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July 9, 2008

Mr. Charles A. Trost, Chair
Drafting Committee to Revise the Uniform Division
of Income for Tax Purposes Act
111 North Wabash Avenue, Ste. 1010
Chicago, Illinois 60602

Re: UDITPA revision

Dear Mr. Trost and Committee Members:

Thank you for the opportunity for my staff, Robynn Wilson, to attend the meeting of the Drafting Committee to Revise the Uniform Division of Income for Tax Purposes Act (UDITPA), held recently in Chicago. The project is complex and will require a great deal of discussion. Alaska is very interested in this process, because Alaska was one of the first adopters of UDITPA in 1959, and continues to use the standard UDITPA for general corporate application.

My purpose in writing is to encourage the Committee to approach this project by first articulating core policy principles upon which the work will be based. Once these principles are established, then the work of the drafters can proceed in the most efficient and effective manner. I believe that there are four policy decisions to be made:

1. **Is apportionable "business income" co-terminus with constitutionally apportionable income?** Since the statute cannot apportion more than is constitutionally allowable, this really means: Can/should the statute apportion less than is constitutionally allowable?

This is an issue in the event that a taxpayer seeks to classify a loss as business income and the state (to which such income item is not allocable) seeks to re-classify the loss as non-business income. Alternatively, this would be an issue where a taxpayer seeks to classify a state-specific income item as business income, while the state may seek to re-classify the income as non-business income, with the result that 100% of the income is allocable to that state.

2. **Is full-accountability a desirable goal?** By full-accountability, I mean that all of a taxpayer's taxable income is apportioned or allocated to the taxing jurisdictions in which it has taxable nexus.

This has at least two components: application of the throw-back rule and "no-where" factors.

- a. The "throwback rule" assigns sales back to the state of origin when such sales were destined for a jurisdiction in which the taxpayer does not have nexus.
- b. Outer-jurisdictional property includes satellites and property held in off-shore federal mineral leases. This property may be removed from the property denominator, or treated as a non-taxable jurisdiction. Removal from the property denominator results in taxable income being spread among the states in which the taxpayer has taxable nexus based on the remaining factor elements. If the property is assigned to a non-taxable jurisdiction, however, then the proportion of property attributable to each state in which the taxpayer has taxable nexus is smaller.

A related situation exists with respect to certain property in transit. For example, the value of a ship traveling over the high seas between Alaska and another state is assigned to numerators based on time within each state, under the MTC Apportionment Regulations. If the mobile property spends equal time in Alaska and another state, one-half of the value is assigned to Alaska and one-half to the other state. However, an argument was presented during the committee meeting last week that suggested some value of the ship should be assigned to the high-seas.

- c. Some sales or gross receipts cannot be sourced as to jurisdiction. These are amounts that are generated within at least one taxing jurisdiction. For example, the actual income-producing activity cannot be readily identified for certain types of intangible income. Without identification of income-producing activity, the associated costs of performance cannot be identified, and therefore, sourcing the income is impossible. If this income is included in the sales denominator, but not sourced to a particular state numerator, this produces "nowhere income."
3. **If income is to be apportioned based on "business activity," then are measures of property, payroll, and sales the correct measures of "business activity"?**
4. **What is the purpose of each of the factors, and is the current definition of each factor meeting the purpose of that factor?** Is the purpose of the sales factor to represent the market state? Or is it to represent each item of income? What about income that is already represented by property or payroll? For example, rental income is generated principally by the ownership of property.

Formulation of the core policy principles will help the Committee to judge the extent to which UDITPA should be revised. Secondary criteria should then be identified to judge whether it is necessary to revise each section. Criteria may include the amount of associated litigation and whether it results in disparate interpretations by the states. These areas can be controversial. However, committee guidance may be useful in promoting uniformity among the states. Lastly, revision criteria may include the perceived need for UDITPA to be modernized so that it operates properly in our global, fluid, and internet economy.

B. Drafting clarification

Even if UDITPA expresses no position on unitary combination, the language should provide for logical application to unitary combination situations for combination states. There are two areas in which clarification and re-drafting is needed to properly provide for unitary combination.

1. **Use of the term “taxpayer”.** In a unitary combination context, UDITPA is inconsistent in its use of the term “taxpayer”. This is a problem commonly referred to as a Joyce/Finnigan problem. Joyce stands for the proposition that “taxpayer” refers to the particular corporate entity doing business in a particular state. Finnigan stands for the idea that the unitary group is the entity doing business in a particular state. Often Joyce/Finnigan is discussed with respect to a throwback provision. However, the question is relevant with respect to other areas. For example, Section 7 allocates interest and dividends to the state of the taxpayer’s commercial domicile, which is reasonably read here to mean the commercial domicile of the particular corporation. In contrast, Section 10 computes the property factor, the denominator of which is the value of “all of the taxpayer’s” property. The only reasonable reading of this is to interpret this as being all of the property belonging to the unitary group. In addition, where there are mergers and acquisitions, the *taxpayer’s cost* may be interpreted as being the cost of the property in the hands of the individual corporation (inside basis) or the cost of acquiring the corporation by the parent of the group (outside basis), which may reflect the depreciated cost of the plant and equipment. This inconsistency is confusing and would benefit from careful re-drafting.
2. **Section 18.** Section 18 provides several options for situations in which the allocation and apportionment provisions do not fairly represent the extent of the taxpayer’s business activity in the state. One of these options is separate accounting. The unitary combination context is based on a premise that the income of any particular company cannot be correctly determined because of the flows of value that occur between members of the unitary group. Some of these flows of value can be quantified through transfer pricing, but many of the flows of value cannot be quantified. Separate accounting relies on complex transfer pricing and ignores unquantifiable flows of value. Separate accounting is incompatible with unitary combination.

We look forward to the opportunity to review specific draft language in the revision of UDITPA, and we will provide section-specific comments at that time. In the meantime, if the Committee has any questions about these comments, please contact Robynn Wilson, Corporate Income Tax Audit Manager, at robynn.wilson@alaska.gov. Thank you for the opportunity to comment.

Sincerely,



Jon Iversen, Director
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Alaska Department of Revenue