

Clandestine Designs — Taxing Authorities Looking to Overhaul Established State Tax Principles

<<http://www.alvarezandmarsal.com/newsletters/taw/images/darkblue.gif>>

Admittedly, the title of this article is hyperbolic. The positions of the Multistate Tax Commission (MTC) and the activities of the National Conference of Commissioners on Uniform State Laws (NCCUSL) are actually known to professionals, like the authors, whose jobs require knowledge and understanding of significant developments and trends. However, given the scope and potential impact of the project that is about to begin, it is apparent that for whatever reason, the major stakeholders in the ensuing debate — corporations and other business enterprises, governors and other members of the executive branches of state governments, and state legislative representatives — have been left in the dark. How can this happen? This is what seems to call for hyperbole.

In the safety of the shadows, away from the prying eyes of concerned taxpayers, taxing authorities are seeking major changes to state taxing regimes nationally. Veiled in darkness, the NCCUSL, with help from the MTC, is about to revisit the Uniform Division of Income for Tax Purposes Act (UDITPA). Indeed, with minimal input aside from the MTC, NCCUSL is seemingly glossing over its own rules and has set its sights on making dramatic changes to state corporate income tax regimes.

To understand the changes that NCCUSL is seeking, it is first important to shed some light on some of the key players and concepts in this cloak and dagger exercise.

National Conference of Commissioners on Uniform State Laws

NCCUSL's main focus is to promote uniform laws across multiple states on topics where "uniformity is desirable and practicable." It works towards this goal by drafting and proposing specific statutes, such as the Uniform Commercial Code. The commissioners that make up the NCCUSL are lawyers who have been appointed to work with NCCUSL by state governments.

In this particular plot, some argue that NCCUSL is circumventing its own rules and process. That is, NCCUSL has a set process for agreeing to, drafting and finalizing uniform statutes. First, its Scope and Program Committee investigates whether a subject is one in which it is desirable and feasible to draft a uniform act, and then submits its findings to NCCUSL's Executive Committee. If the Executive Committee agrees with the Scope and Program Committee that a uniform law should be drafted, a committee of commissioners is appointed to draft one. The act drafted by the committee of commissioners is debated by the entire NCCUSL organization at an annual meeting. Each act must be considered section by section during at least two annual meetings where all of the commissioners are sitting as a single committee, referred to as a Committee of the Whole. After the Committee of the Whole approves an act, the states must vote on the act, and a majority of the states present at the meeting (but no fewer than 20 states) must approve the act before it can be officially adopted as a uniform act. Then, the newly adopted model act is presented to the states for their consideration. As discussed below, in revisiting UDITPA, NCCUSL seems to have glossed over the threshold determination that it must be desirable and feasible to draft a uniform act.

Uniform Division of Income for Tax Purposes Act

What is UDITPA and why would NCCUSL circumvent its own procedures to rewrite it? UDITPA is a uniform act drafted and adopted by NCCUSL in 1957. It presents uniform rules for separating income into business income and non-business income and a formula by which business income is apportioned to states by a three-factor formula. Some have posited that while the theoretical underpinnings of UDITPA stem from late 19th-century Supreme Court cases addressing the property tax implications of railroads, the technical rules attempt to measure three major components in generating income: (1) capital, measured by the property factor, (2) labor, measured by the payroll factor and (3) the market where the income is generated, measured by the sales factor.

Over the years, some states have adopted UDITPA entirely, while others have looked to UDITPA as a guiding model for their own taxing regime. Over the past half-century, across multiple states, a great body of interpretative authority examining UDITPA has evolved. Taxing authorities, adjudicative bodies and taxpayers have quite often looked to other states' courts that have interpreted UDITPA for guidance, even though these interpretations are not binding on them.

A Sleight of Hand May Allow for a Redraft of UDITPA, Despite NCCUSL's Own Requirement

As noted above, according to NCCUSL's constitution, NCCUSL promotes uniformity in laws among states where "uniformity is desirable and feasible." In a statement that can be best described as an exemplar of a conclusory statement, the Executive Director of the MTC flatly stated to the Chair of the Study Committee on Revisions of UDITPA in a memo dated May 2, 2007, that

Model amendments [proposed by the MTC] will help modernize their apportionment laws in a consistent manner and are critical to preserving the original uniformity goals of UDITPA and the Compact. Thus, a project to develop these amendments would satisfy the NCCUSL criteria...by taking a necessary step toward promoting uniformity where uniformity is desirable and practicable.

It is unclear, however, how uniformity and modernity necessarily equate to "desirable and practicable."

The Council On State Taxation (COST) made a compelling case as to why uniformity is not practical in a letter dated January 10, 2008, to the Chair of the Study Committee on Revisions of UDITPA. The letter highlighted that elected state policymakers, as opposed to the revenue service employees who are members of the MTC as well as the commissioners on NCCUSL, purposefully desire not to be uniform with other states in order to "develop an attractive climate for jobs and investment" in their state when compared with other states. According to COST, businesses do not want UDITPA revisited because they believe there is an "inability to achieve uniformity of state tax statutes through a voluntary process."

Further, the COST letter pointed to the simple and yet glaring fact that "with respect to practicality, efforts to achieve uniformity in state tax law via voluntary model statutes have been less than successful by any measure... due to the inability of such laws to be crafted in such a way as to be uniformly embraced by individual state governors or legislatures." COST also surmised that as the broadened UDITPA scope proposed by the MTC included topics such as mandatory unitary combined reporting and nexus standards, it would be less likely, hence less practicable, that the revised UDITPA rules would be adopted by states. Further, even if NCCUSL can work out a compromise between the different states' viewpoints, "such a compromise would never be uniformly adopted [because m]any taxpayers and tax administrators would advocate only for those portions of a revised UDITPA that satisfied their own interests."

As of the date of this publication, NCCUSL has yet to respond publicly to either the MTC's or COST's

letters.

In addition to the points made by COST, the very actions of the MTC states since 1957 show that the states themselves have little interest in uniform laws. What was a standard three-factor apportionment formula has morphed into hybrids that emphasize exporting liabilities to out-of-state companies who, by the way, have little to no ability to exercise any political influence over the legislative process. What started as a uniform definition of business and nonbusiness income has become a hodgepodge of rules ranging from a single transactional test, to multiple transactional and functional requirements, to a standard that defines apportionable income as income that can constitutionally be taxed. What started as an income-producing-activities test based on costs of performance has now morphed into a diverse set of practices — all-or-nothing cost of performance, pro-rata cost of performance and market-based sourcing. Actions speak louder than words. Are these the actions of states that truly desire uniformity? And what might a new uniform act look like five years after enactment?

Case in point: Throughout the 1990s, the MTC worked, at times begrudgingly, in a collaborative effort, with members and representatives of the financial services industry to develop a model apportionment rule for financial institutions. Was the result perfect? Of course not, but it resulted in a series of rules that produced a compromise between market and production states and between the states and taxpayers. As astounding as it might sound, the MTC has now decided that the rules are no longer sufficient and is in the process of proposing an overhaul.

On a related note, the adoption rate of the MTC's model statutes and regulations has been far from overwhelming. One might ask why NCCUSL and the MTC believe this new effort will fare any better.

The original UDITPA had its genesis in a call for uniformity. A committee within the House Committee on the Judiciary, under the chairmanship of Congressman Edwin E. Willis (the so-called Willis Committee) was created to study problems associated with the imposition of state net income taxes on interstate commerce soon after U.S. Public Law 86-272 became a federal law. After five years of study, the Willis Committee ultimately recommended a two-factor formula based on property and payroll and a physical presence nexus standard. It also recommended that state net income taxes be administered by the federal government, with amounts remitted to the Treasury Department returned to the appropriate states. The states collectively balked at this recommendation and, instead, agreed to fix the problem voluntarily by adopting UDITPA and working to seek uniformity. We are as far removed from uniformity as we have ever been. The experiment has failed. Do we really believe that another bite at the same apple will fare a better fate?

The Process Has Begun

NCCUSL has now appointed the drafting committee. It will be chaired by Charles A. Trost, a member of Waller Lansden in Nashville, Tennessee. The co-reporters are Prof. Richard Pomp, University of Connecticut School of Law, and Prentiss Willson, formerly with Morrison & Foerster and Ernst & Young. Other members include William R. Breetz, Jr., Hartford, Connecticut; Robert J. Desiderio, Albuquerque, New Mexico; Steven G. Frost, Chicago, Illinois; Michael C. Geraghty, Anchorage, Alaska; Dale G. Higer, Boise, Idaho; Ann I. Park, Los Angeles, California; and Daniel Robbins, Los Angeles, California. The American Bar Association has appointed two advisors to the committee: Ethan D. Millar, Atlanta, Georgia, and Stephanie Lipinski Galland, Washington, D.C.

The first meeting of the drafting committee is scheduled for May 30–31, 2008, in Chicago. On April 25, NCCUSL released a whitepaper outlining issues to be discussed at the initial meeting. The topics, among

others, include the following:

- * Definition of “commercial domicile”;
- * Inclusion of independent contractors in the payroll factor;
- * Rules for where property is used; non-uniformity of factor weighting;
- * Inclusion of intangibles in the property factor;
- * Exclusion of certain receipts from the sales factor;
- * Throwback and throwout rules; and
- * Rules for cost of performance, including how they may influence location choices.

The drafting committee has also identified other issues, not currently addressed in UDITPA, that may be discussed, including:

- * Mandatory combination;
- * MTC’s definition of unitary business;
- * Economic nexus; and
- * Potential inclusion of procedural rules in the model law.

Should the Taxpayer Community Act to Stop the Redraft of UDITPA?

Many years have passed since UDITPA was first passed in the 1950s. While income from production and manufacturing is still important, service revenue and investment income have grown in importance. The issue at hand is not only who wants the UDITPA rules changed but also how they want them changed.

In the MTC’s May 2, 2007, letter to NCCUSL, it not only asked for a review of UDITPA but also “invite[d] NCCUSL to work with [the MTC] to review and draft model proposed amendments to UDITPA and Article VII of the [Multistate Tax] Compact.” Clearly, the MTC, which is made up of state taxing agencies, has every intention of not only advocating for a change in UDITPA but also being active in the review and redraft. The former executive director of the MTC, Dan Bucks, has stated publicly that the MTC is the “trustee” of UDITPA, indicating that changes should not be made without the direct input from the MTC. There is little doubt that the MTC will be actively engaged in this process. That means taxpayers and other stakeholders must be as well.

Of course, taxpayers also have an interest in any proposed changes to UDITPA. While the existing rules under UDITPA are not perfect, the rules have now engrained certain expectations and applications for taxpayers. Change will undoubtedly add confusion and uncertainty in applying the various state taxing regimes. For example, the MTC has made the substantive recommendation that “the sales factor should be to reflect the market state” as opposed to the cost of performance method put forth in the original UDITPA. While philosophically a market-state standard has certain appeal, one only has to work through such a model, as the authors have done for many clients, to understand how murky and uncertain the practical applications of market-state sourcing really are. The policy drawbacks of uncertainty and complexity must be balanced with the philosophical desire for market-based standards.

The changes the states have made to UDITPA since its adoption in 1957 discussed in the previous section not only underscore a disinterest in uniformity but also demonstrate that NCCUSL is not necessarily fixing any “problems” with UDITPA. The issue that NCCUSL is trying to address is how to handle the trend of states departing from the model rules UDITPA sets forth by tailoring the rules to meet their individual needs. State legislators are elected to set policy and to craft laws, including those pertaining to taxation, to promote the interests of the state and its constituents. For example, many states have adopted

single or heavily weighted formulas based on sales to relieve burdens on in-state companies at the expense of out-of-state companies. Even if UDITPA is amended today to reflect the shift to a single sales factor, in the future states' interests may shift again to another taxing paradigm, such as a gross receipts tax. Further, not all states follow trends and changes. NCCUSL's attempt to codify these shifts seems superfluous because after every rewrite, there will be some degree of customizing by the states. In fact, the rewrites do not take into account states that are content with the stability offered by UDITPA.

Alvarez & Marsal Taxand Says:

As noted above, the MTC has a strong desire to insert itself into the center of a rewrite of UDITPA. This process has gone too far already. Indeed, the voices of those responsible for setting a fiscal climate that is conducive to state economic expansion and growth should be heard. Rather than uniformity, these voices seek a flexible approach that allows each state to selectively tailor a taxing regime to particular circumstances. There should be fresh and open debate among all stakeholders on the appropriateness of this project. It is still early in the process. It's no exaggeration to say our voices can still make a difference.

Disclaimer

As provided in Treasury Department Circular 230, this e-newsletter is not intended or written by Alvarez & Marsal Taxand, LLC, to be used, and cannot be used, by a client or any other person or entity for the purpose of avoiding tax penalties that may be imposed on any taxpayer.

Alvarez & Marsal Taxand, LLC distributes a complimentary electronic newsletter to subscribers on a weekly basis. A&M Tax Advisor Weekly provides comprehensive and timely insight on a wide range of taxation issues including international tax, state and local tax, incentives and current issues. Readers are reminded that they should not consider these documents to be a recommendation to undertake any tax position, nor consider the information contained therein to be complete. Before any item or treatment is reported, or excluded from reporting on tax returns, financial statements, or any other document, for any reason, readers should thoroughly evaluate their specific facts and circumstances, and obtain the advice and assistance of qualified tax advisors. The information reported in these releases may not continue to apply to a reader's situation due to changing laws and associated authoritative literature, and readers are reminded to consult with their tax or other professional advisors before determining if any information contained herein remains applicable to their facts and circumstances.

<<http://www.alvarezandmarsal.com/newsletters/taw/images/line.gif>>

Taxand <<http://www.alvarezandmarsal.com/newsletters/taw/images/template/taxand-logo.gif>> About Alvarez & Marsal Taxand, LLC

Alvarez & Marsal Taxand, LLC, an affiliate of Alvarez & Marsal, a leading global professional services firm, is an independent tax group comprised of experienced tax professionals dedicated to providing customized tax advice to clients and investors across a broad range of industries. Its professionals extend Alvarez & Marsal's commitment to offering clients a choice in tax advisors free from audit-based conflicts of interest. Alvarez & Marsal Taxand serves clients with knowledge, experience and integrity, and an unyielding commitment to delivering unmatched and responsive client service. Alvarez & Marsal Taxand, LLC has offices in major metropolitan markets throughout the United States, in addition to London, England with the recent launch in 2007 of Alvarez & Marsal Taxand UK LLP.

Alvarez & Marsal Taxand is a founding member of Taxand, the first global network of independent tax advisors formed in 2005 by small group of highly respected tax firms around the world.

To learn more, visit www.alvarezandmarsal.com

<http://rs6.net/tn.jsp?e=0014heydc9cdK6zMvdTfFOLcVJUd94ZYy7-OAfDaHNX1-i0BtAjK8hXOBTN1I2PYqm65dRynghIMP3CqYgeaXKqyWAokOrXh22eMm5hU2GmFoukUcdIHUFzyyzjgEdyObHLyUY1ZjZOfB-TXrzNGaZ4iGslnsrOwPR3hSvgfQx0KE3ZeV9wjIy_QhR428zpDHZ8Okm387dASY=>>

Copyright 2008 Alvarez & Marsal Holdings, LLC. All Rights Reserved.

Forward email

<<http://ui.constantcontact.com/sa/fwtf.jsp?m=1100409827074&ea=robert.r.vonick%40disney.com&a=1102092842333>>

Safe Unsubscribe

<http://visitor.constantcontact.com/d.jsp?p=un&v=001PATbu7Y33LEmcSDx2sj03SxluARD8CK_cqeO0ZNj3Hc1K58GxR6feKqCIWdTBfpRWZBowcV0-mM40lpuWKcGww%3D%3D>

This email was sent to robert.r.vonick@disney.com, by taxadvisorweekly@alvarezandmarsal.com

Update Profile/Email Address

<http://visitor.constantcontact.com/d.jsp?p=oo&v=001PATbu7Y33LEmcSDx2sj03SxluARD8CK_cqeO0ZNj3Hc1K58GxR6feKqCIWdTBfpRWZBowcV0-mM40lpuWKcGww%3D%3D> | Instant removal

with SafeUnsubscribe

<http://visitor.constantcontact.com/d.jsp?p=un&v=001PATbu7Y33LEmcSDx2sj03SxluARD8CK_cqeO0ZNj3Hc1K58GxR6feKqCIWdTBfpRWZBowcV0-mM40lpuWKcGww%3D%3D> TM | Privacy Policy

<<http://ui.constantcontact.com/roving/CCPrivacyPolicy.jsp>> .

Alvarez & Marsal Taxand, LLC | 125 Park Avenue | Suite 2500 | New York | NY | 10017