



TAX EXECUTIVES INSTITUTE, INC.

State and Local Tax Policy Statement Regarding the Application of Alternative Apportionment Methodologies

The U.S. Supreme Court has held a state 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 the services provided by the state.¹ The Court has indicated an apportionment formula is *fair*, under both the Due Process Clause and Commerce Clause of the U.S. Constitution, if the formula satisfies standards of both internal and external consistency. Internal consistency requires if the formula was applied by every jurisdiction, it would result in no more than 100% of the taxpayer's unitary income being taxed.² External consistency, "the second and more difficult requirement," requires "the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated."³ The Court has approved many different apportionment methods and declined to mandate a uniform method for all states.⁴

Most states have adopted statutes imposing a standard apportionment methodology applicable to taxpayers that file a corporate income tax return, unless the taxpayer operates in a specialized industry (e.g., airlines), in which case a specialized apportionment methodology may be applicable. Because the standard apportionment methodology may not accurately reflect how income is attributable to a specific state for all taxpayers, state apportionment statutes typically provide that a taxpayer may request, or a taxing authority may require, the use of an apportionment methodology deviating from the statutory methodology.⁵ The ability to use an apportionment methodology that differs from the statutory methodology is commonly known as "Alternative Apportionment." State tax authorities' use of Alternative Apportionment has increased substantially in recent years, in particular where service providers perform services in one state for the benefit their customers located in a different state.

By way of example, many states have standard apportionment statutes requiring the taxpayer to source service revenues for apportionment purposes to the state where the taxpayer's income-producing activity occurs. Under these statutes, the taxpayer does not source revenues to the state where its customers are located if the taxpayer's income-producing activities occurred outside of that state. However, the state tax authorities for such states will sometimes utilize Alternative Apportionment during audits to source service revenues to the state where the

¹ *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

² *Container Corp. of America v. California Franchise Tax Bd.*, 463 U.S. 159, 169 (1983).

³ *Id.*

⁴ See *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978), *reh'g denied*, 439 U.S. 885 (1978).

⁵ See *Generally* Cal. Rev. & Tax Cd. §§ 25101 through 25141; Ky. Rev. Stat. Ann. §§ 141.010 through 141.421; Fla. Stat. §§ 220.15 through 220.153; N.C. Gen. Stat. § 105-130.4

customer is located despite the standard apportionment statute's requirement for the taxpayer to source revenues based on where the income-producing activities take place.⁶ In addition to imposing interest on such assessments, state taxing authorities also sometimes assert penalties against the taxpayer, notwithstanding the taxpayer filed its return in full compliance with state law.⁷

Tax Executives Institute maintains:

- Alternative Apportionment should only be utilized in unusual circumstances where the statutory formula does not fairly represent the amount of the taxpayer's income attributable to the jurisdiction;
- The party seeking to use Alternative Apportionment should bear the burden of proving, by clear and convincing evidence, Alternative Apportionment is appropriate in the taxpayer's circumstance;
- A taxing authority should promulgate regulations specifying taxpayers within a specific industry are subject to Alternative Apportionment before it can assert on audit a taxpayer is subject to Alternative Apportionment because it operates within a specific industry;
- Taxing authorities should be prohibited from imposing penalties upon tax assessments based on Alternative Apportionment if the taxpayer filed its return in accordance with the statutory apportionment methodology.

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⁶ *Bellsouth Advertising & Publishing Corp. v. Chumley, State of Tennessee*, 308 S.W.3d 350 (2009); *Equifax Inc. v. State Tax Comm'n.*, 125 So.3d 36 (Miss. 2013).

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