

# STATE TAXATION: THE ROLE OF CONGRESS IN DEVELOPING APPORTIONMENT STANDARDS

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## HEARING BEFORE THE SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW OF THE COMMITTEE ON THE JUDICIARY HOUSE OF REPRESENTATIVES ONE HUNDRED ELEVENTH CONGRESS SECOND SESSION

—————  
MAY 6, 2010  
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**Serial No. 111-93**  
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Printed for the use of the Committee on the Judiciary



Available via the World Wide Web: <http://judiciary.house.gov>

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U.S. GOVERNMENT PRINTING OFFICE

56-272 PDF

WASHINGTON : 2010

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**STATE TAXATION: THE ROLE OF CONGRESS  
IN DEVELOPING APPORTIONMENT STAND-  
ARDS**

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**THURSDAY, MAY 6, 2010**

HOUSE OF REPRESENTATIVES,  
SUBCOMMITTEE ON COMMERCIAL  
AND ADMINISTRATIVE LAW,  
COMMITTEE ON THE JUDICIARY,  
*Washington, DC.*

The Subcommittee met, pursuant to notice, at 11:07 a.m., in room 2141, Rayburn House Office Building, the Honorable Steve Cohen (Chairman of the Subcommittee) presiding.

Present: Representatives Cohen, Watt, Scott, and Chu.

Staff present: (Majority) Norberto Salinas, Counsel; Adam Russell, Professional Staff Member; and Stewart Jeffries, Minority Counsel.

Mr. COHEN. The hearing will commence here with the banging of the gavel. [Commenced.]

This hearing of the Committee on the Judiciary, Subcommittee on Commercial and Administrative Law will now come to order. Without objection, the Chair will be authorized to declare a recess of the hearing, and there will be votes at 11:30, so we will have to go and be interrupted at some point.

I will recognize myself for a short statement.

In February, this Subcommittee held a hearing on the state tax nexus, simply, when a state may impose a tax on an individual or business entity.

Today's hearing will focus on that next step, assuming that sufficient nexus is established, how should a state determine the imposed tax. States currently follow formulas to apportion the tax based on several different factors.

They include location of the taxpayer's property, taxpayer's income, and even the taxpayer's payroll within that state. That calculation is simple when the taxpayer only conducts business within the state, of course, but becomes more complicated when the business' goods and services are collected—across state lines.

States must determine what portion of the total value of a multi-state taxpayer's property, and each single state should and can tax what they can get away with and what they should get away with. These calculations could lead to double taxation or possibly, in a very unusual case of somebody who loses their job, undertaxation.

Considering that many states are actively competing for business development investment, especially during the current economic climate, states may create apportionment formulas which favor in-state businesses over multi-state businesses or vice versa. Such apportionment formulas may also bring in much-needed revenue.

But do the apportionment formulas burden interstate commerce, one of the issues we will deal with. Some contend states need to adopt a uniform apportionment standard, however, some of the states may not want to be limited by such standards. Others claim that businesses have already tax planned or have based investment on the differing state tax structures and they don't want to interrupt that process.

It is the role of Congress and this Subcommittee in particular to review whether state taxation affecting interstate commerce is burdensome. Specifically, we should determine whether the differing apportionment formulas utilized in this expanding borderless economy are fair and appropriate.

We should question whether the differing formulas favor in-state taxpayers over multi-state taxpayers. We should consider whether uniform apportionment standards are a better alternative, and would create a competitively neutral playing field for in-state and multi-state businesses.

And we should discuss whether such a standard would lead to a more efficient and robust—we haven't heard robust since the health-care debate—economy.

I thank the witnesses for appearing today, and I look forward to their testimony. And I will now recognize my colleague, Mr. Franks, who is not here. Having done that, I will go right along—ah.

Mr. Coble, would you like to give an opening statement?

Mr. COBLE. [Off Mike.] [Laughter.]

Mr. COHEN. We are lucky to have you. We are all lucky to be here in more ways than one.

With Mr. Coble's sage advice, comments and observations, we will then go onto the witnesses. And the first witness today—and I want to thank everybody for participating. Your written statements will be placed in the record. I ask you to limit your oral remarks to 5 minutes. We have got a lighting system. Green means you are in the first 4. Yellow means you are in your last 1. Red means you should conclude or be finished.

Members will be able to ask you questions. The same 5 minutes prevail.

The first witness is Mr. John Swain. I almost made you Lynn Swann's brother. [Laughter.]

Mr. John Swain, professor of college at University of Arizona, an rival school for Mr. Swann, the Rogers College of Law.

Professor Swain has authored and co-authored numerous books including "The Streamlined Sales and Use Tax," and is a regular columnist for State Tax Notes Magazine. He is a frequent speaker at state and local tax conferences, consults with state governments and other entities on tax law.

Before entering academia, he was with a firm in Phoenix where he practiced in the area of state and local taxation.

Thank you, Professor Swain. And if you would begin your testimony, and your 5-minute light is now on.

**TESTIMONY OF JOHN A. SWAIN, PROFESSOR, UNIVERSITY OF ARIZONA, JAMES E. ROGERS COLLEGE OF LAW**

Mr. SWAIN. Okay. Thank you, Mr. Chairman, and Members of the Committee. And I want to thank you for inviting me to testify today.

As the Chairman noted, there is a problem in state taxation, and that problem is how do we divide the income of a taxpayer who does business in more than one state. And for example, let us imagine a business that has customers all over the United States, does manufacturing in Michigan, has distribution facilities in Tennessee, maybe does R&D in California. How do we determine how much income is earned in each of those jurisdictions? It is a thorny problem. The states have a clever and generally good solution to that problem. It is called formula apportionment.

And what the states do is they compute an apportionment ratio for that business, and that is computed by the average of three ratios. The first is the sales factor, and we take the sales in state over the sales everywhere; that is one ratio. Then we take the payroll in state over payroll everywhere. And we take the property in state over the property everywhere. We get those ratios. We average them. And then we come up with an apportionment formula. We apply that to the total income of that business to determine what income is taxed in that state.

I think it is—whenever you are dividing a pie, I believe it is good to have uniform rules otherwise you run into problem of overallocating or underallocating that pie. For example, let us assume that Iowa has an apportionment formula that relies only to sales which, in fact, is true. And then let us say Illinois has a formula that employs the traditional three factor formula I just mentioned.

And then assume there is a business with all its property and payroll in Illinois that is making sales into Iowa—all its sales are into Iowa. What is going to happen?

Setting aside nexus questions, what is going to happen is Iowa will tax all the income of that business because Iowa only relies on sales, and all the sales are in Iowa. But then when Illinois goes to compute that taxpayer's income, sure, there are no sales in that state, so the sales factor is zero, but all the property and all the payroll are in Illinois, and that matters to Illinois. So Illinois is going to tax two-thirds of that business' income. And that business will pay tax on one and two-thirds of its income.

So that is the problem when we have inconsistent rules. Now, the opposite can happen. Assume the same facts but the business is located in Iowa and making all of its sales into Illinois. Iowa won't tax that business at all even though it has payroll and property in Iowa because Iowa doesn't care. It only relies on a sales factor.

Illinois will only have—the sales factor will be one because all the sales are in Illinois, but there is no property or payroll in Illinois. So that ratio will be one-third. And in that case, that business will only be taxed on a third of its income. So we can undertaxation as well.

In the 1960's and 1970's, there was relative peace in the valley. There was relative uniformity among the states, and they used the three-factor formula I described. More recently, the lid has been blown off of uniformity, largely, because of economic development pressures.

States and taxpayers realizes that every time the business adds property, makes a capital investment, adds payroll in a state, their tax bill goes up. And so in the name of economic development, states have begun to overweight their sales factor which, in effect, lowers the weight of the property and sales factors—excuse me—property and payroll factors to attract business, to have a more favorable business environment.

But in this period where some states are changing and some aren't, we have a lack of uniformity and the risk of overtaxation and, actually, undertaxation.

In my view, there is a predicate for intervention that has been met because of the compliance burdens of non-uniform rules, because of the risk of double taxation. It is a burden of interstate commerce. On the other hand, as I mentioned in my example earlier, there is the opportunity for tax planning and undertaxation which I suppose is less of a concern to Congress. Unless the states come to Congress, you know, hat in hand and say please save us from ourselves, I don't know that they are going to do that. But that would be the other possibility.

Thank you very much.

[The prepared statement of Mr. Swain follows:]

PREPARED STATEMENT OF JOHN A. SWAIN

Testimony of John A. Swain  
Professor of Law  
University of Arizona Rogers College of Law

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

Hearing on  
State Taxation:  
The Role of Congress in Developing Apportionment Standards

*State Tax Apportionment: Basic Concepts, History, and Prospects*

May 6, 2010

### Testimony of John A. Swain

I am John Swain, Professor of Law at the University of Arizona Rogers College of Law. I have devoted most of my professional life to the practice and study of state taxation. I am honored by the Chairman's invitation to testify today. I welcome the opportunity to share with the Subcommittee my views on the role of Congress in state tax apportionment. I do not appear here on behalf of any client, public or private, and the views I am expressing here today reflect my independent professional judgment.

My testimony today addresses mainly state income tax apportionment. I will begin by considering the issue of state tax apportionment in the broader context of state tax jurisdiction. I will then explain the basics of state business income apportionment and demonstrate why uniform division of income rules are desirable. The bulk of my testimony is devoted to exploring the history of state income tax uniformity efforts. While much may have been achieved along the way, in the end, the states have failed to reach their ultimate goal of voluntary conformity with uniform division of income rules. Next, I will discuss why states are abandoning uniformity and trending toward destination-based net income and gross receipts taxes. Finally, I will make a few concluding observations on the role of Congress in state tax apportionment.

#### I. BASIC CONCEPTS AND PRINCIPLES

##### A. The Broader Context: State Tax Jurisdiction

Earlier this year this Subcommittee held a hearing on state tax nexus. The focus of that hearing was the question of when does a state have jurisdiction *over a person or entity* for the purpose of imposing or compelling remittance of a tax. This hearing addresses the companion jurisdictional issue: how do we determine which state or states have jurisdiction *over the subject matter of a tax*, such as property, a sales transaction, or income. The resolution of this question is especially important when the taxable item or activity crosses state borders, because states may assert conflicting claims to tax the same item or activity. Such claims can result in the double taxation of persons engaged in interstate commerce. Conflicting state claims can also put stress on our federal system. For these reasons, it seems quite proper that Congress consider what role, if any, it can play in resolving this potential for friction among the states and in protecting interstate commerce.

##### B. Slicing the Jurisdictional Pie

There are two basic approaches to resolving the problem of determining which state or states have jurisdiction over a taxable item or activity. The first is to assign the whole "pie" to a single state, but to allow others states to take tax bites out of that pie to the extent that a taxable item or activity has a connection with those other states. A credit is then allowed by the state that was initially assigned the whole pie, thus avoiding double taxation. State personal income taxes follow this approach. Personal income taxes paid to the state of residence are measured by the

resident's taxable income wherever earned. The state of residence then generally allows a credit for taxes paid to other states on income earned in those states.<sup>1</sup> In this manner, double taxation is avoided.<sup>2</sup>

The second basic approach to eliminating the risk of double taxation is for each state to tax only the slice of the pie that is attributable to that state. No credit for taxes paid to other states is allowed because (assuming uniformity) the rules are designed so that one and only one jurisdiction will ever have a claim to a particular item or slice of an item. Property taxes on mobile property used in interstate commerce and state corporate income taxes are generally imposed using this approach. For example, states will often value railroad rolling stock for property tax purposes by using a formula that apportions property value based on the ratio of in-state track miles to system-wide track miles (or some comparable measure).

Similarly, states generally employ apportionment ratios to divvy up the corporate income pie for the purposes of imposing corporate income taxes. The most well-known apportionment formula is the one embodied in the Uniform Division of Income for Tax Purposes Act (UDITPA). Very briefly, UDITPA provides that "non-business" income is allocated to states on an item-by-item basis. For example, UDITPA provides that non-business dividends and interest<sup>3</sup> are allocated to the commercial domicile of the taxpayer. With respect to "business income," UDITPA provides for formula apportionment. The business income of a multi-state taxpayer is generally apportioned to a state based on a ratio, which is the average of three factors: the property factor, the payroll factor, and the sales factor. These factors are themselves ratios: The property factor is the ratio of the taxpayer's tangible property in the state to its tangible property everywhere. The payroll factor is the ratio of the taxpayer's payroll in the state to its payroll everywhere, and the sales factor is the ratio of the taxpayer's sales in the state to its sales everywhere. The apportionment ratio is applied to the taxpayer's total income to determine the portion of that income which the state will tax.<sup>4</sup>

For example, consider ABC Corporation:

- It has \$10k of tangible property in State A, and \$100k of tangible property everywhere. Therefore its property factor is 0.10.
- It has \$40k of payroll in State A, and \$200k of payroll everywhere. Therefore its payroll factor is 0.20.
- It has \$300k of sales in State A, and \$1m of sales everywhere. Therefore its sales factor is 0.30.

<sup>1</sup> This is also the approach taken by the federal government to taxation of both personal and corporate income: residents are taxed on all their income, regardless of source, and a foreign tax credit is permitted for taxes paid to other countries on the same income. *See* I.R.C. § 901 et seq.

<sup>2</sup> Double taxation still sometimes occurs, for example when there is disagreement over which state is the state of residence, or when the state of residence refuses to allow a credit for taxes paid to another state because the state of residence does not treat the income that gave rise to that tax as income earned out-of-state.

<sup>3</sup> Interest and dividends can be either nonbusiness or business income.

<sup>4</sup> There is a fair amount of complexity underlying these basic rules. For example, the income and factors of foreign subsidiaries are often not included. Additionally, many states have adopted alternative formulas for special industries.

- The average of these three factors is 0.20  $[(.10 + .20 + .30) \div 3]$ , which is its apportionment ratio. Thus, if it has \$2m of income everywhere, then \$400k (0.20 x \$2m) of that income will be apportioned to State A.
- If the State A tax rate is 5%, then ABC Corporation's tax will be \$20k (5% of \$400k).

### C. The Desirability of Uniform Rules

Without uniform rules, there is a risk of both over-taxation and under-taxation of multi-state businesses. This can be demonstrated by a simple example. Assume that all of a taxpayer's tangible property is in Arizona, but that all of its sales are to California. Assume further that California uses only a sales factor to apportion income, while Arizona uses only a property factor.<sup>5</sup> The result in this example is that the taxpayer would be double taxed on all of its income. The taxpayer would be required to apportion 100% of its income to Arizona (because 100% of its tangible property is in Arizona), and it also would be required to apportion 100% percent of its income to California (because 100% of its sales are to California). Assume now that a competing business has all of its tangible property in California, but makes all of its sales to Arizona. In this case the business would not pay any state income tax at all. Arizona would not tax it because it has no Arizona tangible property, and California would not tax it because it has no California sales.

Both the under-taxation and the over-taxation of multi-state businesses are undesirable because they result in an unlevel economic playing field. Over-taxation of multi-state businesses burdens interstate commerce because firms doing business in only one state are taxed only once on their income. Conversely, under-taxation gives multi-state businesses that are under-taxed an unfair competitive advantage over purely local businesses (as well as over multi-state businesses that pay state taxes on all their income).<sup>6</sup>

Another reason why uniformity is desirable is that it lessens taxpayer compliance burdens. Complying with a multitude of non-uniform rules can be tedious, confusing, and expensive. It may, for example, require a taxpayer to capture information that the taxpayer would not be required to capture under a uniform regime.

However desirable, achieving lasting uniformity has been elusive. I now turn to a brief history of state income tax uniformity efforts.

<sup>5</sup> The Supreme Court has upheld the constitutionality of both single property factor apportionment and single sales factor apportionment. *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920) (single property factor); *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978) (single sales factor).

<sup>6</sup> A complete exposition of these basic principles would require significantly more time than allowed by this hearing. I do not mean to imply, for instance, that each state must impose an income tax or adopt the same tax rate. See generally Reuven S. Avi-Yonah, *International Taxation of Electronic Commerce*, 52 TAX L. REV. 507, 517 (1997) (expressing the "single tax principle" in the context of international taxation).

## II. A BRIEF HISTORY OF EFFORTS TO ACHIEVE STATE INCOME TAX UNIFORMITY<sup>7</sup>

### A. The Early Uniformity Movement

Wisconsin adopted the first state corporate income tax in 1911. Many states quickly followed suit, and by 1932, twenty-two states had adopted a corporate income tax. At the time UDITPA was adopted<sup>8</sup> in 1957, 34 states and the District of Columbia imposed a state corporate income tax. With a few exceptions, the states adopted a formula apportionment approach to dividing the business income of corporate taxpayers. Separate accounting was found to be too cumbersome, expensive, and vulnerable to manipulation, and there was already precedent for formula apportionment in the manner in which states assessed common carriers such as railroads for property tax purposes.

In the absence of a coordinating mechanism, the problem of non-uniform apportionment rules soon arose, and the National Tax Association (NTA)—an organization of accountants, economists, lawyers, tax administrators, taxpayer representatives and others interested in a tax policy—took the lead in the early uniformity movement. The NTA supported voluntary uniformity as opposed to the top down imposition of federal rules, but it candidly recognized the political dimension of the problem:

The only right rule is a rule on which the several states can and will get together as a matter of comity. Getting together by the uniform adoption of some equitable method and finding the right rule of apportionment are, in our opinion, synonymous.<sup>9</sup>

As early as 1920, the NTA proposed a formula employing a property and a business factor. The business factor was actually a combination of two factors—an expense factor and a sales factor. The NTA initially proposed that the numerator of the sales component of the business factor include sales that were chiefly negotiated and executed in the state. Subsequently, the NTA moved toward a destination approach to the attribution of sales, as well as toward advocacy of the so-called three-factor Massachusetts formula (property, payroll, and sales).

Apart from voluntary adoption of uniform rules, many other solutions to the uniformity problem were proposed. For example, taxpayers pursued constitutional litigation in attempt to restrict the freedom of states to adopt disparate formulas. By and large, this litigation was (and continues to be) unsuccessful. The U.S. Supreme Court has never struck down an apportionment formula as facially unconstitutional, and it will sustain the application of a formula, so long as

<sup>7</sup> This part of my testimony draws freely from John A. Swain, *A Brief History of UDITPA*, 49 STATE TAX NOTES 759 (2008). Although we often speak in shorthand about achieving state income tax uniformity, this does not mean, for example, achieving uniform rates. Generally what is meant is achieving conformity to uniform rules for dividing the tax base among the states.

<sup>8</sup> The adoption of UDITPA as a uniform law had no impact on individual states' taxing regimes until the legislatures of those states acted individually to adopt UDITPA.

<sup>9</sup> *Proceedings*, National Tax Association (1922).

the apportionment of income is not “out of all appropriate proportions to business transacted ... in that State.”<sup>10</sup> Other proposals included:

- Federal preemption of state power to impose a corporate income tax
- Federal collection of state income taxes on behalf of the states
- A federally mandated uniform apportionment formula
- A credit for state corporate income taxes paid allowed against the federal corporate income tax (similar to the credit that has been allowed against the federal gift and estate tax for state death taxes)

By the time UDITPA was promulgated in 1957, a substantial consensus had formed around the use of the now familiar sales, property, and payroll factors. Indeed, 20 states employed that three-factor formula at that time. Five states used sales, property, and manufacturing cost factors, and two states employed a sales factor-only approach. Two other states used a two-factor property and gross receipts formula. Additionally, six other formulas were in use.<sup>11</sup>

Despite the consensus that began to emerge around an equally weighted three-factor formula based on property, payroll, and sales, the states actually employed diverse approaches to the computation of these superficially identical factors. The diversity of approaches was most pronounced with the sales factor. A study conducted around the time that UDITPA was promulgated found that 13 states used a “destination” approach to computing the sales factor numerator, seven states used an “origin” approach, four states and the District of Columbia used a “sales activities or solicitation” approach, and four states attributed sales to the state in which the sales contract was “negotiated and executed.”<sup>12</sup>

#### B. Adoption of UDITPA

Notwithstanding the “fine missionary work”<sup>13</sup> that was done during the roughly 40-year period following the adoption of the first state corporate income tax, commentators were skeptical about the prospects for achieving uniformity. As one corporate tax manager put it: “...the really surprising thing is that those who have worked on these committees haven’t thrown in the sponge.”<sup>14</sup> Despite the pessimism, the uniformity logjam finally broke. In 1954, the Controllershship Foundation issued a detailed report on the problem. At the same time, the Council of State Governments initiated a similar study. Later that same year, the National Governors’ Conference recommended that a uniform apportionment formula be adopted, based on the now familiar three-factor formula. In 1957, UDITPA was promulgated by National

<sup>10</sup> *Hans Rees’ Sons, Inc. v. North Carolina ex rel. Maxwell*, 390 U.S. 123, 135 (1931). See also *Moorman Mfg. Co. v. Blair*, 437 U.S. 267 (1978) (upholding the constitutionality of an Iowa single sales factor apportionment statute despite the near uniform adoption by other states of three-factor apportionment). The *Moorman* case is discussed later in my testimony.

<sup>11</sup> See Paul J. Hartman, *State Taxation of Corporate Income from a Multistate Business*, 13 VAND. L. REV. 21, 65-66 (1959) (describing the various formulas in use).

<sup>12</sup> *Id.* at 71-73.

<sup>13</sup> Walter Chwals, *The Uniform Apportionment Formula*, 33 TAXES 212 (1955).

<sup>14</sup> *Id.*

Conference of Commissioners on Uniform State Laws (NCCUSL). The final version of UDITPA embraced the destination approach to the attribution of receipts to the sales factor numerator, except for receipts from services and intangibles, which UDITPA attributed to states using a costs-of-performance (origin-based) approach.

A number of causes contributed to the breaking of the uniformity impasse and the adoption of UDITPA in 1957. First, even in the absence of any overt cooperative effort, states had trended towards use of an equally weighted three-factor formula. Second, high-level state government officials had finally become interested in the issue and had concluded that uniformity was either appropriate or necessary in the political environment of the time.

Third, compromise was finally achieved on inclusion of a sales factor in the uniform formula. Contributing to this compromise was the continued industrialization of the South and West and the concomitant realization of the traditional manufacturing states that they too were market states. Additionally, the revenue impact studies conducted at that time suggested that inclusion of the sales factor would not have as radical an impact on state revenues as was previously feared. Moreover, taxpayers—who generally had been stronger supporters of uniformity than state government, at least in principle—began to support inclusion of the sales factor as they came to understand the effect that it would have on their tax liabilities in their home states.

Fourth, the state corporate income tax burden at that time was relatively low, causing taxpayers to focus more on the administrative convenience of a uniform rule than on the potential tax planning opportunities presented by disparate apportionment methods.

Finally, it must be recognized that no broad political consensus was necessary for the promulgation of a uniform law. John Warren, a California state tax administrator at that time, has noted that only eight states attended a Federation of Tax Administrators' meeting held for the purpose of commenting on a draft version of UDITPA.<sup>15</sup> This foreshadowed the cool reception that UDITPA was about to receive.

### C. The UDITPA Aftermath

UDITPA was not an overnight sensation. During the period 1957 through 1964, only three states—Alaska, Arkansas, and Kansas—adopted UDITPA. At the same time, Congress became increasingly concerned about the impact of state taxes on interstate commerce, and a Congressional Committee (known as the Willis Committee) undertook to study the problem. The Willis Committee issued its report in 1964, concluding, among other things, that the lack of uniform division of income rules was doing substantial harm to the national common market.

Almost immediately after the Willis Committee issued its report, a bill was introduced in Congress to impose a uniform apportionment regime. The bill was met immediately with

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<sup>15</sup> John S. Warren, *UDITPA: A Historical Perspective*, 38 ST. TAX NOTES 125 (Oct. 3, 2005).

“uproarious dissent from both business and state government.”<sup>16</sup> The proposed legislation eliminated income allocation and would instead apportion all types of income based on a two-factor property and payroll formula.<sup>17</sup> The proposed formula excluded the sales factor notwithstanding that the vast majority of states at that time employed a sales factor.

The states responded quickly and dramatically. By 1967, nineteen states and the District of Columbia had adopted UDITPA. Additionally, most of these states entered into a Multistate Tax Compact, agreeing, among other things, to allocate and apportion income pursuant to UDITPA and undertake other joint activities to lessen the administrative and compliance burdens of the state corporate income tax.

By 1978, nearly all states that imposed a corporate income tax had either adopted UDITPA or employed a three-factor apportionment formula similar to the one embodied in UDITPA. In that year, however, a taxpayer unsuccessfully challenged the Iowa single sales factor formula. In *Moorman Mfg. v. Blair*, the Supreme Court held that despite the widespread consensus around the equally weighted three-factor UDITPA formula, the Iowa single sales factor formula did not run afoul of either the Due Process or Commerce Clause.<sup>18</sup> Although the Court recognized that “[t]he prevention of duplicative taxation ... would require national uniform rules for the division of income,” and that “the freedom of the States to formulate independent policy in this area may have to yield to an overriding national interest in uniformity,” it opined further that

the content of any uniform rules to which [the states] must subscribe should be determined only after due consideration is given to the interests of all affected States. It is clear that the legislative power granted to Congress by the Commerce Clause ... 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.<sup>19</sup>

The *Moorman* decision blew the lid off the preexisting consensus. States began to follow Iowa’s lead by either adopting single sales factor formulas or by superweighting the sales factor. Currently, 14 states have adopted single sales factor apportionment,<sup>20</sup> while at least 18 states have double-weighted (or more) the sales factor. About 10 states still employ the traditional, equally-weighted three-factor approach.<sup>21</sup> A related trend has been for states to adopt destination sourcing rules for receipts from services and intangibles, which under UDITPA are sourced on an origin basis.<sup>22</sup> This latter trend heightens the risk of double taxation. For example, if a

<sup>16</sup> Frank M. Keesling & John S. Warren, *California’s Uniform Division of Income for Tax Purposes Act (Part I)*, 15 UCLA L. REV. 156, 159 (1967).

<sup>17</sup> H.R. 11798 (88th Cong.).

<sup>18</sup> *Moorman Mfg. Co. v. Blair*, 437 U.S. 267 (1978).

<sup>19</sup> *Moorman*, 437 U.S. at 280.

<sup>20</sup> Two of those states, Indiana and Minnesota, adopted future effective dates of 2011 and 2013, respectively.

<sup>21</sup> The statistics are approximate because of the nuances of some state tax codes. See CCH Corporate Income Tax Quick Answer Chart ¶ 600-200 (2010) (apportionment formulas).

<sup>22</sup> Approximately 10 states now destination source receipts from services. See John A. Swain, *Reforming the State Corporate Income Tax: A Market State Approach to the Sourcing of Service Receipts*, 83 TUL. L. REV. 285 (2008).

business in State A provides a service for a customer in State B, and if State A uses an origin-based rule while State B uses a destination-based rule, then the business will have to include the same receipts in the numerators of the sales factors in both States A and B. Of course, if all states eventually move to single sales factor apportionment and destination sourcing of services and intangibles, then a basic level of uniformity might again be achieved.

The latest chapter in the uniformity story is a recently abandoned effort by the National Conference of Commissioners on Uniform State Laws (NCCUSL) to re-write UDITPA. The exact reasons for dropping the project are not altogether clear, but a compelling case was made (based largely on the near 100 years of experience that I have just described) that state legislatures have little real interest in pursuing division of income uniformity.

### III. The Infatuation with the Sales Factor

Perhaps a more precise explanation for the states' failure to achieve uniformity is that they operate in a competitive environment that prevents them from achieving it under the current UDITPA regime. This is because the UDITPA payroll and property factors have the effect of increasing a firm's state income tax when it makes in-state investments. Thus, given a choice, a firm will invest in a jurisdiction whose tax system does not "punish" its investment decisions, for example, a state that has adopted single sales factor apportionment.

Indeed, ever since the first state corporate income taxes were adopted, there has been a "megatrend" away from origin-based apportionment and towards destination-based apportionment. As I have just described, while the states initially employed apportionment formulas based largely on factors giving weight to the state of production, a number of states quickly added sales factors to the mix, although the manner in which the sales factor numerator was determined (such as the place where the contract was negotiated or accepted) often still gave significant weight to the state of production. Later, a consensus began to form around a destination approach to the sales factor, as well as around the inclusion of the sales factor in the apportionment formula generally. Now, as I have noted, most states either super-weight the sales factor or apportion income based on the sales factor alone. It is difficult to identify a braking mechanism in this trend towards a de facto corporate gross receipts tax. Indeed, the recent adoptions of receipts-based taxes by states such as Michigan, Ohio, and Texas continue to reflect this megatrend, and California is currently considering such a proposal.<sup>23</sup>

### IV. The Role of Congress

I should make it clear that I have not been asked to make any specific recommendations today about what, if anything, Congress should do to address the problem of coordinating state tax

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Receipts from the sale of tangible personal property have always been sourced on a destination basis under UDITPA.

<sup>23</sup> A strong argument can be made that single sales factor apportionment of income causes the state corporate income tax to operate more like a sales or gross receipts tax, and that much of the economic incidence the tax may, in fact, fall on in-state purchasers. In effect, states are forced to tax their own market because of the relative mobility of capital.

apportionment rules. Quite candidly, I am not certain what recommendations I would make if asked. Instead, I offer three concluding observations.

First, given the historical record, it is unlikely that the states will adopt uniform apportionment rules on a cooperative voluntary basis. They have never done so in the near 100-year history of the state corporate income tax. Notably, the only time that the states approached uniformity was under the palpable threat of Congressional intervention.

Second, a prima facie case exists for federal intervention, because the states' failure to coordinate their apportionment rules has resulted in (a) the risk of multiple taxation of interstate commerce, and (b) greater tax compliance burdens on interstate businesses than would arise under a uniform regime.<sup>24</sup>

Third, more fact finding is needed to determine the actual magnitude of these burdens on interstate commerce. For example, it may be that taxpayers, as rational economic actors, have been able to plan their affairs to minimize actual double taxation and benefit from the opportunity for under-taxation that is presented by non-uniform apportionment rules. (This is not to say, however, that the economic inefficiencies caused by a tax regime that motivates firms to distort their behavior to avoid tax might not be a matter of national concern.) Additionally, although compliance with non-uniform rules is more costly as compared to compliance with uniform rules (all else being equal), taxpayers reporting to single sales factor jurisdictions are not required to compute property or payroll factors for those jurisdictions, which somewhat lessens their overall compliance burden. Finally, the current trend toward destination-based single sales factor apportionment may eventually reduce the risk of multiple taxation and result in a sort of de facto uniformity, driven not by a voluntary cooperative effort, but rather by the invisible hand of state tax competition.

It would be naïve for me to suggest that the general trend toward destination-based taxation will result in uniform rules. This is particularly evident when examining the new, business receipts-based taxes that have been recently adopted in Michigan, Ohio, and Texas, and the business net receipts tax proposal currently under consideration in California. Nevertheless, a consensus around single sales factor apportionment and destination sourcing of receipts may still decrease the risk of multiple taxation. Apportionment considerations aside, however, the question remains as to whether these emerging modes of state taxation reflect good tax policy.

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<sup>24</sup> See generally William F. Fox & John A. Swain, *The Federal Role in State Taxation: A Normative Approach*, 60 NAT'L TAX J. 611 (2007).

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Mr. COHEN. Thank you for your testimony.

And we now recognize Mr. Jim Eads. Mr. Eads has been with us before, executive director of the Federation of Tax Administrators since September where he kept capping a 30-year career in state

tax work. He leads the FTA staff in D.C., and he represents the 50 states, the District, and New York City.

Previously, he was director of public affairs for Ryan, a major tax consulting company, where he represents their clients regarding state tax policy and legislative proposals. Past president of the National Tax Association, former chairman of Electronic Commerce Task Force on the Council on State Taxation.

Thank you, Mr. Eads. The light begins.

**TESTIMONY OF JAMES R. EADS, JR., EXECUTIVE DIRECTOR,  
FEDERATION OF TAX ADMINISTRATORS**

Mr. EADS. Thank you, Mr. Chairman, and Members of the Committee. Thank you for opportunity to appear before you today.

As the Chairman said, my name is Jim Eads. I am the executive director at the Federation of Tax Administrators. The Federation is an organization of the state tax agencies of all 50 states as well as the District of Columbia and New York City.

As you know, Navjeet Bal, the commissioner of revenue for the Commonwealth of Massachusetts was scheduled to present this testimony at the hearing in March which was rescheduled today. She could not be here today, and I am honored to be here representing her and the Federation of Tax Administrators.

We gather at a difficult time for state governments. The recession has taken its toll on our citizens and creates the demand for state services and caused record declines in state tax revenues. States have responded by cutting services, laying off state workers, drawing down rainy-day funds, and, in some cases, raising taxes.

The Federal Government has been a vital partner to the states, providing financial assistance, which has allowed the states to meet their balanced-budget requirements without even deeper budget cuts. As the states prepare their budgets for the upcoming fiscal year, it appears that state revenues are no longer in freefall, but state budgets still face enormous challenges as Federal assistance ends, demand for state services remains strong, and state revenues are well below pre-recession levels.

You asked that we discuss the general issue of apportionment of corporate income for state tax purposes and specifically to address the question of what role the Congress has or should have in developing apportionment standards.

This hearing follows on a hearing in February that the Chairman mentioned on nexus issues. You heard then from Utah Tax Commission Chairman Bruce Johnson, and I repeat now, a respectful request that Congress continue to refrain from Federal legislation in areas of state taxation, including apportionment, that are best left to the states. An honest and healthy respect for our Federal system requires no less.

For the better part of 50 years now, the states have found a workable solution to the issue of determining a corporation's taxable income through the application of formulary apportionment. It has served as a stable and widely accepted means to approximate the extent of a business' activity within a state and has proven sufficiently flexible to address a changing economy.

As that economy has evolved toward a service and information economy, states have responded by adjusting their apportionment

formula and also by adopting alternative apportionment regulations for particular industries such as financial institutions, telecommunications, airlines, railroads, trucking companies, television and radio broadcasting.

Despite business' opposition, the multi-state tax commission is undertaking an effort to modernize and standardize the sales factor for services and intangibles to better reflect today's economy and to promote uniformity amongst the states with respect to this important sector of the economy.

We believe that the states are the best laboratories for the evolution of apportionment structures that significantly affect their own fiscal destiny. State tax administrative agencies are confronted daily with issues related to state corporation taxation. They have the knowledge, the experience and expertise to craft what we believe are workable solutions.

Given the diversity and complexity of the American economy and the rapid changes that it is undergoing, it is imperative for both the business community and the states to maintain their flexibility to adjust the apportionment formula to address particular industries and to respond to particular needs of that state.

Any type of Federal intervention in this effort would have a deleterious effect on the flexibility that is in the current apportionment structure and would, in all likelihood, have unintended consequences. Given their expertise, their motivation, and their on-the-ground relations with the business community, the states are best positioned to revise formulary apportionment as it applies to state taxation of interstate commerce.

Thank you for your time and for your consideration of this important issue, and I will be glad to respond to questions at the appropriate time.

[The prepared statement of Mr. Eads follows:]

PREPARED STATEMENT OF JAMES R. EADS, JR.

**Statement of  
James R. Eads, Jr.  
Executive Director  
Federation of Tax Administrators**



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

**State Taxation: The Role of Congress in Developing Apportionment Standards**

**May 6, 2010**

*NOTE: This testimony was originally prepared by The Honorable Navjeet Bal, Commissioner of Revenue of the Commonwealth of Massachusetts, to be presented on behalf of the Federation of Tax Administrators at a hearing originally scheduled for March 11, 2010. When the hearing was rescheduled to this day and Commissioner Bal could not be present, she graciously allowed her testimony to be delivered by Mr. Eads. The Federation of Tax Administrators is an organization of the state tax agencies of all fifty states, as well as the District of Columbia and New York City.*

Statement of

Navjeet K. Bal

Commissioner of Revenue

Commonwealth of Massachusetts



Appearing on behalf of the

Federation of Tax Administrators

Before the

Subcommittee on Commercial and Administrative Law

Committee on the Judiciary

United States House of Representatives

March 11, 2010

Hearing:

State Taxation: The Role of Congress in Developing Apportionment Standards

**Statement of  
Navjeet K. Bal  
Commissioner of Revenue  
Commonwealth of Massachusetts  
Appearing on Behalf of the  
Federation of Tax Administrators**

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

**Hearing:**

**State Taxation: The Role of Congress in Developing Apportionment Standards**

Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to appear before you today. My name is Navjeet Bal, and I am the Commissioner of Revenue for the Commonwealth of Massachusetts. I am honored to be here today, representing tax administrators from across the country, and the Federation of Tax Administrators. The FTA is an organization of the state tax agencies of all fifty states, as well as the District of Columbia and New York City.

As you know, we gather at an extraordinary time for state governments. The same “Great Recession” that has taken its toll on our citizens and increased the demand for state services has caused record declines in state tax revenues. The most recent report by the Rockefeller Institute of Government noted that state tax revenues have declined across all tax types – personal income tax, sales tax and corporate tax – for a record-breaking five consecutive quarters, and are expected to remain weak at least through the first quarter of 2010<sup>1</sup>. States have had to respond

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<sup>1</sup> “State Revenue Flash Report”, Lucy Dadayan, Rockefeller Institute of Government, February 23, 2010.

by cutting services, laying off state workers, drawing down on rainy-day funds and, in some instances, raising taxes. The Federal government has been a vital partner to states, providing increased federal financial assistance during this critical time, which has allowed states to meet their balanced budget requirements, without deeper budget cuts. As the states prepare their budgets for the upcoming fiscal year, which for many of us starts on July 1, it appears that state revenues are no longer in a free-fall. State budgets, however, still face enormous challenges as the additional federal assistance recedes, demand for state services remains strong and state revenues are well below their pre-recession levels.

You have asked this panel to discuss the general issue of apportionment of corporate income for state tax purposes, and specifically to address the question of what the role of Congress should be, if any, in developing apportionment standards. This discussion is a follow up to a hearing that was held last month on nexus issues and state taxation. I would echo the request of my distinguished colleague from Utah, Bruce Johnson, and respectfully ask that Congress continue to respect the sovereignty of the states and refrain from federal legislation in the area of apportionment for state tax purposes. Apportionment is a means to attribute a business entity's income to and among the various states in which the entity does business. Apportionment methodologies have been developed, over time, by the states in response to changes in the American economy. That responsiveness and flexibility have been critical to the states' ability to respond to changes in business, forms of commerce and means of corporate income creation.

While there are still challenges, and likely always will be, states are the best laboratories for the evolution of apportionment structures. State tax administrative agencies are confronted daily with issues related to state corporate taxation, and they have the knowledge, experience and expertise to craft workable solutions to challenges to the apportionment structure. Furthermore, state tax agencies already have the authority and are best positioned to work with the business community, governors and state legislatures in developing statutory and regulatory changes necessary to respond to changes in business. Working either on their own, or through national organizations such as the Uniform Law Commission or the Multistate Tax Commission, states have been able to adjust their apportionment statutes in a deliberative and granular manner as business models have developed.

State income taxation of corporations has evolved over the decades as commerce and industry in America have grown and expanded beyond state lines. Taxation of corporate activity that occurs solely within a state's borders has been a relatively simple affair. That corporate entity's net income, derived from its business activity, is subject to taxation by its state of domicile, in accordance with that state's corporate tax structure and rates. That remains true to this day. Once commerce began to cross state lines, however, such as with railroads and common carriers, questions arose about the level of activity that subjected a corporation to taxation within a state (i.e. *nexus*), and once that was determined, how to divide that corporation's income amongst the states with a claim to it (i.e. *apportionment*). In today's modern economy -- with corporate structures that span the globe, the prevalence of electronic commerce, and the growing importance of the service economy and the sale and licensing of intellectual property and other intangibles -- these questions have grown in complexity.

In response to the need to determine how best to apportion business income amongst the states, states developed a widely-accepted formula that ascertains the amount of property, payroll and sales of a given company within a given state against the amount of property, payroll and sales of that company everywhere. After weighting these factors, the resulting percentage is then multiplied against the company's taxable net income producing apportioned net income that is then taxed in accordance with the given state's corporate tax structure. This so-called three-factor apportionment (a type of formulary apportionment) has its origins in my home state of Massachusetts back at the beginning of the last century, and has developed, been codified and evolved over time in response to changes in the American economy. Apportionment is a complex and elegant arrangement that has provided stability to states and business taxpayers, and yet has proven to be flexible and subject to change as needed to best reflect how and where business income is generated. Federal imposition of an apportionment structure would prove to be cumbersome and inflexible in responding to changes in the economy and in how and where corporate income is created and where it should be subject to taxation.

#### **Constitutional limitations**

The Commerce Clause of the United States Constitution is the source of federal limitations on state taxation of corporations. Article 1, Section 8, Clause 3 of the Constitution

empowers Congress “to regulate Commerce with foreign Nations, and among several States and with the Indian Tribes.” While states are free to regulate commerce within their borders, their ability to regulate interstate and foreign commerce is limited by the Commerce Clause. In *Complete Auto Transit Inc.v. Brady* (1977), the United States Supreme Court held that state income taxes on companies engaged in interstate commerce were not, *per se*, unconstitutional, and that businesses engaged in interstate commerce could be required to shoulder their share of the burden of state taxations. The Court also identified four criteria to judge the constitutionality of state tax law pursuant to the dormant Commerce Clause:

- (1) The tax must be applied to an activity with substantial *nexus* with the state;
- (2) The tax must be *fairly apportioned* to activities carried on by the taxpayer in the state;
- (3) The tax must *not discriminate* against interstate commerce; and
- (4) The tax must be *fairly related* to services provided by the state.

#### **Apportionment**

Formulary apportionment has been widely accepted by the states and by the business community as a method to approximate the extent of a business’s activity within a state, and thereby to reflect the portion of its business income that is taxable in that state. While the earliest apportionment formulas used only property to measure the amount of a business’s income attributable to a particular state, the states soon recognized that this approach favored the so-called “production states” at the expense of the so-called “market states,” a tension that continues to this day. The property, payroll and sales factors that comprise the three-factor apportionment formula are proxies for the extent of the capital, labor and markets that a business has within a state.

In 1957, the National Conference of Commissioners on Uniform State Laws (NCCUSL) issued the Uniform Division of Income for Tax Purposes Act (UDITPA), which adopted the Massachusetts three-factor formula. UDITPA also distinguished business income, which is subject to the apportionment formula from non-business (or investment) income, which UDITPA treated as allocable to a particular state. In 1967, the Multistate Tax Compact was established which incorporated UDITPA into its model apportionment provisions. The Compact also created the Multistate Tax Commission (MTC) to promulgate regulations interpreting UDITPA. States joining the Compact have to adopt UDITPA (or offer it as an alternative method). Thirty-

six states and the District of Columbia have now adopted UDITPA, either on its own or as part of the Compact or both. Formulary apportionment, and the concepts reflected in UDITPA have held up well over the past fifty years in part because the states have been able to adapt the formulary apportionment approach to address developments in the economic marketplace and changes in the nature of business.

The Supreme Court has upheld a variety of apportionment formulas under the Commerce Clause, including three-factor apportionment. Indeed, in *Moorman Mfg. Co. v. Bair* (1978), the Supreme Court recognized that states may have different apportionment formulas (such as single sales factor in Iowa and three-factor apportionment in Indiana ) that may result in taxation by the states in the aggregate of more or less than the full amount of income of a particular business taxpayer. The Court did not, however, find that the Iowa's single sales factor apportionment structure was unconstitutional simply because it might lead to an overlap in taxation with Indiana's more traditional, three-factor formula. The Court was reluctant to engage in "extensive judicial law-making" by applying the Commerce Clause to test particular state apportionment structures. Subsequent Court cases have, in recognition of the difficulties inherent in perfectly determining an apportionment percentage, required a taxpayer seeking to contest the application of a state's apportionment percentage to prove by "clear and cogent evidence" that the application of the percentage is "out of all proportion" to the business of the taxpayer as conducted in the state.

***Apportionable vs. Allocable income.*** As a threshold matter, one must decide whether a taxpayer's business income (that is, its income derived from its trade or business) is subject to taxation in more than one jurisdiction, and therefore should be apportioned between the multiple jurisdictions. So, for example, in Massachusetts, our apportionment statute (M.G.L. c. 63 §38) states that all of a corporate taxpayer's taxable net income is allocated to Massachusetts if the taxpayer does not have income from business activity that is taxable in another state. A business is taxable in another state if it is subject to tax in that state or if the state has jurisdiction to impose a net income tax on that business, regardless of whether it actually does. If a taxpayer does have business income that is taxable in another state, then it must apportion that income. Most corporations taxable in Massachusetts are required to use the three-factor apportionment formula (with a double-weighted sales factor) to determine the amount of its income that is

taxable in Massachusetts. Manufacturing corporations and certain mutual fund service corporations use a single sales factor formula in Massachusetts.

***The three-factor apportionment formula.*** The UDITPA/three-factor formula multiplies a corporation's net taxable income by a fraction, the numerator of which is the property factor, plus the payroll factor plus the sales factor, and the denominator of which is 3. The apportionment formula was developed at a time when commerce consisted mostly of manufacturing and mercantile businesses, and the production and sale of tangible goods, and gave equal weight to each of the three factors. The property and payroll factors represented the contribution of the so-called "production" states where a taxpayer's manufacturing plant or retail store would be located. The sales factor was meant to recognize the contribution of the so-called "market" states in providing a market for a taxpayer's goods. As the American economy has changed over the past century, the property and payroll factors have remained fairly constant. The sales factor, however, has come under pressure to adapt to the rise of the service economy as well as the sale and licensing of intangible property (e.g. patents, know-how, trademarks and copyrights). Over time, many states have moved to a double-weighted sales factor or even a single sales factor to place greater emphasis on the importance of a taxpayer's market in the generation of its income. In addition, a number of state statutes and regulations have modernized their sales factor provisions as they relate to services and intangibles, to place emphasis on where the services and intangibles are actually used or consumed.

***Property factor.*** The property factor is a fraction itself, the numerator of which is generally the average value of a corporation's real and tangible personal property owned or rented and used in a state during the taxable year and the denominator of which is the average value of all the corporation's real and tangible personal property owned or rented and used during the taxable year.

In order to minimize inconsistencies caused by different depreciation schemes amongst the states, the average value of property is generally defined to be its original cost, increased to reflect capital additions or improvements, and decreased to reflect portions of the property that are sold or disposed of during the year, with no adjustments made for depreciation.

In limited circumstances, states may include certain intangible property in the property factor. For example, under Massachusetts law (which is based on an MTC model statute) the

property factor for financial institutions includes the average value of the financial institution's loans and credit card receivables that are located within the Commonwealth during the applicable taxable year in the numerator, and includes the value of loans and credit card receivables everywhere in the denominator. Both loans and credit card receivables are valued at their outstanding principal amounts, giving recognition to the value of these types of intangible property for financial institutions.

**Payroll factor.** The payroll factor is the simplest and least controversial of the three factors. The payroll factor is a fraction, the numerator of which is the total amount paid by a corporation in a state as compensation, and the denominator of which is the total amount of compensation paid by the corporation.

Specific provisions under the payroll factor address employees who work in multiple jurisdictions, independent contractors, "leased" employees and temporary employees. While the payroll factor has been the simplest to administer, even here we see the importance of providing flexibility to the states to respond to new business models, such as the growth of employee leasing companies.

**Sales factor.** The sales factor has been the subject of the most scrutiny and change over the last fifty years. The purpose of the sales factor is generally to recognize the contribution of the market in creating income for corporations, and this has the effect of spreading income from production states to market states. While the sales factor was developed in the context of an economy that was predominantly composed of manufacturing and the sale of tangible goods, the sales factor typically encompasses all "gross receipts" generated as business income (i.e. not investment income), including, among other things, receipts from the sale of goods, income derived from services, rental income and income from the sale and licensing of intangibles.

**Sale of tangible goods.** Prior to UDITPA, there were three different rules used for the sourcing of sales of tangible goods for purposes of the sales factor. The "origin rule" allocated sales to where the orders for goods were filled. The origin rule duplicated the property and payroll factors and was subject to manipulation as taxpayers would maintain inventories in low-tax or no-tax states. The "destination rule" allocated sales to where the goods were shipped or where the purchaser is located, thereby recognizing the contributions of the market. The

“solicitation rule” allocated sales to the place where the employee activity occurred that was responsible for the sale.

UDITPA adopts the destination rule for determining where sales are made. The destination rule balances the property and payroll factors which favor the production state, and gives credit to the market state in the creation of corporate income. UDITPA has two important exceptions to this rule.

The first is for sales to the U.S. government, which can be thought of as present in all fifty states. Such sales are allocated to the location of the office, warehouse or factory from where the goods were shipped.

The second exception is instances in which a taxpayer is not subject to taxation (because it does not have sufficient nexus) in the destination state. In that case, UDITPA “throws back” the income to the origin state, and thereby avoids “nowhere” income that is not taxable in any state. Because the throwback rule may be viewed as overweighting the contributions of the origin state (which may also be where the property and payroll factors are higher), some states have adopted a “throw out” rule with eliminates the sale from both the numerator and the denominator, thereby allocating the net income from that sale amongst the several states.

*Sales of intangibles and services.* Section 17 of UDITPA states that sales other than sales of tangible property are generally attributed to a state based on where the income-producing activity is conducted. If such activity occurs in multiple states, then sales are attributed to the state with the greater proportion of the income-producing activity based on where the costs of performance are predominantly incurred. This tends to duplicate the payroll and property factors, and is distortive because it allocates all of the sales to the state that has the largest percentage of the income-producing activity, even if that percentage is only slightly larger than the state with the next largest amount of income-producing activity. Further difficulties arise in identifying the relevant “income-producing activity,” as well as its cost and location.

Given the move by most states to either a double weighted sales factor or a single sales factor, the distortion caused by the cost of performance rule in over-emphasizing the production states, and under-counting the contributions of the market states, and the growth of the service economy, more and more states have been moving away from the strict cost of performance rules. Instead, states are looking to where the benefit or service is received, where the service is

performed or using a proportional cost of performance measure to more fairly apportion the sales factor related to services.

*Alternative Apportionment Methods.* The generally applicable apportionment factors described above work well as applied to a majority of taxpayers. States, however, have the authority to issue alternative apportionment regulations for particular industries, and particular business taxpayers have the ability to request alternative apportionment treatment, in both cases to address distortions caused by the apportionment factors as they are applied to a particular situation. It is this flexibility that is critical to states' ability to respond to changes in the marketplace and developments in how corporate income is created.

In some instances, states have adopted alternative apportionment regulations, based often on model statutes or regulations issued by the MTC, to address particular industries such as financial institutions, telecommunications, airlines, railroads, trucking companies and television and radio broadcasting. The MTC, through its working groups and sub-working groups, has developed these model alternative apportionment statutes or regulations to address particular distortions in the apportionment formula as it is applied to a particular industry. Representatives of the business community attend the MTC working group meetings, and provide input, although they are not voting members. Once the model statutes or regulations have been approved in accordance with MTC's procedures, states may adopt them in response to their own needs. It should be noted that states embrace, for the most part, uniformity in how the apportionment factors are developed, although they may differ on the weighting of the three factors within the apportionment formula.

In other cases, states have developed their own statutory or regulatory responses to developments in business. For example, Massachusetts has specific provisions dealing with the determination of the sales factor and the licensing of intangible property. Massachusetts law states that the income-producing activity related to the licensing of intangible property shall be considered to be in Massachusetts if the intangible property is used in Massachusetts. Intangible property includes copyrights, patents, trademarks, tradenames and similar intangibles where the use of the property may be transferred separately from ownership.

Royalties or other licensing fees paid for marketing intangibles such as service marks, trademarks or tradenames, are apportionable to Massachusetts to the extent that the goods or

services employing such marketing intangibles are sold to Massachusetts customers, again recognizing the “use” of those intangibles. Licensing fees for intangibles not used in the marketing of other goods, such as the license of a patent for use in a manufacturing process, are attributed to the Commonwealth to the extent that such patent is actually used in the state.

While these licensing provisions are not part of an MTC model provision, at least six other states have particular provisions addressing the apportionment of income from the licensing of intangible property rights for purposes of the sales factor. States have been able to respond to the vast increase of the importance of the intangible property sector of the American economy, and the increasing role that income from the sale or licensing of such intangible property plays in the creation of corporate taxable income. This is an instructive example of the importance of flexibility and control for states over the apportionment factors to respond to changes in the economy.

*UDITPA update.* In 2006, in an effort to promote greater uniformity and ease of compliance in the treatment of sales of services and the sale and licensing of intangible property, the MTC initiated an effort to update and revise Section 17 of UDITPA to reflect the changes in the American economy. The Uniform Law Commission (ULC), as successor to NCCUSL, also participated in this effort, as the UDITPA is a ULC model statute. While the ULC ultimately decided that UDITPA should be revisited in its entirety, the MTC has focused on a limited number of issues, with the most prominent being an update and revision of Section 17. There has been significant resistance from the business community to any efforts to update and standardize UDITPA and promote greater uniformity with respect to Section 17. The MTC is nevertheless moving forward with its efforts to modernize Section 17 and other limited provisions of the Compact.

### **Creating Workable Solutions**

The fair apportionment of corporations’ taxable income amongst the states is a complex and challenging one. For the better part of fifty years now, the states have found a workable solution through the application of formulary apportionment that has served as a stable and widely accepted means to approximate the extent of a business’s activity within a state, and has proven sufficiently flexible to address the changing economy. Formulary apportionment has

been seen as a fair way to apportion income derived from business between the production states and the market states through the property, payroll and sales factors. As the American economy as evolved towards a service and information economy, states have responded by adjusting their apportionment formulae and also by adopting alternative apportionment regulations for particular industries. There has been an organic development of the alternative apportionment provisions through the MTC and within the states, giving states the flexibility to respond to changes in industry. The proliferation of states adopting a double-weighted sales factor or single sales factor (or both, in the case of Massachusetts) is further evidence of the responsiveness and flexibility of the current apportionment structure, which allows governors and legislators to respond to the nature of the economy and the interests of the business community within their borders. The MTC and the ULC each provide a deliberative forum for the states and business interests to consider potential changes to UDITPA and the Compact, and to achieve greater uniformity in state approaches.

Given the diversity and complexity of the American economy, and the rapid changes that it is undergoing, it is imperative for both the business community and the states to maintain the flexibility they need to adjust the apportionment formula to address particular industries or to respond to business needs within a particular state. Any type of federal intervention in this effort would have a deleterious effect on the flexibility that is in the current apportionment structure, and would in all likelihood have unintended consequences resulting in distortions in how and where business is conducted. Given their expertise, motivation and their on-the-ground relations with the business community, the states are best positioned to revise formulary apportionment as it applies to state taxation of interstate commerce.

I thank you for your time and for your consideration of this important issue.

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Mr. COHEN. Thank you, sir.

We are approaching a record, two witnesses who have not gone to the red light.

You are on the spot, Mr. De Jong.

Mr. De Jong is a tax counsel at Tax Executives Institute, Inc. He focuses primarily on state and local tax issues, drafted several Su-

preme Court amicus briefs, written advocacy pieces on issues ranging from economic nexus to state add-back statutes and penalties.

Prior to joining TEI, he worked in the McLean, Virginia, office of Ernst and Young. The majority of his time was spent on state and local tax practices, assisting clients with a broad variety of issues.

Thank you, Mr. De Jong. Don't feel any great, you know, burden, but it is all on you. [Laughter.]

**TESTIMONY OF DANIEL B. DE JONG, TAX COUNSEL,  
TAX EXECUTIVES INSTITUTE, INC.**

Mr. DE JONG. Thanks for taking away that burden. Is this working for you?

Mr. COHEN. Your time started.

Mr. DE JONG. Okay. [Laughter.]

Good morning, and thank you for your invitation to Tax Executives Institute to participate in this hearing and to provide the business perspective on issues related to the apportionment of income for state corporate tax purposes.

Founded in 1944, TEI is the preeminent worldwide association of in-house tax professionals with more than 7,000 members representing over 3,000 of the world's largest businesses located in the United States, in Canada, Europe, and Asia.

My testimony today will focus on two areas. First, I will discuss the practical effects of the current patchwork of state apportionment rules and how they affect multi-state businesses. Second, I will describe the challenges that exist to achieving consensus in this area.

But before jumping into apportionment, I think it is also important to note that complexity exists in determining the tax base, the pie that Mr. Swain described, that must ultimately be divided among the states. This includes determining which entities must be included in a tax return which can be complicated, in part, because of the general lack of uniformity among the states.

After identifying the entities to be included in each state tax return and the tax base of those entities, businesses must apportion that income to the various states in which they have nexus. For the reasons outlined by Professor Swain, many states have moved away from a standard formula based on a corporation's property, payroll, and sales and have used their apportionment formulas to benefit and encourage in-state investment.

For example, by moving the payroll and property factors out of the apportionment calculation, the state can benefit in-state businesses by eliminating the ratios tied to the production of a taxpayer's goods and services. The resulting lack of uniformity increases the compliance burden on multi-state business.

Perhaps the most striking example of this disconnect is the manner in which receipts from the sale of services and intangibles are sourced for purposes of the sales factor. Under many state statutes, taxpayers must source those receipts to the state in which the income-producing activity is performed. Many other states, however, have begun to source sales to the location where the customer receives the benefit of those services.

Inconsistent application of these rules can result in both double taxation and taxation of less than one hundred percent of a taxpayer's income. TEI's written statement includes an example of a taxpayer that provides computer help desk services and ultimately paid tax twice on half of its income as a result of the varying sourcing rules applicable to multi-state service providers.

The example also shows that these inconsistent rules can work in favor of the taxpayer. By moving its headquarters from one state to another, the taxpayer in that example would pay state income taxes on only half of its income. While the example may seem only an interesting hypothetical, situations of a similar nature are not uncommon for businesses across the country.

This brings us to the question: "Is it possible to achieve consensus on a uniform apportionment standard?" Based on experience across the country, the challenge will be significant. Some degree of complexity is inherent in any multi-jurisdictional tax system. Changes in one area would likely benefit some businesses and disadvantage others.

This occurs because the facts and circumstances of each business can vary by industry, geographic location, and other factors. Over the years, there have been repeated efforts to promote state and local tax consistency and uniformity. These efforts have, for the most part, 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 international competitive concerns.

A one-size-fits-all approach to apportionment may not be uniformly supported by the business community. For example, a uniform apportionment formula that includes a payroll or property factor would increase the state tax burden on businesses that located production facilities in states that offered single-sale-factor apportionment formulas in order to attract in-state investment. That may also run contrary to policy decisions made by states to promote in-state investments.

In conclusion, Tax Executives Institute thanks the Subcommittee for the opportunity to share our perspective on the complexities of our multi-state tax system in general and apportionment matters in particular. And with 25 seconds to spare, I welcome the opportunity to answer any questions. [Laughter.]

[The prepared statement of Mr. De Jong follows:]

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**Statement**  
**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**  
**May 6, 2010**

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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. 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."<sup>1</sup>

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.<sup>2</sup> 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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<sup>1</sup> *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 192 (1983).

<sup>2</sup> "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](http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm) (last visited April 26, 2010).

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

TEI's 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**

In February, the Subcommittee heard testimony on the issue of state tax nexus. Because the concept of nexus limits the states' right to tax a nonresident, multistate business, crossing the nexus threshold can trigger the requirement to file a tax return in a state and necessitate calculations to determine the tax due to the state, which includes properly apportioning the taxpayer's income among the states in which the taxpayer conducts business.

Before applying an apportionment ratio, 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.

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<sup>3</sup> *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](http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_09_complete_en.pdf) (last visited April 26, 2010).

For example, many states require taxpayers to “add back” the federal domestic 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 differ from state to state.

#### **B. CONSTITUTIONAL LIMITATIONS ON APPORTIONABILITY**

In order to encourage the free flow of trade throughout the states, the 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.<sup>4</sup> Permitting states to apportion that income would result in the state’s overreaching and 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.”<sup>5</sup> The Court’s decisions require 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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<sup>4</sup> 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.

<sup>5</sup> *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 439 (1980).

activities;<sup>6</sup> the Court has described a unitary business relationship as one marked by “functional integration, centralization of management, and economies of scale.”<sup>7</sup>

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.<sup>8</sup> 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.”<sup>9</sup> 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 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.

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<sup>6</sup> *Connecticut General Life Ins. Co. v. Johnson*, 303 U.S. 77, 80-81 (1938).

<sup>7</sup> *Mobil Oil Corp.*, 445 U.S. at 438.

<sup>8</sup> *Id.* at 439.

<sup>9</sup> *Id.* at 441-42.

### 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 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.”<sup>10</sup> 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.”<sup>11</sup> The Supreme Court has permitted the use of mandatory unitary combined reporting in a number of cases.<sup>12</sup>

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

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<sup>10</sup> *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 164-65 (1983).

<sup>11</sup> *Pioneer Container Corporation v. Beshears*, 684 P.2d 396, 399 (Kan. 1984).

<sup>12</sup> See e.g., *Container Corp., supra*, and *Barclays Bank PLC v. Franchise Tax Board*, 512 U.S. 298 (1994).

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 individually have nexus there.<sup>13</sup> 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.<sup>14</sup>

For businesses with international operations, the identification of the entities included in the "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<sup>15</sup> – "a number of states began to show interest in worldwide combined reporting."<sup>16</sup> Ultimately, the extreme unpopularity of the worldwide

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<sup>13</sup> 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).

<sup>14</sup> 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*).

<sup>15</sup> *Barclays Bank PLC*, *supra*.

<sup>16</sup> 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/revenelaws/2007-2008/Meeting%20Documents/Meetings%20for%20Report%20to%202009%20Session/19%20November%202008/History%20and%20Considerations%20for%20Combined%20Reporting%20-%20MTC.pdf> (last visited April 26, 2010).

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.<sup>17</sup>

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.<sup>18</sup> 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.

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<sup>17</sup> “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 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.

<sup>18</sup> *See e.g.*, MTC Model Statute for Combined Reporting §§ 5.A.iv & vi (2006).

#### 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 interstate affairs.”<sup>19</sup> 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.<sup>20</sup> 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*,<sup>21</sup> which allowed the use of a single-sales factor to apportion multistate business income. Since then, states have 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

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<sup>19</sup> *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 460 (1959).

<sup>20</sup> UDITPA was developed by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in 1957, which is now known as the Uniform Law Commission.

<sup>21</sup> 437 U.S. 267 (1978).

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 with disparate rules among the states.<sup>22</sup> At the same time, there is disagreement among the states and taxpayers (and sometimes among taxpayers themselves) on whether the rules used to source gross receipts in the sales factor adequately reflect the taxpayer's activity in the state given the economy's evolution from one based on manufacturing to one based increasingly on services and intangibles; this divergence of views is intensified where the services and intangibles are capable of being delivered to customers remotely.

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.<sup>23</sup> 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."<sup>24</sup> 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,

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<sup>22</sup> Many other factors also played a role in the shift, including demographics, technology, global competition, and the success of states' economic development efforts.

<sup>23</sup> UDITPA § 17(a).

<sup>24</sup> UDITPA § 17(b).

receipts from the sale of services must be sourced to that state if the customer receives the services in the state.<sup>25</sup>

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 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 help desk 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.<sup>26</sup> 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).

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<sup>25</sup> LLC § 5/304(a)(3)(C-5)(iv).

<sup>26</sup> Virginia apportions income based on a three-factor formula consisting of a property, payroll, and double-weighted sales factor. See Va. Code Ann. § 58.1-408.

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.<sup>27</sup>

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,<sup>28</sup> while financial institutions

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<sup>27</sup> 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)?

<sup>28</sup> *See* Md. Regs. Code § 03.04.03.08(E)(2).

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 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, 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 in 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.  
Washington, D.C.

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Mr. COHEN. Thank you, Mr. De Jong. What a great panel. I think we should give them applause. [Applause.]

That was very special.

I am going to yield to Mr. Watt for first questions. Normally—Mr. Watt, you are recognized for 3 minutes.

Mr. WATT. Three minutes?

Mr. COHEN. Well, I think we have votes at 11:30. I would like to give everybody a shot.

Mr. WATT. Okay. That is fine. I will try to stay within my time. My green light is not on, though. So you better start the clock.

Mr. Eads, you are with this multi-state task force that is doing some work in this area. To what extent will they address coming up with some uniformity on the definition of "nexus"?

Mr. EADS. I alluded in my testimony to the multi-state tax commission, which is working on an issue with regard to apportionment. I represent the Federation of Tax Administrators which includes all the states' tax agencies.

Right now, the issue of nexus is governed by two United States Supreme Court decisions based on the Constitution.

Mr. WATT. I understand that. I am trying to figure out whether anybody in this task force or any of the multi-state discussions are trying to come up with some kind of uniformity in that area.

Mr. EADS. There is an effort, yes, among the states to—particularly at the multi-state tax commission—to address the issue of nexus as well as issues with regard to apportionment. As you might well imagine being a participant in the legislative process, getting everyone in a particular group to agree about something, sometimes, can be problematic.

Mr. WATT. Are they anywhere in the neighborhood of having some kind of consensus about what the definition of "nexus" is?

Mr. EADS. Well, it depends on which state—I am sorry—which tax we are talking about, Mr. Watt. In the area of sales taxes, there is going to be some legislation and has been legislation introduced in the Congress in the past which would establish a universal definition of nexus for sales taxes.

There is also, pending before this Committee, a bill which would also define nexus in the corporate income tax—

Mr. WATT. I think you may be missing it. You are lobbying for the states to work this out, and then you are telling me about legislation that has been introduced here. So what I am trying to get a sense is whether there is any possibility of whether the states, if we stay out of this, can resolve this without legislation.

Mr. EADS. The states can make some progress, but when—as we have in the sales tax area, the Supreme Court has ruled based on the Constitution. There may not be a whole lot that the states can do. The states can act collaboratively, and they probably can even act collaboratively within the Constitution.

But it is very difficult to get there.

Mr. WATT. Mr. Chairman, I will yield back before my red light comes on, too.

Mr. COHEN. Thank you, sir. I appreciate it.

Mr. Coble has left the building, like Elvis.

Mr. Scott, you are recognized.

Mr. SCOTT. Thank you.

Professor Swain, you mentioned a situation where people in Iowa could, if you run a business out of Iowa which just has a sales—if they were in Illinois selling in Illinois taxed at a hundred percent and moved their corporate headquarters across the street as Mr. De Jong has indicated, would they cut their corporate taxes?

Mr. SWAIN. Yes. I think—I mean, my scenario was—

Mr. SCOTT. If you move a company that is doing business in Iowa, selling in Iowa, property in Iowa—if you just pick up your corporate headquarters, move—excuse me—in Illinois—and pick up just the corporate headquarters and move it to Iowa where all your customers all still in Illinois, you could be taxed on one-third—

Mr. SWAIN. Yes. You could reduce your tax liability substantially—

Mr. SCOTT. You have got population places like Bristol, Tennessee; Bristol, Virginia; Kansas City, Illinois; Kansas City, Missouri. Do people locate across state lines to try to save some money? Does that actually happen?

Mr. SWAIN. Oh, certainly. Certainly. And you have to move your operations, not just your headquarters because they count your property and your payroll. But if you move your operations, you can—you find a tax haven if you can.

Mr. SCOTT. Now, we are just talking—we are talking about corporate income tax. How many people use all three? Sales, payroll, and property? How many just use sales? How much variation is there?

Mr. SWAIN. It is a moving target. It is in my written testimony. I am thinking maybe 11 to 14 or somewhere—15-ish—use the traditional formula. I think it is up to about 14 or so that use sales only. And the rest are using a superweighted sales factor. It is somewhere in there in my testimony.

Mr. SCOTT. Now, if you pay your corporate tax in one state, do you necessarily get a credit in the other state?

Mr. SWAIN. No. The interesting thing about the state system is it is not a credit system. It is just—each state determines the slice of the pie it is going to tax, end of story. No credits for taxes paid in other jurisdictions.

Mr. SCOTT. And how continuous a nexus do we have to have to trigger all of this apportionment?

Mr. SWAIN. Well, that is an open question for income tax, but the trend with state courts is that you just need what we call an economic nexus. You don't need a physical presence in order to trigger income tax liability. That hasn't been determined by the Supreme Court, but the clear trend with state courts is to allow what we call economic nexus for income taxes.

Mr. COHEN. Ms. Chu from California, an expert on this as many other topics.

Ms. CHU. Thank you, Mr. Chair.

Mr. Eads, Professor Swain argues that, without uniform apportionment rules, there is a risk of both overtaxation and undertaxation of multi-state businesses. How do you respond to that?

Mr. EADS. There is a risk. Professor Swain is correct that there is a risk. It is not a perfect system. It is a system that, on a case-by-case basis, has been to the U.S. Supreme Court and been found to be constitutional. There is a good body of case law from the Supreme Court about what the states have done and what is constitutional and what is not.

The struggle that the Congress would have would be if it wanted to craft a piece of legislation to find something that would please everyone. And as Mr. De Jong said in his testimony, even among the business community, that would be hard to do.

So is it a perfect system? No. Is it a working system that achieves—I hesitate to use this term but—rough justice? Yes.

Ms. CHU. And how about the issue of double taxation in services? Of course, we know that tangible goods. It is very clear where that tangible good comes from.

But with services, there is the risk of being double taxed because it has to do with where the service is rendered versus where it is being received.

Mr. EADS. Representative Chu, certainly, the evolving nature of the economy has put some stresses and strains on the tax system. Many state tax laws were drafted in an era when we were a mercantile system. People went to stores and bought things. There wasn't nearly as much service in the economy when many tax laws were adopted.

And so there are some stresses and strains that need to be worked out to try to address that segment of the economy to make the tax system work and to be fair to taxpayers.

Ms. CHU. Okay. Thank you. I yield back.

Mr. COHEN. Let me ask a question or two about maybe—first, Mr. Eads.

You said that you think that we should respect the sovereignty of the states and refrain from Federal legislation in the area of apportionment for state taxes purposes. You don't see any benefit at all from any kind of uniformity?

Mr. EADS. Mr. Chairman, I do. I think the devil is in the details. That is—as Mr. De Jong alluded to in his testimony, even amongst the business community, it would be hard to find a consensus about what the standard should be. That would also be true among my members.

So is there a role for Congress to try to alleviate some burden? Yes. As I indicated in my testimony, however, what the Congress would have to do is try to avoid those unintended consequences that would just create a new set of problems or a new burden that business would have to confront.

The fact of the matter is—

Mr. COHEN. And do you not think Congress can do that in its infinite wisdom and its ability to craft, you know, meaningful and reasonable and rational legislation devoid of political considerations and special influences?

Mr. EADS. I am a hundred percent confident of the Congress' ability to do that, Mr. Chairman. [Laughter.]

Mr. COHEN. This Congress too? [Laughter.]

Thank you for your endorsement.

Do either of you gentlemen feel that Congress should do anything in this area? Or are you laissez-faire as well?

Mr. SWAIN. Well, I live—go ahead. I mean, I have kind of the ivory-tower perspective. I mean, conceptually, it is a good idea. It is what should be done. I understand the politics is difficult. And I don't have much of an opinion on that.

But, you know, first, do no harm. I think that is what the states are worried about; that if Congress tried to do something, it might do some harm rather than some good even though, conceptually or in the abstract, uniformity makes complete sense.

Mr. COHEN. And Mr. De Jong?

Mr. DE JONG. My perspective—our members would probably—to answer a question of should there be uniform apportionment standards with a yes, and then you asked each one of them what that uniform standard would be, they would probably give you a hundred different answers to what it would be.

So I think it would be difficult to build up a consensus behind a single solution to that problem. It is very complex.

Mr. COHEN. I want to thank the Members of the Committee for attending, and I want to thank the witnesses very much for your testimony and time.

I wish we had more time, but we have to vote—we have the healthy—a bill that would help provide for—cash for clunkers is what it is. It is called Home Start, a very important bill. And then we have to vote for motherhood, literally, voting for Mother's Day. So we all want to get up there and do that to precede apple pie.

So we thank the witnesses today. Without objection, Members have 5 legislative days to submit any additional written questions which we will forward to the witnesses and ask you to respond as promptly as you did your testimony.

Without objection, the record will remain open for 5 legislative days for submission of any other additional materials. I thank everyone for their time and patience. The hearing is adjourned.

[Whereupon, at 11:38 a.m., the Subcommittee was adjourned.]



## A P P E N D I X

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### MATERIAL SUBMITTED FOR THE HEARING RECORD

PREPARED STATEMENT OF THE HONORABLE JOHN CONYERS, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN, CHAIRMAN, COMMITTEE ON THE JUDICIARY, AND MEMBER, SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

Nearly 50 years ago, the House Judiciary Committee established a special subcommittee on State taxation affecting interstate commerce, known as the “Willis Committee,” to study these complicated issues and to make recommendations.

Unfortunately, State taxation affecting interstate commerce has become even more complex in the Age of the Internet.

The Subcommittee on Commercial and Administrative Law has conducted a series of hearings—both legislative and oversight—examining these issues, including a hearing it conducted last February that focused on defining nexus.

Today’s oversight hearing considers how States calculate tax liabilities for multistate businesses in light of the fact that different States utilize different formulas.

Given the potential for taxation formulas to burden interstate commerce, it is critical for Congress to understand them.

Accordingly, I welcome today’s hearing. As we hear testimony from today’s witnesses, we should consider the following three points:

First, to help our Nation lift itself out of the current economic climate, we should work to lessen unnecessary burdens on interstate commerce. As our businesses thrive and increase production, more jobs are created. As more workers get back on their feet, they create a market for more goods and services that further helps our businesses to thrive.

But to foster our country’s economic revival, businesses need clarity and fair tax policies to operate. They need simple and clear tax structures to know what activities will trigger tax liability in a State.

Accordingly, we should urge the creation of State and local tax policies that are clear and fair and that will not burden interstate commerce.

Second, many State and local governments across the United States are also suffering during this three-year-long economic downturn.

With reduced revenues and looming fiscal obligations, State and local governments are having to make tough choices to spur economic growth while balancing their budgets.

My home State of Michigan has been hit especially hard as its tax base continues to dwindle. In response, Michigan has had to cut spending and tweak its tax policies just to stay afloat.

It’s important, however, that State and local governments create tax policies that not only pay for providing essential services, but also spur economic development, and in turn, job creation.

For example, State governments often formulate tax policies in hopes of attracting investments and businesses to the State.

Within these tax policies, State governments have to determine how to tax multistate companies.

We should not at this hearing question the effectiveness of such tax policies. Instead, we should focus on whether these tax policies burden interstate commerce.

Nonetheless, Congress should take seriously the plight of State and local governments. In fact, last month, this Subcommittee held a hearing on how pending legislation could affect State and local government revenues, especially during the current economic downturn.

Third, we should encourage State and local governments—together with the relevant taxpayers—to work together to establish tax policies that eliminate over-taxation of multistate taxpayers, while ensuring that there is no under-taxation.

And we should encourage the parties to work together to lessen the administrative burdens for both businesses and governments.

To the extent that there are issues involving over-taxation and under-taxation—as we know from the creation of the Uniform Division of Income for Tax Purposes Act, and its widespread adoption—the interested parties should work collaboratively to achieve a tax policy that is mutually beneficial.

They can choose to follow a uniform standard, or tweak the current differing standards, or do nothing at all.

Although Congress can provide a legislative solution if the relevant parties cannot agree upon one, I would hope the interested parties could try to develop their own solutions before involving Congress.

We are interested in how, for instance, the Multi-state Tax Commission will approach the apportionment issue.

Of course, if there exists a problem that cannot be solved through mutual agreement, then Congress may need to intercede.

If Congress later chooses to provide a solution, the legislative record from today's hearing should provide us with a basis for creating meaningful legislation.

I thank Chairman Cohen for holding this very important hearing. And I encourage him and this Subcommittee to continue its review of State taxation issues to ensure that State tax policies do not burden interstate commerce.

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PREPARED STATEMENT OF THE HONORABLE HENRY C. "HANK" JOHNSON, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF GEORGIA, AND MEMBER, SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

Thank you, Mr. Chairman, for holding this hearing today.

Today we will examine the general issue of apportionment of corporate income for state tax purposes. Specifically, this hearing will give Members the opportunity to hear from witnesses about what Congress should do, if anything, in regards to apportionment standards. I hope the witnesses will be able to shed some light on this issue.

Apportionment is a means to attribute a business entity's income to and among the various states in which the entity conducts business.

When an entity conducts businesses in multiple jurisdictions, it is necessary to determine which of the entity's activities, and how much of the income derived from those activities, should be attributed to each jurisdiction in which it conducts business. States currently set their own corporate tax formulas.

Given the tumultuous economy, and record unemployment, states are hurting. States are struggling to create budgets to provide essential services, such as public education, police, and fire personnel, for their citizens. Therefore, this is an issue that should not be taken lightly.

As I think about apportionment, several questions come to mind. Should Congress step in and legislate? If so, how should Congress proceed? How would federal legislation affect multistate businesses? How would it impact interstate commerce?

Hopefully, the witnesses can enlighten us on these and other questions.

I thank the Chairman for holding this hearing today, and I look forward to hearing from the witnesses.

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RESPONSE TO POST-HEARING QUESTIONS FROM JOHN A. SWAIN, PROFESSOR,  
UNIVERSITY OF ARIZONA, JAMES E. ROGERS COLLEGE OF LAW

**Questions for the Record**  
**Subcommittee on Commercial and Administrative Law**  
**Hearing on State Taxation: The Role of Congress in Developing Apportionment Standards**  
**May 6, 2010**

John A. Swain, Associate Professor of Law, University of Arizona James E. Rogers College of Law

Questions from the Honorable Steve Cohen, Chairman

1. **According to your written testimony, several states have adopted single sales factor formulas or superweighted the sales factor within the formula. Please explain why a state would place more weight on the sales factor. How do the states come to the conclusion to weigh one factor more than another?**

The property and payroll factors give weight to the place where a taxpayer's goods or services are produced, while the sales factor gives weight to the location of the market for those products. Thus, the lesser the weight a state gives to the property and payroll factors, the lesser the state income tax disincentive for businesses to invest in that state. If a state employs sales-factor-only apportionment, for example, then there is essentially no negative state income tax consequence attached to investing in that state. Because states compete with each other to attract and keep investment, they have, in a sense, been forced by competitive pressures to reduce the weight of the property and payroll factors by increasing the sales factor. States probably do not fully appreciate that by relying on the sales factor they are in effect taxing their own markets. Because, however, the legal incidence of the state income tax falls on business taxpayers rather than on the individuals to whom some of that tax burden is being passed as an economic matter, elected officials are probably less sensitive to this aspect of sales factor overweighting.

2. **You note in your written testimony that state legislatures have little real interest in pursuing division of income uniformity. Please explain in more detail why you believe that.**

It would have been more accurate for me to say that the states have little real ability to achieve voluntary uniformity. Cartels tend to break down overtime, as the attractions of non-compliance become too strong. It only takes a few states seeking the rewards of becoming a tax haven to precipitate the disintegration of the prior consensus. The history described in my written testimony illustrates this phenomenon. It was only a palpable threat of Congressional intervention that motivated widespread adoption of UDITPA in the late 1960's and early 1970s, but that momentary cartel is now broken.

3. **In your written testimony, you indicate that a recent trend has been for states to adopt destination sourcing rules for receipts from services and intangibles, moving**

**away from an origin sourcing rule. Please explain this in more detail. What is the difference between destination and origin sourcing rules?**

UDITPA provides that sales of tangible personal property are attributed to the destination of the goods, i.e., the market. With respect to services and intangibles, however, UDITPA attributes service receipts to the state in which the services are performed, regardless of where they are consumed. In other words, receipts from services and intangibles are attributed to the state of production (origin) rather than to the state that provides the market (destination) for the services or intangibles. Many services are consumed where they are provided: a haircut, for instance. In these cases it makes no difference whether services are attributed to the destination state or the origin state; they are one and the same. Many other services, however, can be provided remotely: a lawyer in Pennsylvania can give advice to a client in Illinois; a bank in New York can lend money to a borrower in Texas; or a technician in California can fix software installed on a computer in Massachusetts. Intangibles, such as copyrights and patents, are often created in one place but consumed in another. Thus, assigning service and intangibles receipts to the numerator of the origin state sales factor, rather than to the numerator of the destination state sales factor, is often contrary to the purpose of the sales factor, which is to reflect the contribution of the market state to the production of income. Moreover, including service and intangibles receipts in the numerator of the origin state's sales factor is duplicative of the payroll and property factors, which already reflect the weight of the taxpayer's income-producing activities in the origin state.

Thus, on the one hand, I believe that the states that are turning to destination sourcing of service and intangibles receipts are getting it right. On the other hand, unless all states adopt this reform, taxpayers will continue to be faced with inconsistent rules that may require them to attribute receipts to the numerators of sales factors in two states. For example, if a business does consulting work in Arizona (a state that attributes services to the place of performance) for a client in Minnesota (a state that attributes services to where the customer is located), then the business will be required to include the receipts from doing that consulting work in the numerators of the sales factors in both states. In effect, this results in double taxation.

**4. As you are aware, this Subcommittee held a hearing on state tax nexus rules in February 2010. How, if at all, does the issue we are discussing today affect state tax nexus issues?**

Nexus thresholds should be pegged at the point where the costs of compliance and enforcement exceed the benefits of collecting a tax. The simpler and more uniform the apportionment rules, the lower should be the nexus threshold. The complexity created by non-uniformity supports a higher nexus threshold. In all cases, however, nexus thresholds should be pegged to standards that are reasonable proxies for compliance burdens. In today's economy, physical presence is not a reasonable proxy for compliance burden and should be replaced or supplemented by a *de minimis* sales volume threshold. In other words, certain volumes of sales should support taxable nexus with a state even if a taxpayer does not have a physical presence in that state. The more uniform the tax system, the lower the sales volume threshold can be. If compliance burdens are high, then the sales volume threshold should be pegged at higher levels.

**5. You have devoted most of your professional life to the study and practice of state taxation. So this area is your expertise. In your opinion, looking at this from a policy perspective, what should Congress do regarding state tax apportionment rules? What is the fairest rule? The simplest rule?**

If the 100-year history of the state corporate income tax tells us anything, it is that it is unrealistic to hope that the states will be able to achieve, and maintain, state tax apportionment uniformity. As I have testified, uniformity is desirable as a means to achieve both tax equity and reduced enforcement and compliance burdens. I am very mindful of state sovereignty, but, done right, federal involvement in the rather prosaic task of apportioning income among the states—which of necessity requires some sort of coordinating mechanism—may not be a serious threat to that sovereignty.

I believe that the fairest and simplest approach would be to require states to employ the time-tested UDITPA three-factor formula, with a few modernizing adjustments. For example, in deference to the trend of superweighting the sales factor, it may be advisable to double weight that factor. Many states already double weight the sales factor, and double weighting occupies the middle ground between sale-factor only apportionment and the traditional equally-weighted three-factor formula. Double weighting is also supportable because it has the effect of giving 50 percent weight to the market (reflected in the double-weighted sales factor) and 50 percent weight to the place of production (reflected in the payroll and property factors). This 50/50 split appeals to a rough justice sense of fairness.

Additionally, I would deviate from the original version of UDITPA by adopting a destination approach to the sales factor attribution of all receipts, including receipts from services and intangibles. As I have testified, this better achieves the purpose of the sales factor, which is to reflect the contribution of the market state to the creation of income. Also, there is a clear trend toward using this approach, and currently about 10 states destination source services and/or intangibles.

Finally, regarding fairness, I will again quote the National Tax Association's 1922 observation that "... the uniform adoption of some equitable method and finding the right rule of apportionment are, in our opinion, synonymous."

**6. At the hearing, during questioning from Congressman Scott, you provided a brief response about the number of states using each type of formula. Please provide greater detail about which states use certain types of formulas. Also, is there a trend over the last ten years toward states using a certain formula? Over the last five years?**

According to the Federation of Tax Administrators, as of January 1, 2010:

- 14 states have adopted single sales factor apportionment (California, Colorado, Georgia, Illinois, Indiana, Iowa, Louisiana, Maine, Minnesota, Missouri, Nebraska, New York, Oregon, and Wisconsin). In some states the use of a single sales factor formula is elective, and a few states have adopted delayed effective dates.
- 19 states double weight, or more, the sales factor (Arkansas, Arizona, Connecticut, Florida, Idaho, Kentucky, Maryland, Massachusetts, New Hampshire, New Jersey, New Mexico, North Carolina, Pennsylvania, South Carolina, Tennessee, Utah, Vermont, Virginia, and West Virginia).
- 11 states employ an equally-weighted three-factor formula (Alabama, Arkansas, District of Columbia, Delaware, Hawaii, Kansas, Mississippi, Montana, North Dakota, Oklahoma, and Rhode Island).

According to the 2004 Commerce Clearing House (CCH) Multistate Corporate Income Tax Guide:

- 4 states employed single sales factor apportionment (Illinois, Iowa, Missouri, and Nebraska).
- 28 states doubled weighted, or more, the sales factor (Arizona, Arkansas, California, Colorado, Connecticut, Florida, Georgia, Idaho, Indiana, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, New Hampshire, New Jersey, New York, North Carolina, Ohio, Oregon, Pennsylvania, South Carolina, Tennessee, Virginia, West Virginia, and Wisconsin).
- 15 states employed an equally-weighted three-factor formula (Alabama, Arkansas, District of Columbia, Delaware, Hawaii, Kansas, Mississippi, Montana, New Mexico, North Dakota, Oklahoma, Rhode Island, South Dakota, Utah, and West Virginia).

According to the Federal of Tax Administrators, the data for 2001 was approximately the same as in 2004.

To summarize, there was an initial trend after the Supreme Court's 1978 decision on Moorman Manufacturing to adopted double-weighted (or more) sales factors. In recent years, however, the trend has accelerated toward single sales factor apportionment.



RESPONSE TO POST-HEARING QUESTIONS FROM JAMES R. EADS, JR.,  
EXECUTIVE DIRECTOR, FEDERATION OF TAX ADMINISTRATORS

Questions for the Record  
Subcommittee on Commercial and Administrative Law  
Hearing on State Taxation: The Role of Congress in Developing Apportionment Standards  
May 6, 2010

James R. Eads, Jr., Executive Director, Federation of Tax Administrators

Questions from the Honorable Steve Cohen, Chairman

1. According to Professor Swain's written testimony, several states have adopted single sales factor formulas or superweighted the sales factor within the formula. Please explain why a state would place more weight on the sales factor. How do the states come to the conclusion to weigh one factor more than another?

*ANSWER: The motivations for a legislature's decision to adopt a weighted or single sales income apportionment factor are diverse. Among the possible reasons are:*

- *Sales are arguably the primary factor that produces income for a business, especially for service providers.*
- *The state might view itself as a "market" state with more customers than facilities or employees and a weighted sales factor might more accurately reflect a company's income producing activity.*
- *A business heavily invested in property in one state or with many employees in that state, but few customers, might actually target customers and make more of its income in other market states and factors of property and/or payroll might distort income.*

2. In his written statement, Professor Swain suggests that "state legislatures have little real interest in pursuing division of income uniformity." Is he correct? Why would states not pursue a uniform standard?

*ANSWER: States look to their revenue systems to do two primary things:*

1. *Produce adequate and stable revenues to pay for government, and*
2. *Be perceived by taxpayers as fair in their application. These are often difficult goals to achieve and may depend on specific concerns of taxpayers and policy makers in that state. Thus, states may not look far beyond these factors. If the state's tax system meets these two criteria the state may not be too interested in whether their tax system is identical to another state's.*

3. Imagine that Congress addresses the state tax apportionment issue and establishes a uniform standard. How would this affect state and local government revenues? Do you have accurate numbers on the effect of establishing such a standard?

*ANSWER: The Federation of Tax Administrators does not have an accurate estimate of the impact of such hypothetical legislation. Since apportionment formulas currently vary,*

*it would almost inevitably produce winners and losers, both states and businesses. Winners would not complain, but losers can reasonably assert that they relied on the existing tax system and should not be disadvantaged without a clear reason for doing so. Our testimony suggested that Congress should not enact such legislation because there is little, if any, evidence of a problem of sufficient magnitude to merit the Congress' attention. The states might very well suggest that Congress' effort might be better directed at simplification of a complex federal revenue code, on which most states "piggy-back," and improving the federal fiscal condition.*

4. With Michigan, Ohio, and Texas already adopting business receipts-based taxes, and California considering one, do you see more states doing so? What would be the benefits for a state to adopt such a tax structure? The detriments? Do you have figures on how much increased revenue the new tax structures brought for Michigan, Ohio, and Texas?

*ANSWER: It is reasonable to expect that other states may look at innovative tax regimes that might better meet their needs. Generally states seek adequacy, stability, cost-effectiveness and fairness in a tax system. Depending on the nature of a state's economy and taxpayer mix, such different tax structures might very well be a right choice. One rationale for the states that have adopted such taxes is that are alleged to be less volatile producers of revenue, thus increasing the adequacy of revenue for meeting ongoing operating needs. One argument against such taxes is that, due their stability, they fail to recognize economic fluctuations that might hurt a business' profitability and make it less able to pay tax. Michigan has long had such a tax and it appears to be part of a tax system that has met state revenue needs under most circumstances. Both Ohio and Texas enacted their tax to meet a specific revenue need and to fit within their specific state tax system. It appears that both states are generally satisfied that the taxes are meeting those needs. We will seek data as to how these structures have met the predictions as to their impact.*

5. During the hearing, you responded to a question from Congresswoman Chu about the evolving nature of the economy, and how state tax laws were drafted in an era when the economy was more of a mercantile-based system. Please explain in more detail from a historical perspective the evolution of state tax laws from a mercantile-based system to a service-based system, and how states are adjusting to the new economy.

*ANSWER: In my answer to Congresswoman Chu, I was thinking in part about state sales taxes that were mostly adopted during the era of the "Great Depression" when income taxes were proving inadequate. Those taxes reflected an economy in which tangible items were sold, not services. As services have become an ever more important segment of our economy, states have responded by expanding their taxation of services, particularly consumer services. One concern about taxing services is that, particularly when services purchased by businesses are taxed, taxes can "cascade" or "pyramid" and cause taxes to be applied on successive transactions. Indeed, service companies do present some challenges to the apportionment system in that those companies may not rely on the traditional income producing factors. My written testimony mentioned the fact that states*

*are adopting apportionment schemes that address these situations. The key principle is that the states are doing this and making decisions that best meet their needs, rather than simply complying with a mandate that is remote from and might not take into account the intricacies of the situation.*

6. In his written statement, Mr. De Jong states that a “one-size-fits-all approach to apportionment may not be uniformly supported by the business community.” He gives several reasons for supporting that statement. Would states support a one-size-fits all approach to eliminate the burden on interstate commerce and the complexities involved for the states and the businesses having to compute taxes?

*ANSWER: In this instance the states tax agencies would agree with the representative of the Tax Executives Institute and would not support a one-size fits all approach.*

7. In your opinion, looking at this from a policy perspective, not a states’ rights perspective, what should Congress do regarding state tax nexus rules? What is the fairest rule? The simplest rule?

*ANSWER: We believe that companies that exploit a state’s markets and compete with locally based businesses should pay the same taxes as every other business operating in that state. This is the only fair approach. There are two significant nexus issues that have been considered by the Congress, nexus for purposes of determining liability for corporate income (and similar) taxes and nexus sufficient to require collecting sales and use taxes. The states have traditionally opposed Congressional action on the former and supported Congressional action regarding the latter. The reason that Congressional action in the area of state taxes is generally problematic is that the issues are varied and complex and the solutions are varied and complex and indeed, it is difficult to craft an easily understood one-size-fits-all solution. Congress would do well if it allowed the states to collect taxes that best fit their needs. This means that Congress should get the federal government out of the way and allow the states to require collection of sales and use taxes and collect corporate taxes subject to constitutional due process limits. As to the simplest rule, that would be one that requires either everyone to pay or no one to pay. The goal is worthy. The path to the goal is rough.*



RESPONSE TO POST-HEARING QUESTIONS FROM DANIEL B. DE JONG,  
TAX COUNSEL, TAX EXECUTIVES INSTITUTE, INC.

**Questions for the Record**  
**Subcommittee on Commercial and Administrative Law**  
**Hearing on State Taxation: The Role of Congress in Developing Apportionment Standards**  
**May 6, 2010**

**Tax Executives Institute, Inc.**<sup>1</sup>

**Questions from the Honorable Steve Cohen, Chairman**

- 1. In your written statement, you suggest that Congress adopt “a national, uniform threshold for the taxation of nonresident workers.” Please explain.**

TEI has supported earlier versions of the Mobile Workforce State Income Tax Fairness and Simplification Act, currently introduced as H.R. 2110. Employers nationwide have a direct stake in the development of fair and uniform rules governing nonresident taxation and withholding, regardless of whether they are large multinational corporations or small businesses that pursue opportunities outside their home state. Establishment of a national standard providing a minimum threshold for taxation of nonresident workers would bring a measure of certainty and uniformity to an area of the tax law where uncertainty and inconsistency cannot help but impede economic growth and efficiency. A national standard would also enhance taxpayer compliance by making it easier for employers to develop standardized systems and processes for tracking and reporting information necessary to accurately withhold state income taxes for traveling employees.

In today’s mobile economy, a business’ activities or customers are rarely confined to a single state. Regardless of whether a company is large or small, privately held or publicly traded, the pursuit of new business is not limited by geographic boundaries. Employees regularly travel from their usual place of employment (*i.e.*, their “home” or residence state) to other states to fulfill their employment obligations. When they do, they and their employers become subject to a wide array of disparate tax and withholding regimes. The tax and compliance burdens are not limited to any particular class of employee (*e.g.*, those who work for large multinational corporations). Thus, employees of the American Red Cross or another social service/welfare organization whose jobs take them to one or more states devastated by a hurricane to coordinate relief efforts are subject to the same tax consequences as a privately employed individual.

The current patchwork of divergent and sometimes inconsistent regulatory regimes makes it difficult for employers and their employees to comprehend and comply with their obligations. The challenge of analyzing the rules, developing procedures to ensure compliance, training employees, and then undertaking to collect the necessary information and perform the required calculations remains significant. Moreover, while some states may not vigorously enforce their rules in respect of all employers and employees (*e.g.*, where the employer has adopted rules of

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<sup>1</sup> Tax Executive Institute, Inc. was represented at the Subcommittee’s hearing on May 6 by Daniel B. De Jong, Tax Counsel on the Institute’s legal staff.

administrative convenience to withhold tax when employees exceed a certain number of days in the state), the *potential* for enforcement action cannot be ignored.

TEI recognizes the states' prerogative to design taxing systems to meet their particular needs. The Mobile Workforce bill, however, does not strip states of the ability to tailor their tax systems to fit their diverse economies and specific policy goals; rather, it establishes a reasonable threshold regulating when nonresident individuals engaging in interstate commerce and their employers are subject to those tax systems.

**2. In your written statement, you describe the complexities created when business enterprises are composed of multiple entities, and how those entities are considered for tax purposes. You indicate that there is no uniformity among the states. Is there a way to simplify that calculation? Should we look for uniformity?**

Of the 45 states that impose a corporate income tax, 22 require each member within an affiliated group of corporations with nexus to file a separate state tax return – even if the group files a consolidated federal return. Corporations subject to tax in these states account for intercompany transactions with affiliated entities using an arm's-length standard. In the remaining 23 states, affiliated entities conducting a unitary business must file a single combined return. States vary in their definitions of both “affiliated entities” and “unitary business.” Generally, entities must be connected by direct or constructive ownership of more than either 50% or 80% to meet the definition of an affiliate. While unitary groups generally exhibit characteristics of interdependence “so as to form one integral business rather than several business entities,”<sup>2</sup> states employ varying factors to determine whether the members of an affiliated group are engaged in a unitary business.<sup>3</sup>

The goal for including these entities in a single combined return is to better capture “the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise.”<sup>4</sup> The Supreme Court has upheld the constitutionality of mandatory unitary combined reporting in a number of cases.<sup>5</sup> The analysis of whether entities are unitary, however, is often fact-intensive, prone to subjective conclusions, time consuming and administratively difficult. A lack of a consistent definition of a “unitary” business among the states adds to the burdens on taxpayers filing in multiple combined reporting jurisdictions.

<sup>2</sup> *Pioneer Container Corporation v. Beshears*, 684 P.2d 396, 399 (Kan. 1984).

<sup>3</sup> For example, California applies a definition of unitary that stretches to the limits of the Commerce Clause of the U.S. Constitution. See California Franchise Tax Board Notice 89-713 (Oct. 31, 1989). Arizona, on the other hand, has adopted a narrower rule that excludes corporations from a unitary combined return if they provide only “accessory” functions to the overall business of the affiliated group. “Accessory” services in this case are those not contained in the group’s products or its delivery to the customer such as centralized management, treasury functions, legal and accounting, and other internal services provided by one branch or affiliate to another. See *R.R. Donnelley & Sons Co. v. Department of Revenue*, Arizona Court of Appeals, Division One, No. 1 CA-TX 08-0007, April 29, 2010.

<sup>4</sup> *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 164-165 (1983).

<sup>5</sup> See e.g., *Container Corp.*, *supra*, and *Barclays Bank PLC v. Franchise Tax Board*, 512 U.S. 298 (1994).

For businesses with international operations, the identification of the entities included in a “unitary group” can be even more daunting. During the 1970s and early 1980s, a number of states required taxpayers with international operations to include those activities in their combined returns (commonly referred to as the “worldwide unitary method”) – even where those international operations were conducted through separate, foreign legal entities. The Supreme Court ultimately held that the application of these principles to the international operations of multinational business groups did not violate the U.S. Constitution, without regard to whether those businesses were headquartered outside of the country.<sup>6</sup>

In response to criticism of the worldwide combined reporting, states have migrated to a “water’s-edge” approach, offering worldwide combined reporting as an option upon the election of the taxpayer. Under the water’s-edge method, unitary businesses generally include only domestic entities in the combined return. More recently, states have begun requiring taxpayers to include an apportioned amount of the income or losses of certain foreign affiliates in an otherwise water’s edge return when the foreign affiliates (1) earn income attributable to sources within the United States, (2) earn more than a threshold amount of their income from the sale or license of intangibles or services to other members of the unitary business that are doing business within the United States, or (3) are doing business in a “tax haven” jurisdiction.<sup>7</sup>

States have adopted these rules purportedly to prevent taxpayers from shifting income outside of the water’s-edge group to low-tax foreign jurisdictions. Often, however, they ensnare legitimate and common business transactions put in place with no tax avoidance motive. For example, a foreign parent of a subsidiary doing business in the United States may charge the subsidiary an arm’s-length rate for the provision of administrative services such as treasury functions, regulatory compliance, tax compliance, or other management-related services. Foreign-owned multinationals also frequently license intellectual property such as patents, trademarks, or copyrights to U.S. subsidiaries for use in manufacturing, printing, or other U.S.-based operations in exchange for a royalty. Under exceptions to the water’s-edge rules (summarized above), these foreign parent corporations could be pulled into a state tax return even though they are not required to file a U.S. federal corporate tax return. Including these entities in a water’s-edge return imposes an increased state tax burden on multinational enterprises because it often results in state taxation of income that is excluded from the federal income tax base as non-U.S.-source income under the Internal Revenue Code or exempted from U.S. federal taxation under a tax treaty (U.S. tax treaties do not generally apply to state taxes).

Development of a federal solution addressing state combined returns would not be easy; it would almost certainly pit the interests of some taxpayers against those of others. For example, taxpayers with businesses located mainly in states requiring separate company reporting likely would oppose a national standard since it would increase their state tax compliance burden. In contrast, multinational businesses headquartered overseas might agree that a federal rule prohibiting the inclusion of all foreign entities from state combined returns would more accurately reflect their business conducted in the United States. While the conflicts could be tempered by engrafting a series of elections on a national combined reporting framework, such a

<sup>6</sup> *Barclays Bank PLC v. Franchise Tax Board*, *supra*.

<sup>7</sup> See *e.g.*, MTC Model Combined Reporting Statute §§ 5.A.iv & vi (2006).

labyrinthine system of rules could be viewed as merely substituting one complicated regime with another.

- 3. In your opening statement, you stated: “Over the years, there have been repeated efforts to promote state and local tax consistency and uniformity. These efforts have, for the most part, met with limited success for a variety of reasons . . . interstate or international competitive concerns.” Please explain in more detail how interstate, and especially, international competitive concerns have impacted those efforts. How has the international community reacted to efforts to promote tax consistency and uniformity in apportionment? Has the European Union dealt with apportionment?**

In 1966, federal legislation was introduced that would have implemented a national two-factor apportionment formula based on a taxpayer’s payroll and property. Responding to that federal initiative, many states passed legislation adopting the Uniform Division of Income for Tax Purposes Act (UDITPA), which was promulgated nearly a decade earlier by the National Conference of Commissioners on Uniform State Laws (NCCUSL). That model statute sets forth an equally weighted three-factor apportionment formula based on a taxpayer’s property, payroll, and sales. In the years that followed, many states and taxpayers came to regard UDITPA’s three-factor apportionment formula as a constitutional standard.<sup>8</sup> That impression changed with the Supreme Court’s 1978 decision in *Moorman Manufacturing* upholding the constitutionality of Iowa’s single sales factor apportionment formula.<sup>9</sup>

Although states did not immediately discard their three-factor systems, in recent years more and more states have modified their apportionment formulas to provide out-of-state businesses with an incentive to invest there. Thus, today 32 states have moved to apportionment formulas that put additional weight on the sales factor. Illustrating the policy rationale behind this migration, one California legislator recently stated during a hearing on single sales factor legislation that “[t]his bill is about putting California first.” While understandable, this trend erodes confidence in the ability of states to achieve conformity or uniformity on apportionment standards on their own.

Although international controversy specific to apportionment has been less common, the related issue of combined reporting has produced significant criticism from foreign jurisdictions and multinational businesses. During the 1970s and 1980s, California and several other states required multinational businesses to include foreign affiliates in their state combined returns (referred to as “worldwide combined reporting”). This effectively pulled the earnings of non-U.S. companies into the state tax net, even though the foreign entities were not even required to file a U.S. federal income tax return. The states argued that their apportionment formulas effectively mitigated the inclusion of those foreign earnings in the tax base and properly reflected the income of the multinational unitary group attributable to the state. Although businesses

<sup>8</sup> By the 1970s, 44 of the 45 states that had a corporate income tax used a three-factor apportionment formula.

<sup>9</sup> *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978).

objected, the U.S. Supreme Court upheld the constitutionality of the worldwide combined reporting in two cases.<sup>10</sup>

As a result of the Court's decisions and alarm that additional states might mandate worldwide combined filing, President Ronald Reagan established a "Working Group," whose members represented the affected parties in the dispute: multinational corporations, state governments utilizing the worldwide unitary method, and the federal government. The results for the related hearings were transmitted to President Reagan on July 31, 1984, in the *Chairman's Report On The Worldwide Unitary Taxation Working Group: Activities, Issues and Recommendations*.

Nearly a year after the release of this report, the British House of Commons approved a measure to permit the United Kingdom to retaliate against any states employing the worldwide unitary method by withholding tax refunds on dividends paid by U.K. subsidiaries of U.S. parent companies doing business in worldwide unitary states.<sup>11</sup> Other countries also voiced their discontent with the worldwide unitary system. One representative of Japanese business interests, for example, stated that numerous Japanese manufacturing companies would avoid locating facilities in states that employed the worldwide unitary system and would even consider pulling their existing investments out of those states.<sup>12</sup> In December 1985, legislation was introduced in the Senate and House of Representatives to significantly curtail states' abilities to impose worldwide unitary reporting.<sup>13</sup> Ultimately, as a result of the extreme unpopularity of the worldwide combined reporting concept and the threat of federal intervention, states backed away from requiring its use.

Question 3 also asks about Europe's experience with apportionment. As part of a strategy to reduce tax obstacles that hinder the competitiveness of the internal European market, the European Commission began a project in 2001 to study the efficacy of providing companies that operate in more than one European Union (EU) member state with a common consolidated corporate tax base (CCCTB). One critical issue addressed as part of this project was the allocation of profits among the Member States of the EU, and a related study analyzed three possible mechanisms for apportioning a consolidated tax base.<sup>14</sup> The first option called for a division of profits by the relative gross domestic product (GDP) of the Member States of the EU (or of the Member States in which the taxpayer did business). While simple, the study concluded that this method would not accurately reflect a taxpayer's level of activity in the different Member States since it bases apportionment on something largely independent of taxpayer business activities. The report also considered apportionment based on property, payroll, and

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<sup>10</sup> See *Container Corp. of America v. Franchise Tax Board*, *supra*; *Barclays Bank PLC v. Franchise Tax Board*, *supra*.

<sup>11</sup> For additional information regarding the British response to worldwide combined reporting, see Robert D. Wallingford, *British Retaliation Against the California Unitary Tax: The Needed Impetus for a Federal Solution*, 8 *Journal of Comparative Business and Capital Market Law* 345 (1986).

<sup>12</sup> Japan, Inc. Reinforces Complaints about the Unitary Method, 22 *Tax Notes* 653 (1984).

<sup>13</sup> S. 1974 and H.R. 3980.

<sup>14</sup> For additional information on the project evaluating an EU CCCTB, please see the European Commission Taxation and Customs Union webpage on the Common Tax Base, available at [http://ec.europa.eu/taxation\\_customs/taxation/company\\_tax/common\\_tax\\_base/index\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm).

sales (similar to systems used in the United States and Canada), as well as a system based on the value added by the taxpayer in each Member State. An in-depth discussion of this study is beyond the scope of these questions, but the conclusion bears repeating: “As expected, the conclusion is that there is no such thing as a ‘perfect’ mechanism.”<sup>15</sup> The EU working group on the CCCTB submitted its final report in 2008, and the issue remains under deliberation.

**4. Your constituency is the business community. As a voice for the business community, please explain why Congress should or should not address the issue of apportionment through legislation.**

Uniformity in state taxation benefits multistate business generally by making the process of computing and paying those taxes more efficient. That lauded efficiency, however, has been subordinated in favor of using apportionment as an economic development tool.<sup>16</sup> Many businesses have responded by locating or expanding operations in those states with more favorable apportionment rules. For example, many manufacturing companies have accepted states’ invitations to utilize single sales-factor apportionment rules when deciding where to locate or expand manufacturing facilities. Eliminating the ratios tied to the production of manufacturers’ products (*i.e.*, property and payroll) effectively lowers their overall state income tax burdens. For taxpayers located in states with less favorable apportionment formulas, however, the resulting variations in factor weighting or sourcing rules can whipsaw taxpayers, subjecting their income to multiple taxation.

Variations in the rules used to source receipts for purposes of computing the sales factor can also affect the tax liabilities of multistate businesses. Of particular note, states have begun to re-examine the sourcing rules applicable to sales of services and intangibles, with many states sourcing sales based on where the benefits of the services are received by a taxpayer’s customers or where the purchaser uses the intangibles. (Absent the change, the sales would have been sourced based on where the costs associated with providing those services were incurred.) The standard of “location of use or benefits derived” is a highly subjective standard which is difficult to administer. The varying rules have produced conditions ripe for double taxation and for taxation on less than all of a taxpayer’s income.

While the current patchwork of standards increases the tax compliance burden for multistate businesses, a consensus on whether there should be a national apportionment standard – and what such a standard should be – does not exist. Changes to apportionment formulas by definition redistribute the tax burden among taxpayers by altering the measuring stick used to gauge their economic activity in the states where they do business. A federal apportionment standard would likely eliminate double taxation resulting from the application of inconsistent apportionment rules benefiting taxpayers currently subject to multiple taxation. At the same

<sup>15</sup> Ana Agundez-Garcia, *Taxation Papers, 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 (October 2006) at page 86.

<sup>16</sup> See *e.g.*, Sanjay Gupta, Jared Moore, Jeffrey Gramlich, & Mary Ann Hofmann, *Empirical Evidence on the Revenue Effects of State Corporate Income Tax Policies*, 62 *National Tax Journal* 237, 264 (June 2009) (“States readily admit that the primary reason for apportionment formula changes is to remain competitive and to ‘incentivize’ businesses to locate/remain in the state.”).

time, a uniform federal standard would frustrate the policy decisions made by states to encourage in-state investment. These uneven results make it unlikely that the business community would achieve consensus in supporting any single federal set of standards.

**5. With Michigan, Ohio, and Texas already adopting business receipts-based taxes, and California considering one, do you see more states doing so? What would be the benefits for the business community if states adopted such a tax structure? The detriments? Have businesses seen their tax bills increase dramatically after adoption within these states?**

States income tax collections are inextricably linked to the general economy: If the economy is sluggish and businesses do not generate profits, there is no income for states to tax. This often occurs at the same time demands for state services increase, exacerbating the loss of tax revenue with the increased costs of providing state services. The current economic downturn provides a perfect example of the mismatch. In an effort to reduce this volatility, some states have enacted gross receipts-based taxes on a wide variety of economic activities at a relatively low rate as an alternative to the corporate income tax.<sup>17</sup> Although based on gross receipts, the Michigan tax and California proposals referenced in this question represent taxes better categorized as value-added taxes where deductions from gross receipts are allowed for many business inputs. In May 2010, the Oklahoma legislature passed legislation imposing a new business activity tax based on a taxpayer's "net receipts" – similar to Michigan's new tax.<sup>18</sup>

The gross receipts-based taxes<sup>19</sup> imposed by Michigan, Ohio, and Texas (as well as the proposal in California) share a number of characteristics, but they differ in many important respects. All are imposed at a rate lower than most corporate income taxes, but that lower rate comes at the expense of a much broader tax base. Within each of the taxes, taxpayers must apportion their receipts to the various states using the same or similar sourcing rules as those applying to a corporate income tax. Additionally, each employs a complicated and different method for determining which entities file as part of the group required to complete a return and pay tax. As a result, while perhaps stabilizing receipts, these new taxes did *not* simplify state tax compliance for multistate businesses. Indeed, they created greater uncertainty by replacing a corporate income tax that had developed over many years with untested taxes that both taxpayers and tax administrators struggle to apply without the benefit of experience.

The effects of these new taxes on multistate businesses have varied significantly. Because the tax is based on gross receipts and not net income, businesses generate tax liabilities even in years when they would have no positive taxable income under a traditional income tax. This significantly increases the tax burden on companies struggling financially that already must pay other taxes not based on net income such as local property taxes and sales and use taxes. Thus,

<sup>17</sup> See, e.g., Report of the California Commission on the 21<sup>st</sup> Century Economy (September 2009) at 44, *et seq.* Texas does not fit this same mold. Its move to a receipts-based tax was prompted more by a prohibition within the state constitution against the imposition of an income tax on individuals.

<sup>18</sup> S.J.R. 61.

<sup>19</sup> For ease of reference, both pure gross receipts taxes (e.g., Ohio's Commercial Activities Tax) and value added taxes (e.g., Michigan's tax) are referred to as gross receipts taxes.

gross receipts-based taxes are disadvantageous for businesses with current operating losses. For those businesses consisting of an affiliated group of entities, the effects of gross receipts-based taxes that require combined reporting vary according to whether new entities brought into the combined tax return reduce the group's apportionment to these gross receipts states enough to mitigate the more expansive tax base. Given the myriad ways in which these taxes affect multistate business, it is difficult to provide any generalized conclusions about their effects.

**6. Of the several formulas states currently use, rank the formulas in how they benefit businesses. Or are the benefits different based on the type of industry or whether a business is multi-state?**

The varying apportionment rules used by states affect business differently depending on factors ranging from geographic location and type of business to legal structure and other attributes, so it is impossible to rank them. Manufacturers may benefit from an apportionment formula consisting of a single sales factor that sources sales to the state in which customers receive their goods, at least to the extent that the business ships most of its products to purchasers located outside the state in which its manufacturing facilities are located. Any benefits created by that single sales factor apportionment formula might be eliminated, however, if the state enacted a throwback rule requiring all sales to states in which the manufacturer does not have nexus to be included (or thrown back) into the sales factor numerator of the state from which the products were shipped. That same manufacturing company would prefer that the states in which it did not have manufacturing facilities employ a three-factor apportionment formula since its apportionment ratio in those states would be lowered by the lack of property or payroll in those jurisdictions. These rules, however, disadvantage manufacturers located in states with less favorable apportionment rules. This pits the interests of some manufacturers against those of others.

Similar considerations exist for service providers and businesses dealing in intangibles. TEI's written statement provides an example showing how a taxpayer could reduce its state tax burden by two-thirds simply by moving its location from one state to another. That benefit would evanesce, however, if either of the states in that example changed their approach to sourcing sales of services for purposes of the sales factor. This could put the interests of service businesses located in one state at loggerheads with those based in other states.

States have also constructed special apportionment formulas and sourcing rules for specialized industries in an attempt to better reflect the location of their business activities. For example, oil pipeline companies and transportation companies often use a formula based on property in the state or on miles driven in the state to apportion their income. A uniform national apportionment standard that did not take into account these factors could significantly alter the tax liabilities of those businesses.

**7. In your opinion, looking at this from a policy perspective, not a states' rights perspective, what should Congress do regarding state tax nexus rules? What is the fairest rule? The simplest rule?**

The lack of clarity and uniformity in the states' definitions of business activity tax nexus imposes significant burdens on business taxpayers. The range of possible rules is so broad – and their effect on particular industries or taxpayers so divergent – that it is impossible to define, as a general matter, what the fairest, simplest, or best rule is. There is a growing consensus, however, that a national standard for determining the jurisdictional limitations on states' rights to tax multistate businesses is necessary for U.S. and non-U.S. businesses alike.<sup>20</sup> Thus, TEI commends the Subcommittee for holding its recent hearing to examine the issue more closely.

A single “bright-line” test for nexus would govern only the taxing jurisdiction of the states, and would not interfere with the use of state tax codes to encourage in-state investment through the use of apportionment formulas, targeted credits and grants, or special additions or subtractions from the tax base. Those types of policy decisions would remain in the hands of the states avoiding any undue erosion of the principles of federalism, though concededly the contours of any such decisions might be affected by a national nexus standard.

**8. Imagine that Congress addresses the state tax apportionment issue which we are discussing today, and establishes a uniform standard. How would this affect the business community's revenues? Would it make a difference where the businesses were located, such as in-state or out-of-state? Do you have accurate numbers on the effect of establishing such a standard?**

The possible effects of a national set of apportionment rules would vary depending on numerous factors described in detail above (*e.g.*, geographic location, industry, choice of legal entity, *etc.*). No draft legislation currently exists, however, that would permit quantification of the effects of a uniform standard on the business community.

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<sup>20</sup> U.S. tax treaties do not apply to most state business activity taxes, and the amount of contact necessary to create nexus in a state for a foreign business may be significantly less than that required to create a federal tax filing obligation. Consequently, foreign businesses may find themselves subject to a state business activity tax while exempt from the U.S. federal corporate income tax. *See e.g., Matter of Infosys Technologies Limited*, DTA No. 820669, N.Y. Div. of Tax App. (Feb. 21, 2008), *aff'g* DTA No. 820669, N.Y. Div. of Tax App. ADL Unit (Feb. 15, 2007) and Washington State Department of Revenue, Special Notice: New “Economic Nexus” in Washington State May Impact “Foreign Corporations” (May 28, 2010).