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Apportionment: Normal Formulas Are Unfair and Can Be Challenged

Let's acknowledge that companies' advantages in the market arise partly from their human capital and use of assets—both tangible and intangible

By Mitchell A. Newmark and Eugene J. Gibilaro

For the 2022 tax year, of the forty-five states (plus the District of Columbia) that impose a corporate income tax, more than thirty require the use of a single sales factor normal apportionment formula; and, when we also consider states that put additional weight on the sales factor, that number climbs above forty.[1] The trend is clear, and approaching near unanimity among the states, that the sales factor is the most weighted factor to the near exclusion of all others when apportioning the income of a corporation (and, in several jurisdictions, the income of other entities, including partnerships). When we further consider that most of these jurisdictions also require market-based sourcing for sales, it is evident that, in most states, the location of the corporation's customers drives the apportionment percentage.

But does this practice make sense, and is it fair as applied to your company? Although it is a reasonable point that customers are essential to generating income, it is equally true that a corporation's property and employees are also essential to generating income, yet most states now give little or no weight to these additional factors. The Multistate Tax Commission's own hearing officer's report for its proposed amendments to the Uniform Division of Income for Tax Purposes Act (UDITPA)—which is Article IV of the Multistate Tax Compact—stated that "[a prominent economist] also thought a sales factor had no role to play in an apportionment formula, a common opinion among economists when UDITPA was being debated and one shared by the Willis Committee, which recommended only property and payroll factors."[2] The Willis Committee was the congressional subcommittee established after the enactment of Public Law 86-272 in 1959, which mandated that the House Judiciary Committee and the Senate Finance Committee "make full and complete studies" of state taxation of interstate commerce and "recommend[] to the Congress proposed legislation providing uniform standards to be observed by the States in imposing income taxes on income so derived."[3] The Willis Committee released its findings in two installments in 1964 and 1965 and, though Congress considered legislation in the wake of their release that would have required states to allow taxpayers to elect a two-factor (i.e., property and payroll) apportionment formula, the legislation was not enacted.[4] In January 1966, the National Association of Tax Administrators (the predecessor to the Federation of Tax Administrators) gathered to prevent legislation arising from the Willis Committee's work and, in November 1966, states commenced drafting the Multistate Tax Compact, which the first state enacted in 1967.[5]

We must acknowledge that companies are driven by ideas, innovation, and human energy, which primarily come from its employees. We must also acknowledge that companies' advantages in the market also arise from their use of assets—both tangible and intangible. Consideration of only the location of a corporation's customers to the exclusion of the location of property and payroll may lead to a roughly fair apportionment in some instances, but certainly not in all. When corporations have invested substantially in their infrastructure and their people, they should be prepared to push back against the application of wooden and narrow statutory apportionment formulas that do not appropriately take those investments into consideration. The key is how to push back and win.

US Constitutional Principles of Fair Apportionment

The US Supreme Court has explained that it will sustain a state taxing provision against a constitutional challenge when "the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State."[6] At issue when analyzing the constitutionality of a jurisdiction's statutory apportionment formula is the second item—fair apportionment—and the question, at its most basic, is simply whether the formula is fair.

In applying the fair apportionment requirement, the Supreme Court has observed that apportionment formulas are "a rough approximation of a corporation's income that is reasonably related to the activities conducted within the taxing State" and that such formulas "will occasionally over-reflect or under-reflect income attributable to the taxing State."[7] Notwithstanding the imprecision of formulary apportionment, the Supreme Court has declined "to impose strict constitutional restraints on a State's selection of a particular formula."[8] However, *the application* of a statutory apportionment formula will be struck down when a taxpayer sufficiently demonstrates that the income attributed to the state by the formula is "'out of all appropriate proportions to the business . . . transacted in that State' or has 'led to a grossly distorted result.'"[9] These principles come from the US Supreme Court's decision in *Moorman Manufacturing. Co. v. G. D. Bair* (1978), to which states often point in asserting that single sales factor apportionment formulas survive taxpayer challenges. But such states are engaged in selective reading and wishful thinking.

For example, in two cases, the Supreme Court has struck down single-factor apportionment formulas. In *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell* (1931), the Supreme Court held that North Carolina's single property factor statutory apportionment formula, which was based on real and personal property located within the state, was unconstitutional as applied to the taxpayer. The taxpayer was in the business of tanning, manufacturing, and selling leather products, was incorporated

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in New York, and owned a manufacturing plant in North Carolina.

The taxpayer offered evidence that the income from its business was generated from three distinct sources and demonstrated, through the use of separate accounting principles, that approximately seventeen percent of its income was attributable to its manufacturing activities performed in North Carolina. However, the state's apportionment formula yielded an apportionment percentage ranging from between approximately sixty-six and eighty-five percent during the years at issue (what the Supreme Court later described as a "more than 250 percent difference").[10] The Supreme Court concluded that this level of distortion was out of all appropriate proportion to the business transacted by the taxpayer in North Carolina.[11]

Moreover, in *Norfolk & Western Railway Co. v. Missouri State Tax Commission* (1968), Missouri's statutory apportionment formula required that railroad rolling stock be apportioned to the state for property tax purposes based on the proportion of the taxpayer's railroad track miles in Missouri relative to the taxpayer's railroad track miles everywhere. The taxpayer, primarily a coal-carrying railroad, had leased all the property of another railroad company that engaged in a substantial amount of business in Missouri. Under the statutory formula, eight percent, or approximately $20 million, of the taxpayer's rolling stock was apportioned to Missouri.

The taxpayer offered evidence that the actual percentage of its rolling stock located in Missouri on the assessment date was three percent, or approximately $7.6 million, a distortion of approximately 165 percent. The taxpayer also demonstrated that: 1) its coal operations required a substantial amount of specialized equipment that rarely ever entered Missouri, and 2) the company had leased most of its rolling stock regularly present in Missouri and that Missouri had assessed such property in the year before the lease at approximately $9 million. The Supreme Court stated that, when a taxpayer comes forward with strong evidence tending to prove the formula yields a grossly distorted result, the state is required to "make the accommodations necessary to assure that its taxing power is confined to its constitutional limits."[12]

Finally, again in the *Moorman* decision, the Supreme Court held that Iowa's single sales factor statutory apportionment formula was presumptively valid, and that Iowa was not constitutionally prohibited "from requiring taxpayers to prove that application of the single-factor formula has produced arbitrary results in a particular case."[13] The taxpayer was an Illinois corporation engaged in the manufacturing and sale of animal feed. Although the products the taxpayer sold were all manufactured in Illinois, the taxpayer had warehouses and sales representatives in Iowa and made sales to customers located in Iowa.

The Supreme Court observed that the taxpayer did not sufficiently demonstrate that a significant portion of its income attributed to Iowa under Iowa's single sales factor statutory formula was in fact attributable to its Illinois operations, finding that "the record does not contain any separate accounting analysis showing what portion of appellant's profits was attributable to sales, to manufacturing, or to any other phase of the company's operations."[14] This absence was more of a strategic decision on the part of Moorman, the taxpayer, to attempt to invalidate all single sales factor formulas and not just to win its own case. The Supreme Court expressly left open the door for other taxpayers to sufficiently demonstrate that a single sales factor statutory apportionment formula operates unconstitutionally as applied to them. Far from foreclosing taxpayer challenges to single sales factor formulas, the Supreme Court's decisions as a whole body of law have invited further challenges and provide a framework for what a taxpayer needs to demonstrate in order to win such a challenge.

Why Are Single Sales Factors Unfair, and What Does It Take to Win?

To explain the unfairness of single sales factors—and what it would take to win an as-applied constitutional challenge to a state's statutory single sales factor apportionment formula—we will examine two examples of companies in different lines of business under simplified facts to make our point. First, we will consider a manufacturing corporation

that has a large manufacturing plant and workforce in one state and that makes sales to customers located throughout the United States. Second, we will consider a company providing consulting services that has all its employees located in a single state and that provides most of its consulting services remotely from that state, with employees communicating with clients primarily by telephone and by videoconferencing software.

In *Moorman*, it was insufficient for the manufacturing company to simply assert that the mere presence of its manufacturing facility in Illinois demonstrated that Iowa was taxing an unconstitutional portion of the company's income. The Supreme Court noted that the company had six warehouses with inventory in Iowa and an Iowa sales force of over 500.[15] Moreover, the company did not demonstrate the profitability of its Illinois manufacturing operation. The Supreme Court explained that without separate accounting, it could just as reasonably assume that access to the Iowa market was generating most of the company's profits whereas the manufacturing portion of the business in Illinois was being operated at only marginal profitability or even at a loss.[16]

Our sample manufacturing corporation would need to demonstrate, using economic analyses such as separate accounting and factual development of where and how income is generated, that its manufacturing operations outside the taxing state are profitable, and that the taxing state's statutory single sales factor formula is necessarily attributing to the state a part of the corporation's income that is being generated by the out-of-state manufacturing operations.

However, merely showing that separate accounting yields a different result will likely not be sufficient to win an as-applied challenge to the statutory apportionment formula. For example, in *Butler Brothers v. McColgan* (1942), the taxpayer used separate accounting to demonstrate that its California business operations were not profitable, but the Supreme Court nonetheless declined to invalidate the application of California's statutory apportionment formula, finding that the taxpayer "has not shown the precise sources of its net income" and did not demonstrate that "factors which are responsible for that net income are present in other States but not present in California."[17]

To meet this evidentiary standard, our manufacturing corporation would need to demonstrate that its income is generated primarily through its manufacturing process and its activities performed by key personnel outside the state. This could be accomplished through economic analysis by an expert witness. It would be helpful to the company's case if it does not have relatively significant activities in the state that seeks to apply its statutory single sales factor apportionment formula (whereas in *Moorman*, the taxpayer had six Iowa warehouses and an Iowa sales force exceeding 500). The fewer or more limited activities the corporation performs to exploit the in-state market, the more persuasive it will be to a court that the corporation's in-state activities are not primarily responsible for generating its income.

For our other example, the consulting services company, inasmuch as a cost-of-performance sourcing methodology for sales should consider where the services are performed (that is, where the company's property and payroll are located), the potential challenge would be in a state with a statutory single sales factor apportionment formula that also imposes market-based sourcing for sales, a reasonable assumption given that most states that have adopted a statutory single sales factor formula have also adopted market-based sourcing for sales of services.

To be constitutionally fair, "the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated."[18] In our service company example, a statutory apportionment formula that considers only the location of the service company's customers and places no weight on where the company's employees are located and actually performing the services (or contemplating how to increase the extent of the services) does not reflect a reasonable sense of how the service company generates its income. As with our manufacturing corporation example, the argument against the statutory formula is more persuasive if the service company does not perform relatively substantial in-state solicitation activities.

Moreover, it is important to note that if the service company's headquarters are in a state that requires cost-of-performance sourcing for service revenue, then the impact of the out-of-state market-based sourcing approach by the taxing state will result in double taxation of the company's income. Proving actual double taxation, in addition to producing evidence demonstrating that the taxing state's statutory formula does not reasonably reflect how income is generated,

could further bolster the service company's challenge to the statute.

Our two examples are simplified to illustrate the point that statutory single sales factor apportionment formulas are unfair and ripe for challenge. Any such challenge would require a fact-specific analysis of the multistate operations of the challenging company as well as an analysis of any unique factors in the industry in which that company operates.

Conclusion

An apportionment challenge can be worth the effort. It is unlikely that a state would agree to alternative apportionment based on the above arguments during an audit. Nonetheless, the audit level is a good time to begin laying the groundwork and factual bases for court and tribunal constitutional challenges to a state's normal statutory apportionment formula as applied to the company. The US Constitution requires that a state's apportionment formula must always be fair. Simply because a formula is a normal statutory formula does not necessarily mean that it always operates fairly. To the contrary, there will be times when it operates very unfairly, and taxpayers should be prepared to stand up for their rights when doing so ensures that "fair" really does mean "fair."

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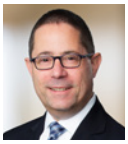
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Endnotes

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8 *Moorman Mfg. Co.* at 273.

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10 *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 184 (1983).

11 *Hans Rees' Sons, Inc.* at 135.

12 *Norfolk & W. R. Co.* at 329.

13 *Moorman Mfg. Co.* at 281.

14 *Moorman Mfg. Co.* at 272.

15 *Moorman Mfg. Co.* at 269.

16 *Moorman Mfg. Co.* at 272.

17 *Butler Brothers v. McColgan*, 315 U.S. 501, 509 (1942).

18 *Container Corp. of Am.* at 169.