whether the rules used to source gross receipts in the sales factor of the apportionment formulas adequately reflect the taxpayer's activity in the state given the evolution of our national economy from one based on manufacturing to a multifaceted economy based increasingly on services and intangibles.

Perhaps the most striking example of this burgeoning disconnect is the manner in which receipts from the sale of services and intangibles are sourced for purposes of the sales factor. Under UDITPA, taxpayers must source those receipts to the state in which the income producing activity is performed.[23] If the income producing activity is performed in multiple states, the receipts from a particular item of income are sourced to the state in which "the greater proportion of the income-producing activity is performed…, based on costs of performance."[24] This approach tends to source sales to the state of performance. More recently, some states have moved away from this cost-of-performance sourcing rule to one that sources receipts based on the market into which the taxpayer sells its intangibles or services. In Illinois, for example, receipts from the sale of services must be sourced to that state if the customer receives the services in the state.[25]

Consider the following example: Corporation A has its headquarters in Virginia from which it provides computer help desk services to its customers. It provides these services to customers located in Virginia (50%) and Illinois (50%). Corporation A also has a small office in Illinois where its sales force works to generate additional sales from Illinois customers. Under

[22] Many other factors also played a role in the shift, including demographics, technology, global competition, and the success of states' economic development efforts.
[23] UDITPA § 17(a).
[24] UDITPA § 17(b).
[25] ILCS § 5/304(a)(3)(C-5)(iv).

Virginia law, Corporation A must source its sales from computer help desk services based on the location where it incurs the greatest costs of performing those services. Because Corporation A does that work in Virginia (through the Internet and over the phone), all gross receipts from its data processing services will be sourced to Virginia; and since the company also has the vast majority of its payroll and property located in Virginia, it will wind up apportioning nearly all of its income to Virginia. Illinois, on the other hand, employs a single-sales factor to apportion income to the state. Receipts are sourced to Illinois for purposes of that sales factor based on where the customer receives the benefit of those services. In this case, 50% of Corporation A's services are received in Illinois resulting in the company paying Illinois corporate income tax on 50% of its income. Because of the conflict between the two states' rules for apportioning income, Corporation A will effectively pay tax twice on 50% of its income.

Conversely, if Corporation A were headquartered in Illinois, it would pay tax on only 50% of its income. In Virginia, none of the company's sales would be included in its sales factor numerator because none of the costs of performing its services would have been incurred in Virginia (they would have been incurred in Illinois).

To address situations resulting in a taxpayer paying state tax on less than 100% of its income, some states have implemented rules referred to as "throwback" or "throwout" rules. A throwback rule works by assigning sales otherwise sourced to states where the taxpayer is not subject to tax back to the state from which the sales were made. For example, if Corporation B sold light bulbs from its warehouse in Missouri to a customer in Oregon, those sales would be included in the numerator of Corporation B's Missouri sales factor if the company did not have nexus in Oregon. A throwout rule applies in the same situation but works by excluding sales to

"no nexus" states from the sales factor completely, thereby reducing the denominator of the sales factor and increasing the income apportioned to the state.[26]

To address situations where a state's apportionment formula does not accurately reflect a multistate business's activity in the state, most states have a discretionary mechanism that allows adjustments to the standard formula or the utilization of alternative methods for sourcing business income. Regrettably, while states routinely use their equitable apportionment powers to increase the tax burden of multistate businesses, they rarely grant comparable relief to taxpayers that request it. This one-way street is not only unfair, but burdensome (beyond any additional tax that might be due) because of uncertainty over whether and when the states might utilize an alternative apportionment method.

Finally, many industries must comply with apportionment rules applicable exclusively to them. For example, some states require trucking companies to apportion their multistate income using a ratio of miles driven in the state to miles driven everywhere,[27] while financial institutions often must use other methods. Other states have moved away from a tax based on income to a gross receipts tax, or rely primarily on resource extraction taxes.

E. THE CHALLENGE OF ACHIEVING CONSENSUS

The foregoing description of the diversity among the states and the complexities associated with identifying and apportioning the tax base among the states in which a business operates – while not exhaustive – prompts the question "Is it possible to achieve consensus?" Based on experience across the country, the challenge will be significant. To be sure, a balance must be struck between the states' legitimate need for revenue and taxpayers' relief from double

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[26] The application of these rules can be tricky. For example, what happens when a company sells its goods to customers located in a state that has chosen not to impose a corporate income tax (*e.g.,* Nevada or Wyoming)?

[27] *See* Md. Regs. Code § 03.04.03.08(E)(2).

taxation of their income and the vagaries of multiple apportionment regimes. Some degree of complexity, however, is inherent in a multijurisdictional tax system, and changes in one area would likely benefit some businesses and disadvantage others, both because different industries have different concerns and because the facts and circumstances of different businesses' operations can vary significantly.

Over the years, there have been repeated efforts to promote state and local tax consistency or uniformity. Some of these efforts have been under the aegis of the Uniform Law Commission (ULC) (formerly known as the National Conference of Commissioners on Uniform State Laws (NCCUSL)), the progenitor of UDITPA, and others have been sponsored by the Multistate Tax Commission, Federation of Tax Administrators, or ad hoc groups of interested parties (such as the National Tax Association's Communications and Electronic Commerce Tax Project). To date, these efforts have met with limited success for a variety of reasons: state economic and budgetary pressures, concerns about state sovereignty, geographic and demographic considerations, and interstate or transnational competitive concerns.

Because of the diversity of views across industries, a one-size-fits-all approach to apportionment may not be uniformly supported by the business community. To be sure, allocation and apportionment of the same income should not occur, but beyond that unanimity is unlikely. Changes to apportionment formulas by definition redistribute the tax burden among taxpayers by altering the measuring stick used to gauge economic activity particular states. For example, a state's changes in its apportionment formula could increase the tax burden on in-state businesses while decreasing the burden on out-of-state businesses. That may run contrary to policy decisions made by states to promote in-state investments.

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In conclusion, Tax Executives Institute thanks the Subcommittee for the opportunity to share our perspective on the complexities of our multistate system in general and apportionment matters in particular. I welcome the opportunity to address any questions.

Respectfully submitted,

Tax Executives Institute, Inc.
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