chair John Chiang
member Judy Chu, Ph.D.
member Michael C. Genest

State of California
Franchise Tax Board

05.30.08

Chairman Charles Trost and
Members of the UDITPA Drafting Committee
National Conference of Commissioners on
Uniform State Laws

First, we would like to acknowledge the wisdom of the National Conference of Commissioners on Uniform State Laws (NCCUSL) for undertaking a review of the Uniform Division of Income for Tax Purposes Act (UDITPA). UDITPA is over fifty years old and it has informed state division of income tax laws for a number of years. The economy of the country, however, has changed, and it is time to review UDITPA and make changes necessary to better reflect and account for the manner in which multistate business enterprises now earn their income. Second, we wish to thank the UDITPA Drafting Committee for the opportunity to comment on the possible scope of its review of UDITPA and commend it for the obvious thoughtful consideration evidenced by the questions it has proposed for comment. Finally, we also wish to acknowledge the efforts of the Committee in establishing ground rules for this initial meeting of the Drafting Committee that will ensure a fair and equal presentation of views and issues.

These responses are submitted on behalf of the Franchise Tax Board of the State of California (FTB) in response to the document issued in April of 2008 by the Uniform Division of Income for Tax Purposes Act Drafting Committee of the National Conference of Commissioners on Uniform State Laws. The FTB staff is generally recognized as having the greatest level of experience among the states in the administration of the UDITPA. California is accepted as being the source of the business-nonbusiness income distinction that is one of the core principals of the current version of UDITPA. It is also recognized as being the primary advocate of the use of the unitary business principle and the combined report concept. The FTB has been a party in a number of cases that have been decided by the United States Supreme Court involving the unitary business principle and UDITPA. In addition, it has participated as an *amicus* in a number of other cases involving state taxation that have been considered by the United States Supreme Court.

These responses have been prepared by the Legal staff of the FTB and are preliminary in nature. They are offered with the hope that they may assist the Drafting Committee in determining the scope of the review it will be undertaking. The comments address the questions raised sometimes from a theoretical perspective, sometimes from a practical perspective, and in some cases from both perspectives. They are informed by the experience of the staff of the Franchise Tax Board in administrative, judicial and legislative forums.

Sincerely,

Benjamin F. Miller
Counsel, Multistate Tax Affairs

Legal Division MS A260
PO Box 1720
Rancho Cordova CA 95741-1720
tel 916.845.3320
fax 916.843.6122
ftb.ca.gov

Response of the California Franchise Tax Board to
UDITPA Issues to Consider For Revision
UDITPA Drafting Committee, April 2008

We have attempted to set forth the questions and text included in the NCCUSL document in their entirety.

Unstated questions, which the Franchise Tax Board believes are inherent in the text, have been added when deemed appropriate and are in italics.

The responses are indicated by a **bold** heading and are indented.

Current UDITPA

Section 1

(a)

Several States have amended their statutes to eliminate the distinction between business and nonbusiness income, choosing instead to tax income on an apportioned basis to the extent permitted by the U.S. Constitution.

Is this an alternative worth considering?

> **Response:** No. There is no question that state consideration of income in its tax base is limited by the unitary business principle, which has been found to be implicit in the Due Process Clause of the Fourteenth Amendment, therefore it would not be Constitutionally permissible for UDITPA to exceed the limits established by the Constitution. However, these limits have been, and can only be, determined by judicial construction of the Constitution. Describing business or nonbusiness income, or apportionable as compared to allocable income, by reference to a judicial standard, which continues to be susceptible to interpretation, does not provide a concrete standard. It is believed that it would be preferable to establish an objective standard, which approaches but does not exceed, the current constitutionally recognized limits rather than establishing a rule that does not have an objective standard. An objective standard will promote uniformity. Uniformity will give rise to full accountability. This means there will be neither under- or over-taxation.
>
> Many states have considerable case law that has developed regarding the use of the current definition that has provided predictability to taxpayers in most fact patterns. The current rules have been vetted in many states and work well in most circumstances.

If so, how should a statute implement that approach?

> **Response:** N/A

A narrower change that some states have made is to clarify that income arising from assets used in the business generates business income. This is similar to a comment to the original section 1(a) of UDITPA[1] that has sometimes been ignored. This change was intended by some states to clarify that the income arising from the cessation of business, or from an extraordinary "once in a corporate lifetime" gain generates apportionable business income. *Should the income from assets used to generate business income be defined as business income?*

> **Response:** Yes, under California's case law, this is clearly the case. In Hoechst Celanese Corp. v. Franchise Tax Bd. (2001) 25 Cal.4th 508, the Court found that a sale of an asset that was part of the unitary business was apportionable.

At the least, it would seem some clarification of the language is called for: e.g., confirming whether there is one test or two (i.e., both transactional and functional).

> **Response:** Yes. The California Supreme Court addressed the existence of two tests in Hoechst Celanese Corp. v. Franchise Tax Bd. (2001) 25 Cal.4th 508. Clarification would provide greater uniformity. Much of the inconsistency in state decisions with respect to this issue has arisen because of imprecise drafting in the current statute. If it were made clear in the statute that there are two tests, this would resolve the lack of uniformity on this issue.

If UDITPA were to confirm that two tests exist, should the phrase "acquisition, management, *and* disposition" be changed to "acquisition, management, *or* disposition?"

> **Response:** Yes, the test should be phrased in the disjunctive. This is a reasonable solution to address one of the problems. By providing that any asset that is acquired, or managed, or disposed of as an integral part of the business operations of the taxpayer gives rise to business income, one of the ambiguities in the current definition will be removed. It should be noted that the phrasing as interpreted by the California Supreme Court in Hoechst Celanese Corp. v. Franchise Tax Bd. (2001) 25 Cal.4th 508, was construed as describing the type of rights that exist with respect to the property rather than the specific transactions involved.

[1] "Income from the disposition of property used in a trade or business of the taxpayer is includible within the meaning of business income."

Are the MTC regulations defining the transactional and functional test workable?

> **Response:** Yes, they provide considerable guidance and are consistent with the applicable constitutional case law in the area. This is not to say they could not be made more comprehensive.

If depreciation on an asset has reduced apportionable income during the period when the asset was used in the business, should there be a recapture of that amount of depreciation on the sale of that asset?

> **Response:** Yes, this seems fair and would provide consistent treatment to the taking of the depreciation deductions in determining apportionable income.

A related question is whether the apportionment formula should be modified to deal with situations in which the apportionable gain has accrued over a period of time.

> No, the level of complexity added by such a system would far outweigh the benefit of any theoretical precision gained by such a system. Exceptions might exist in the case of installment sales and taxpayers utilizing the completed contract method. In those unique scenarios, it seems appropriate to recognize that either the gain was earned in one year though reported over time by the election of the taxpayer or is earned over time even though the contract is completed in only one year.

In that case, should the gain be apportioned by the factors existing in the year of realization?

> **Response:** Yes, this is far simpler and is appropriate in most circumstances. However, as is provided under the current Section 18 regulations, if the sale is substantial and occasional, the sale would be removed from the sales factor. This allows the gain to be apportioned over the normal factors of the business rather than the aberrational spike caused by the occasional sale.

Should such gain be apportioned using some averaging mechanism, such as using the average of the prior years' apportionment percentages?

> **Response:** No, again this is overly complex for most situations. However, as stated above, this may be appropriate for installment sales and those using the completed contract method of apportionment.

Should a separate apportionment formula be used for such gain?

> **Response:** No. Frequently the gain realized is in part the recovery of deductions taken in prior years or reflects appreciation occurring over a number of years. It would be administratively burdensome, and highly subjective, to attempt to determine whether the gain represented recapture or prior deductions and accumulated appreciation with assignment of some portion to a particular time period.

A related question is whether the gross receipts generated by nonrecurring gain, or gain that has accrued over a substantial period of time, should be included in whole or in part in the receipts factor of an apportionment formula (see section 15 below)?

> **Response:** No, the sales factor should reflect the normal operations of the business that give rise to apportionable income. Furthermore, attempting to determine what annual accounting period appreciation accrued would not be feasible administratively.

Is clarification necessary to determine when a business asset is converted to a nonbusiness asset?

> **Response:** Yes, theoretically this seems constitutionally necessary for conversion to a nonbusiness use. It does not appear to be practical, however.

(b)

Section 1(b) defines “commercial domicile."[2] This definition summarizes succinctly the existing legal standard.

Could the definition be strengthened/clarified to reduce future litigation?

> **Response:** Yes, but the possibility of a clear rule is somewhat tempered by the factual nature of the inquiry. Perhaps a presumption could be applied that would make the inquiry more administrable.

Are there situations when a business might be viewed as having more than one commercial domicile?

> **Response:** Probably not, under the current definition of commercial domicile.

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[2] “‘Commercial domicile’ means the principal place from which the trade or business of the taxpayer is directed or managed.”

In combination states should commercial domicile be determined on an entity-by-entity concept or should the commercial domicile be determined for the combined group?

> **Response:** It should be determined entity-by-entity. Within a commonly owned reporting group, there could be different commercial domiciles because the various entities are in differing lines of business. There may be differing commercial domiciles for foreign versus U.S. operations as well.

In a water's edge return, should commercial domicile be determined taking into account only the U.S. corporations?

> **Response:** Yes, since only U.S. activities are normally considered. If foreign entities were included in the water's-edge definition, then a foreign commercial domicile would be appropriate.

(c)

Section 1(c) defines "compensation."[3] (The Comment to UDITPA indicates it is derived from the Model Unemployment Compensation Act, which has been adopted in all states.)

Is the definition of compensation broad enough to include modern forms of compensation?

> **Response:** The definition is broad enough and there are ease of compliance reasons to refer to this data, which is collected and reported for other purposes. However, there are circumstances where the classification of whether an individual is an employee, which is currently left to common law rules, may be hard to apply. Also, there should be greater clarity as to how to treat stock options and other deferred non-traditional types of compensation.

Should the payroll factor be broadened to include independent contractors?

> **Response:** Yes, in some circumstances the inclusion of independent contractors may be advisable. This may, however, give rise to disputes that should be avoided.

If so, is the existing definition of compensation adequate in that situation?

> **Response:** Depends on the other answers, but a broader definition may be advisable to deal with non-traditional forms of compensation.

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[3] "'Compensation' means wages, salaries, commissions and any other form of remuneration paid to employees for personal services."

(d)

Section 1(d) defines "financial organization."[4] The MTC has a model formula for apportioning the income of financials (adopted 11/17/1994). Its definition of "financial organization" does not tie directly to UDITPA, but rather suggests starting with the individual state's definition. *Should the MTC definition be used?*

> **Response:** No, this would not be conducive to uniformity. However, it must also be noted that there are other purposes for which states define financials so there are implications outside of UDITPA.

Section 2 (below) removes "financial organizations" and "public utilities" from UDITPA. Presumably, these entities were removed because they operated solely within one state. That is no longer true. Nonetheless, they present unique issues. Should financial organizations and/or utilities be removed from further consideration?

> **Response:** No, the removal of these activities appears to have been based on the heavy regulatory framework surrounding these industries at the time of the original drafting of UDITPA. They were not, however, necessarily single state businesses. For example, one of the earliest applications of the unitary business principle was to interstate railroads. Utilities and financials are no longer subject to such intensive regulation and they should not automatically be removed from consideration.

(e).

Section 1(e) defines "nonbusiness income."[5] See 1(a) above.

> **Response:** See 1**(a)** above.

(f).

Section 1(f) defines "public utility."[6] Some states--e.g., California--do not include this definition. Is this definition relevant in an era of deregulation?

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[4] "'Financial organization' means any bank, trust company, savings bank [industrial bank, land bank, safe deposit company], private banker, savings and loan association, credit union [co-operative bank], investment company, or any type of insurance company."

[5] "'Non-business income' means all income other than business income."

[6] "'Public utility' means [any business entity which owns or operates for public use any plant, equipment, property, franchise, or license for the transmission of communications, transportation of goods or persons, or the production, storage, transmission, sale, delivery, or furnishing of electricity, water, steam, oil, oil products or gas]."

Response: Probably not.

(g).

Section 1(g) defines "sales."[7] Is this definition satisfactory?

Response: No, the current definition has lead many states to opt out and create their own definitions or to seek a variance under section 18. One of the strategies frequently being employed by taxpayers is inflation of the denominator of the sales factor to lower the apportionment fraction. Limiting sales by definition will effectively combat this strategy. Many states have already modified their laws to remove intangibles from the definition of sales. By our count this number is at least thirteen states. There are many others that have developed a rule of net instead of gross receipts for certain intangibles as well. The trend away from the inclusion of gross receipts from intangibles is in recognition of the large effect these types of receipts can have on the factor and the relative disparity in the earning capacity (i.e., profit margin) of intangibles assets. The European Economic Community, which is considering the definition of sales currently, has suggested that it be limited to the sales of goods and services. This is a simpler approach and is consistent with a market reflection purpose of the sales factor.

Should anything be done in response to the "treasury function" issue raised by Microsoft?

Response: Yes, the definition of sales should be modified to remove these types of receipts from the sales factor. This is already the rule in most states and is, in fact, the more uniform position.

(h).

Section 1(h) defines "state."[8] Presumably, no change is necessary.

Response: This is correct.

Section 2.

Section 2 sets forth the requirement for allocation and apportionment.[9]

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[7] "'Sales' means all gross receipts of the taxpayer not allocated under Sections 4 through 8 of this Act."

[8] "'State' means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof."

It excludes financial organizations and public utilities from coverage. If these entities are brought within the UDITPA regime, a conforming change is needed here. *Should financial organizations and public utilities be brought within UDITPA?*

> **Response:** Yes, in particular, in a combined reporting regime, states frequently encounter commonly owned entities with financial activities.

The section also excludes an individual rendering purely personal services. Presumably, this exclusion recognizes that individuals are subject to a personal income tax regime, which typically taxes residents on their worldwide income and provides a credit for income taxes paid to other states. Is there any reason to bring individuals within UDITPA?

> **Response:** Is there any reason not to do so? There are sourcing issues for non-residents and the allowance of tax credits for individuals. An individual may have a need to apportion income similar to a corporation. Sole proprietorships may be a good example of such a circumstance.

Section 3.

Section 3 sets forth the rule for when a taxpayer is taxable in another state and, therefore, becomes an apportioning taxpayer.[10]

Arguably, the first clause is unnecessary because it is swallowed by the second. *Is the first clause unnecessary because it is swallowed by the second?*

> **Response:** Yes, paying a tax usually means that the taxpayer has conceded that the taxing authority had jurisdiction to impose the tax. However, there are circumstances where a taxpayer may pay a tax voluntarily to avoid an even larger liability based on throwback. Removing the first clause may remove this incentive.

Should there be clarification that mere jurisdiction to tax by a state that does not levy an income tax is sufficient (as contrasted with an actual tax liability)?

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[9] **Section 2.** "Any taxpayer having income from business activity which is taxable both within and without this state, other than activity as a financial organization or public utility or the rendering of purely personal services by an individual, shall allocate and apportion his net income as provided in this Act."

[10] **Section 3.** "For purposes of allocation and apportionment of income under this Act, a taxpayer is taxable in another state if (1) in that state he is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or (2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not."

Response: Yes, this seems consistent with the current rule and would clarify the application.

Do we need a right to apportion provision at all?

Response: No

Are the MTC regs governing when a corporation can apportion workable?

Response: Yes

Should anything be done about a taxpayer that "voluntarily" pays tax in another state in order to avoid a throwback rule?

Response: Yes, there are situations where paying the tax may be less costly to the taxpayer than the throwback. In such circumstances, the payment of the tax should not be enough to end the inquiry. The jurisdictional ability to tax should be the touchstone of the inquiry. Voluntarily paying should be rebuttable based on the facts.

What rules should be applied to determine if a corporation is taxable by a foreign country?

Response: U.S. constitutional standards seem to be most appropriate. This is the standard in California. See Appeal of Dresser Industries, 82-SBE-307 (1982), where the SBE held that the U.S. constitutional standard applied, but P.L. 86-272 did not, when determining jurisdiction to tax in a foreign country.

Section 4.

Section 4 allocates rents and royalties from certain enumerated assets as prescribed by sections 5-8.[11] What rules apply to assets not enumerated in Sections 5-8?

Response: They appear to be ignored. There should be a default rule/presumption to avoid nowhere income.

[11] **Section 4.** Rents and royalties from real or tangible personal property, capital gains, interest, dividends or patent or copyright royalties, to the extent that they constitute nonbusiness income, shall be allocated as provided in paragraphs 5 through 8 of this Article.

The rules sometimes allocate the gain on the sale of a nonbusiness asset differently from the way the income generated by that asset is allocated. Does this dichotomy make sense?

> **Response:** No. It is assumed that the allocation referred to is for purposes of the sales factor and royalty income.

Section 5.

Section 5 prescribes rules for allocating nonbusiness rents and royalties from property located in the state.[12] Section 5(a) allocates net rents and royalties from real property to the state of use. Section 5(b) allocates net rents and royalties from tangible property to the state of use, or to commercial domicile if the taxpayer is not taxable in the state of use (or organized in that state). Section 5(c) allocates mobile property by an apportionment methodology.

Should the default to commercial domicile be retained?

> **Response:** Probably. Commercial domicile remains a valid constitutional location to impose the tax.

What does a "royalty from real property" refer to? Oil and gas royalties?

> **Response:** We are not sure. Perhaps this is referring to a severance payment for extractive rights to remove items such as oil or natural gas? But it would not necessarily be limited to oil and gas.

Are the rules for determining where property is "utilized" workable?

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[12] **Section 5.** "(a) Net rents and royalties from real property located in this state are allocable to this state.

(b) Net rents and royalties from tangible personal property are allocable to this state:

(1) if and to the extent that the property is utilized in this state, or

(2) in their entirety if the taxpayer's commercial domicile is in this state and the taxpayer is not organized under the laws of or taxable in the state in which the property is utilized.

(c) The extent of utilization of tangible personal property in a state is determined by multiplying the rents and royalties by a faction, the numerator of which is the number of days of physical location of the property in the state during the rental or royalty period in the taxable year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the taxable year. If the physical location of the property during the rental or royalty period is unknown or unascertainable by the taxpayer, tangible personal property is utilized in the state in which the property was located at the time the rental or royalty payer obtained possession."

Response: Yes, however, California has not had much experience in applying this section. Other states may know more due to their use of this type of approach in the business income context.

Section 6.

Section 6 essentially parallels Section 5[13] for capital gains from tangible property (in the state where located if taxable; otherwise commercial domicile). Intangible property is allocated to the state of commercial domicile.

Is it appropriate to retain a commercial domicile rule for tangible property?

Response: Default may not be needed, as nexus should follow from having property in the state, but there appears to be no harm in retaining the rule.

Should there be rules dealing with the moving of an asset on the eve of its sale in order to minimize the tax?

Response: Yes.

Section 7.

Section 7 allocates interest and dividends to commercial domicile.[14]

Should commercial domicile be replaced by the state where the underlying intangible property is managed?

Response: Theoretically, yes, management may be more localized, especially for an international corporation. Management of the specific assets giving rise to the income is a more exact method. However, this may give rise to factual disputes that are not worth the potentially greater accuracy.

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[13] **Section 6.** "(a) Capital gains and losses from sales of real property located in this state are allocable to this state.

(b) Capital gains and losses from sales of tangible personal property are allocable to this state if

(1) the property had a situs in this state at the time of the sale, or

(2) the taxpayer's commercial domicile is in this state and the taxpayer is not taxable in the state in which the property had a situs.

(c) Capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state."

[14] **Section 7. "**Interest and dividends are allocable to this state if the taxpayer's commercial domicile is in this state."

Section 8.

Section 8 allocates patent and copyright royalties to the state where they are utilized.[15]

Are the rules on where a patent or copyright is utilized workable?

Response: Yes

Does it make sense to allocate to the jurisdiction where utilized when the royalties generate nonbusiness income covered by sections 5 and 8, while continuing to use cost of performance rules when the royalties generate business income and are governed by section 17?

Response: No, allocation to the jurisdiction where the intangible is utilized is the better rule. In fact, many states have moved towards the utilization rule for business income purposes. This may well be the more uniform position as time goes forward.

Section 9.

Section 9 sets forth the three-factor formula.[16]

Should the term "allocation" in the heading of Sec. 9 be replaced by "apportionment"?

Response: Yes, this would remove some ambiguity in the terms.

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[15] **Section 8.** "(a) Patent and copyright royalties are allocable to this state: (1) if and to the extent that the patent or copyright is utilized by the payer in this state, or (2) if and to the extent that the patent or copyright is utilized by the payer in a state in which the taxpayer is not taxable and the taxpayer's commercial domicile is in this state.

(b) A patent is utilized in a state to the extent that it is employed in production, fabrication, manufacturing, or other processing in the state or to the extent that a patented product is produced in this state. If the basis of receipts from patent royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the patent is utilized in the state in which the taxpayer's commercial domicile is located.

(c) A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the basis of receipts from copyright royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the copyright is utilized in the state in which the taxpayer's commercial domicile is located."

[16] **Section 9.** "All business income shall be apportioned to this state by multiplying the income by a faction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three."

Should a factor be eliminated if its denominator is zero?

> **Response:** Yes, the inclusion of a zero factor results in significant distortion of the apportionment formula. California has held the inclusion of a zero factor to be correctable under section 18. See Appeal of Oscar Enterprises, LTD, 87-SBE-069, Oct. 6, 1987.

What should be done with the current lack of uniformity with so many states moving to more heavily sales factor weighting whereas the existing UDITPA calls for three equally weighted factors?

> **Response:** This should be addressed by a requirement that multiple factors are utilized. This is the correct approach from a theoretical perspective, but it involves business development issues for the states, so it may be difficult to address. An example of where a sales factor only formula would be likely to be found unconstitutional is the case of an integrated oil company with the oil field in one jurisdiction in sales in another. Assigning all income to the state where the sales take place would be inappropriate. This is likely to be an issue that will have significant uniformity impact.

What, if anything, should be done about all of the existing industry-specific apportionment formulas?

> **Response:** If the industry-specific standards were applied to each of the individual apportionment factors the issues would be largely solved. For example, the transportation industry frequently makes an apportionment based on mileage. If this were modified so mileage was applied to allocate: 1) property used cross jurisdictionally; 2) payroll engaged in cross-jurisdictional transactions; and 3) sales arising from cross jurisdictional shipping, a better formula would result. This would bring these formulas into conformity with standard factors.

Section 10.

Section 10 sets forth the property factor rule.[17]

Should intangible property be included in the property factor?

[17] **Section 10.** "The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the tax period and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the tax period."

Response: Theoretically, yes, but such property may be impossible to situs, so the practical answer is "no". While theory would suggest that these assets are generators of value that give rise to the business income subject to apportionment, in practice it may be an impossibly hard task to develop rules for these assets to be included. There are large issues related to situs, similar to the sales factor rules (should they be assigned to where the intangible is used? If so, what does this mean?) as well as issues of valuation. Many intangibles are self created and may have little to no basis, while others may be purchased and have a very large basis. This is very problematic as well. These issues may be too large to overcome.

Perhaps the sale factor recognition of royalties and other flows of value from these assets is already adequate to reflect the importance of the intangibles. Valuation of intangibles usually is done as a multiplier of an income stream anyway. A property factor rule based on utilization may end up simply replicating the sales factor and thereby reflect these assets twice.

If so, where should it be treated as located?

Response: Location of use seems most appropriate. However, because for most businesses this will be everywhere the business is located, the assets would be evenly spread. This would be mathematically similar, if not identical, to not including the assets at all. As stated above, the existing factors, especially sales, are what give rise to the value of the intangibles and the inclusion may be unnecessary.

How should property used in each of two (or more) independent unitary businesses be treated for purposes of the formula?

Response: It should be included in the formula for both, either on a proportional basis or, if used by both, in its entirety in both. This is not a double counting situation. The businesses are filing separate returns on separate income.

Should property under construction be included in the property factor?

Response: Probably not. Should be consistent with rule for assets no longer used to produce business income.

How should property in transit or movable property be handled?

Response: Destination seems to have worked adequately.

Under what circumstances should property be viewed as being withdrawn from the business and removed from the property factor?

Response: When the property is no longer useable in the business subject to apportionment. This would include conversion to nonbusiness property.

If a taxpayer changes its manner of valuing property or removes property that it still owns from the property factor should it disclose that situation?

Response: Yes. Disclosure encourages uniformity and may lead to less inconsistent filing positions.

How should cars assigned to employees be treated?

Response: Too small to worry about. The regulations under section 18 already provide for a throw out of insubstantial receipts for the sales factor. This seems like a similar issue for the property factor.

Section 11.

Section 11 sets forth the rule that property should be valued at original cost.[18] Is that still the optimal valuation rule?

Response: Yes, this is the most practical method. While it is admittedly a rough approximation, when applied uniformly it works well. The complexity in using fair market value outweighs the precision that would be gained.

Is original cost to be preferred to original cost less tax depreciation?

Response: Yes, less need to track assets, especially when states have differing depreciation methodologies.

To original cost less financial accounting depreciation?

Response: Yes, again this adds complexity and is unnecessary. It should be noted, however, the European Union is considering an approach similar to this.

Should we clarify that capitalized intangible drilling and development costs are included in the property factor?

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[18] **Section 11.** "Property owned by the taxpayer is valued at its original cost. Property rented by the taxpayer is valued at eight times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from sub-rentals."

Response: Yes.

How should inventory be dealt with?

Response: It can be excluded. This depends on your view of the purpose of the property factor. If it is mainly to reflect the cost of the instruments of production, it should not be necessary to include inventory. Also, the location of inventory may be easily manipulated. It can also be argued that it may duplicate the sales factor.

Is a multiplier of 8 still valid for rental property?

Response: This method has not been the subject of much debate and seems to work well.

How should property that is subrented be handled?

Response: Included if subrents give rise to business income, or excluded if they give rise to nonbusiness income because nonbusiness. If they give rise to both business and nonbusiness income, normally you could subtract the subrents from the rents to arrive at an appropriate value or do it on a percentage-of-use basis since subrent might result in too small a reflection of the business portion of the rental property.

Should there be a throwback or throwout rule for property?

Response: Yes, outer jurisdictional property, such as satellites or undersea cables, which is not located in any state, should be thrown out of the factor as it cannot be assigned to any numerator and will result in nowhere income if included. Beyond this, throw out would seem to be unnecessary as property normally creates nexus.

How should property that is no longer actively used in the business be dealt with?

Response: Removed

Section 12.

Section 12 uses an opening and closing value of property, divided by two, or a monthly alternative, for determining how to obtain a property factor value.[19] Is any change required?

[19] **Section 12.** "The average value of property shall be determined by averaging the values at the beginning and ending of the tax period but the [tax administrator] may require the averaging of monthly values during the tax period if reasonably required to reflect properly the average value of the taxpayer's property."

Response: No. However, picking up some examples from the MTC regulations could provide greater specificity.

Section 13.

Section 13 sets forth the payroll factor rule.[20]

Should the factor be broadened to include independent contractors?

Response: It should be considered. We are starting to encounter this as a planning strategy; could be particularly important for states that do not use a combined report. It will, however, add complexity.

What if the independent contractor is a corporation?

Response: The activities of the corporation's employees could be utilized. In addition, it should be noted that having two entities have the same item in a factor is not a problem as long as they are not combined.

How should such payroll be sitused?

Response: The current rule assigns an employee to an individual state. All payroll per individual assigned to one state is easily administered but not always accurate. This may be mainly a compliance issue so basing the rule on employment taxes seems to work.

What about management fees paid to related corporations?

Response: It depends on whether the entities are in a combined report, if they are not in a combined treat as payroll to the extent that is what the payment it is for.

Should there be a rule for handling affiliated payroll companies?

Response: Depends on whether the state is a combined report state.

If so, are there circumstances where such a rule should be extended to nonaffiliated independent contractors?

Response: Yes, this is a planning strategy we have encountered.

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[20] **Section 13.** "The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the tax period by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the tax period."

How should compensation paid to employees generating nonbusiness income be treated?

Response: It should be excluded if identifiable and material.

How should compensation paid to persons in states where the taxpayer is exempt from taxation be treated?

Response: It should be thrown out if material. Arguably this could be addressed through adopting a factor presence nexus standard. It is likely to be too controversial.

How should deferred compensation be treated?

Response: Included. SEE BELOW.

How should stock options be treated?

Response: Included. This should be directly addressed in the definition of compensation.

If a taxpayer modifies its treatment of compensation should it notify the state?

Response: Yes.

Is a throwback or throwout rule appropriate for payroll?

Response: Yes, depends on nexus rules.

Section 14.

Are the rules for determining when payroll is assigned to a state workable?

Response: Yes, they are simple and administrable but not necessarily accurate.

Section 15.

Section 15 sets forth the sales factor rule.[21]

What receipts should be included that are now excluded?

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[21] **Section 15.** "The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period."

Response: None

What receipts should be excluded that are now included?

Response: Sales could be limited to sales of goods and services as is being proposed in Europe. Sales of intangibles cause far more problems than anything else and should be excluded in most circumstances.

Should the gross receipts from the sale of assets whose gain has accrued over a long period of time be excluded?

Response: Yes depending on materiality.

Should a special apportionment formula be used *for assets where gain has accrued over time*?

Response: No.

What rules should apply for situsing the gross receipts on the sale of intangibles, such as goodwill?

Response: Throwout. Goodwill arises from the operation of the business as a whole so it is already reflected by the normal factors.

Section 16.

Section 16 sets forth the rule for locating sales from sales of TPP.[22]

Is a throwback or throwout rule appropriate at all?

Response: Yes, a throwback rule is probably best. One or the other is needed to avoid nowhere income.

Should intercompany sales be eliminated in a combined report setting?

Response: Yes. Not having an intercompany elimination of sales rule would lead to double counting of sales when transferred between members of a unitary group, inconsistent with basic unitary theory.

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[22] **Section 16.** "Sales of tangible personal property are in this state if:

(a) the property is delivered or shipped to a purchaser, other than the United States government, within this state regardless of the f.o.b. point or other conditions of the sale; or

(b) the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser."

Should there be a similar rule for sales to affiliates even in separate return states?

> **Response:** Only to prevent tax avoidance.

Should there be a special rule for dock sales?

> **Response:** Yes. The issue has been the subject of litigation in many states with inconsistent results. Uniformity would be promoted with a specific rule, although this is usually a pretty intensive factual inquiry.

Does the destination rule work for sales to distributors and other intermediaries that will resell the goods?

> **Response:** Deals with nexus, generally it has not been a material issue. If the issue is the ultimate destination or consumer, the states have lived with the current situation without finding any significant problems of which the Franchise Tax Board is aware.

Should there be a double throwback rule?

> **Response:** Throwout is probably better. Double throwback is technically complicated, thus creating administrative burdens for states and taxpayers.

Should the preconditions that trigger throwback be changed?

> **Response:** It should be limited to taxability, not to taxed.

Section 17.

Section 17 situses services using a cost of performance standard. At one time, place of performance might have correlated with place of consumption. In today's economy, however, the cost of performance standard is an origin-based standard that is inconsistent with the destination principle used for situsing sales of tangible personal property. How important is it to coordinate the rules for tangibles with those for services and intangibles?

> **Response:** It is very important. The purpose of the sales factor, regardless of whether the sale is of a tangible or intangible item, is to find the market for the taxpayer's goods or services.

Should the cost of performance standard be retained?

> **Response:** No. It has proven to be unworkable.

The cost of performance standard situses sales based on the state where the majority of costs occurred, so that a state with 4% of the costs would get 100% of the sales if each of the other states accounted for 3% of the costs. If the cost of performance standard is to be retained, should it be implemented on a proportionate basis rather than a "winner takes all basis," so that sales will be sitused to a state based on its share of the costs of performance?

> **Response:** If retained, it should be implemented on a proportionate basis. If implemented on a proportionate basis, it still would be very hard to apply because it assumes you can still determine costs, which has proven to be a difficult task.

How should cost of performance be determined?

> **Response:** Shouldn't be used.

How to deal with historical costs?

> **Response:** They shouldn't be considered. Historical costs that are causally related to the receipts for the goods sold are relevant if costs of performance is to be used, but the same problems remain.

Does a cost of performance rule encourage service providers to locate in low-tax jurisdiction?

> **Response:** Yes.

Is it a problem if it does?

> **Response:** Yes it may lead to manipulation.

A cost of performance standard ensures that sales will be sitused in jurisdictions that have nexus. What weight should be placed on that feature?

> **Response:** This is necessary to make sure that 100 percent of the income is assigned to jurisdictions where the taxpayer is taxable.

Can a destination-based rule be administered?

> **Response:** Yes, address of the customer should be sufficient for it to work.

Should a throwback or throwout rule be adopted for services?

> **Response:** Throwout would probably be better. Throwback would require some sort of assignment mechanism, which would add to complexity and

difficulty in administration, and would tend to assign all receipts to one location.

How should a destination principle deal with tax avoidance strategies that involve delivering the service or intangible to a low-tax jurisdiction?

Response: If that is where delivered it should be assigned there. Absent a showing of artifice or lack of economic substance, if that's where the market is that's where it is.

Should different rules apply to sales made to related parties?

Response: It should only be necessary in a separate entity setting.

If a destination rule is adopted, does a different rule have to be developed for specific industries as the MTC now does?

Response: Generally that is what the MTC rules do, but a broad rule should be sufficient.

Is this tantamount to having different apportionment formulas for different industries?

Response: It does not have to be. A good uniform rule based on a consistent principle should work.

Which of the various state approaches should be further studied?

Response: All. Minnesota has adopted rules governing assignment of sales from services and intangibles; other states that have gone to single sales factor apportionment formulas have adopted rules other than cost of performance. Iowa was of course the first state to use a sales factor only for apportioning income.

Should sales be sitused in a state if they are derived from customers in a state?

Response: Yes, subject to nexus.

Should sales be sitused in a state if they are attributable to a state's marketplace?

Response: Yes.

Should sales be sitused in a state if the benefit of the services is received in a state?

Response: Yes, but this could add a great deal of complexity to the analysis (what about the sale of services or an intangible to an entity that in turn uses it in a number of different jurisdictions… should the service or intangible be sitused to the headquarters state or the states of ultimate use?)

Should sales be sitused in a state if the purchaser received the benefit of the service in a state?

Response: Yes. See above. Minnesota has a cascading rule based on the location of the receipt of the service: first to where services are received; then to the location of the office of the customer from which the services were ordered; then to the office of the customer to which the services are billed.

Should sales be sitused in a state if the recipient received the benefit of the services in a state?

Response: Yes. See above.

Is there useful guidance in the repealed Florida tax on services?

Response: The Franchise Tax Board does not know. Implementation and administration were very difficult and caused massive taxpayer confusion but the committee should consider everything.

Is there useful guidance in the Ohio CAT?

Response: There probably is but the Franchise Tax Board has not examined it.

Is their useful guidance in the SSTP?

Response: Probably. Based primarily on location of the customer, which does reflect the market.

Is there useful guidance in the experience of other countries?

Response: Probably.

Do services require different rules from intangibles?

Response: No, they both should be based on market reflection.

Section 18.

Section 18 sets forth the authority for alternative apportionment.[23]

Can anything meaningful be said about the concept of distortion?

Response: Yes, there must be an out clause to deal with unanticipated or unusual circumstances.

Can the situations where either the taxpayer or tax administrator is entitled to apportionment relief by described with greater precision?

Response: Probably not.

Should the "petition" requirement be eliminated either entirely or for certain types of alternative methods?

Response: Yes, for alternative methods. In other cases, however, the state needs some sort of notice if a taxpayer is applying an alternative apportioning methodology.

Should a parent automatically be entitled to include the apportionment factors of a subsidiary if the dividends from the subsidiary are included in the parent's apportionable (business) income?

Response: No.

Does Section 18 authorize the adoption of special formulas?

Response: Yes, but specific authority in the statute could prevent future litigation on the issue.

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[23] **Section 18.** "If the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the [tax administrator] may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(a) separate accounting;

(b) the exclusion of any one or more of the factors;

(c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

(d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."

POSSIBLE ISSUES TO CONSIDER NOT COVERED BY EXISTING UDITPA

1. Some of the "Comments" to the original Act have not been followed. For example, the Comment to Section1 that property used in the business, when sold, generates apportionable income has been ignored in some states. Should it be made clear that the "Comments" are to be considered part of the legislative history of UDITPA and should be considered by decision makers?

    Response: Yes. Comments could provide useful additional guidance on the drafters' intent.

2. How do we handle the various state and MTC rules for alternative formulas (e.g., MTC's Model Uniform Financial Institutions Apportionment Rule, Model Uniform Statute for REITs, Model Uniform Statute for RICs, Proposed Uniform Rule for Apportionment of Income from Telecommunications and Similar Services, etc?

    Response: Writing better, more modern standard rules will render many of the alternative formula rules unnecessary. There will not be a need to use many of the alternative formulas if the standard rules can be applied to a larger universe of taxpayers. Several of the other items cited to in the question are separate and discrete issues from those presented by UDITPA and may best be consider in another proceeding or are adequately dealt with as proposed Model acts.

   Should they be folded into a revised UDITPA?

    Response: Yes, to the extent they represent variations in formulary apportionment resulting from areas not addressed in UDITPA they should be considered in trying to rewrite general UDITPA rules. If the rules address issues beyond the scope of UDITPA it may be best to leave them out so as not to hamper the prospects for uniformity.

   Are some industries so large that rules should be considered?

    Response: Probably.

3. Existing UDITPA has nothing regarding corporations that invest in partnerships (LLCs). A few states have regulations on the subject. Should revised UDITPA deal with this?

    Response: Possibly. Care should be taken not to allow issues such as this to bog down dealing with the most important issues.

4. Mandatory combination. MTC has a model Proposed Model Statute for Combined Reporting, adopted August 17, 2006. The current lack of uniformity among the states using combination seems to be a problem. For example, compare *RR Donnelley* in Arizona (financing subsidiaries whose entire business is from affiliates not unitary) with *Miami Corp.* in Oregon (timberlands in Florida, oil and gas reserves in Louisiana, securities portfolio in Illinois, and a tree farm in Oregon were unitary based on sufficient centralized management, administrative services, and financing), and the new NY rules where combination is based on substantial intercorporate transactions.

   Should UDITPA provide for mandatory combination?

   > **Response:** This is likely to create problems in achieving uniformity though it is noted that recently there has been an increase in interest by separate entity states. Theoretically it would be appropriate and would aid uniformity. Combined reporting, however, has been a "hot-button" issue with the business community and attempting to deal with it in UDITPA may make it more difficult to achieve uniformity. Because the MTC has a model act addressing this issue it may not be necessary for the Drafting Committee to address it.

   What standard should be used for mandatory combination?

   > **Response:** An objective standard if this is to be pursued. But it needs to be recognized that combined reporting necessarily raises Constitutional Due Process issues.

5. Should taxpayers be permitted to **elect** combined reporting?

   > **Response:** Yes. An election should be binding and for an extended period of time. Using an election may resolve Constitutional concerns since it would be elective.

   Should taxpayers be permitted to **elect** the filing of consolidated returns?

   > **Response:** Yes, with agreement to waive nonbusiness income. Again the election should be binding and for an extended period of time. Using an election may resolve Constitutional concerns since it would be elective

6. Are the MTC regulations defining a unitary business workable?

   > **Response:** Yes.

7. If combination is required, should there be a uniform methodology for how to combine entities not subject to the same formula? For example, California

Response: Yes.

8. Should the project take on the issue of economic nexus?

   Response: Theoretically yes because it will promote uniformity if adopted. However, it is likely to be highly contentious and may hinder the adoption of a revised UDITPA.

9. Should procedural issues be included?

   a. Model tax court

      Response: Not necessary.

   b. Pay to play

      Response: No.

   c. Are the MTC regulations on Consistency and Uniformity in Reporting workable?

      Response: Yes, it leads to uniformity.

   d. Are there statutes of limitations that are unreasonably too short?

      Response: Perhaps but the Franchise Tax Board is not specifically aware of any.

   e. Should interest rates be equalized?

      Response: That is a question similar to tax rates and should not be addressed.

   f. Should federal extensions to file control for state purposes?

      Response: Yes they should extend state statutes.

   g. Are the periods for filing protests too short?

      Response: We do not believe the California periods are too short.
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h. Should the due date for corporate income tax returns be at least 30 days beyond the federal due date?

Response: Probably, but not sure this is worthy of the committee's consideration.