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The Uniform Division of Income for State Tax Purposes

By WILLIAM J. PIERCE

A uniform state law should provide a reasonable method for allocating and apportioning the income of most multistate businesses for tax purposes. Its basic purpose should be the simplification of the task of computing state taxes. Recently the American Bar Association approved such an act, submitted by the National Conference of Commissioners on Uniform State Laws. The author, a member of the national conference and draftsman of this particular legislative proposal, explains some basic features which have been included in this proposed law.

THE UNIFORM DIVISION of Income for Tax Purposes Act was approved by the National Conference of Commissioners on Uniform State Laws and the House of Delegates of the American Bar Association during their annual meetings in July. The uniform act deals with the allocation and apportionment of income of multistate businesses and is designed for enactment in those states which have either net income taxes or taxes measured by net income. The text of the act was printed in the August, 1957 issue of TAXES, at page 631. It is the purpose of this article to explain some of the basic features of the proposal and to discuss the pros and cons of certain of its features.

At the outset it should be made clear that the uniform act makes two significant basic assumptions that should not be overlooked. First, it assumes that the state *has jurisdiction* to levy the particular tax. Thus, the question of whether the levy itself is violative of either the Due Process Clause or Interstate Commerce Clause of the United States Constitution is assumed to have been given satisfactory disposition.[1] Second, the uniform act assumes that the existing state legislation *has defined the base of the tax* and that the only remaining problem is the amount of the base that should be assigned to the particular taxing jurisdiction. Thus, the statute does not deal with the problem of ascertaining the items used in computing income or the allowable items of expense.

[1] For representative cases see: *American Manufacturing Company v. St. Louis*, 250 U. S. 459 (1919): *Shaffer v. Carter*, 1 STC ¶ 235, 252 U. S. 37 (1920): *McLeod v. J. E. Dilworth Company*, 1 STC ¶ 538, 322 U. S. 83 (1929); *J. D. Adams Manufacturing Company v. Storen*, 1 STC ¶ 529, 304 U. S. 307 (1938): *Connecticut General Life Insurance Company v. Johnson*, 303 U. S. 77 (1938): *Gwin, White & Price, Inc. v. Henneford*, 1 STC ¶ 531, 305 U. S. 434 (1939); *McGoldrick v. Berwind-White Coal Mining Company*, 1 STC ¶ 532, 309 U. S. 33 (1940): *Wisconsin v. J. C. Penney Company*, 1 STC ¶ 250, 311 U. S. 435 (1940); *Northwest Airlines, Inc. v. State of Minnesota*, 1 STC ¶ 475, 322 U. S. 292 (1944): *Freeman v. Hewit*, 2 STC ¶ 200-019, 329 U. S. 249 (1946): *Ott v. Mississippi Valley Barge Line Company*, 2 STC ¶ 200-031, 336 U. S. 169 (1949); *Spector Motor Service, Inc. v. O'Connor*, 2 STC ¶ 200-044, 340 U. S. 602 (1951).

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These assumptions must be kept in mind as there has been some confusion in the concepts involved. The proposal *does not* provide for the tax or the tax base; it merely provides for an equitable means of apportioning and allocating the income to individual states when the taxpayer is engaged in business in more than one state.

Constitutionality of Apportionment Formulas

One constitutional law question deserves brief mention and that is the validity of any apportionment formula. The United States Supreme Court has generally sustained any formula which is reasonably designed to determine the amount of income attributable to local business activity.[2] However, if the application of the formula causes an arbitrary or unreasonable result, application in that specific fact situation has been held to be violative of the Constitution.[3] The basic apportionment formula provided in the uniform act appears to meet the basic constitutional requirements, but if its application results in an arbitrary or unreasonable tax levy in relation to local business activity, the taxpayer may obtain relief. The uniform act expressly recognizes that this possibility may occur in some instances by providing alternative methods of allocation and apportionment in Section 18. However, a reading of the Supreme Court decisions indicates that it is extremely difficult for any taxpayer to show that the use of a formula causes an arbitrary and unreasonable levy in relation to local business activity.

Basic Problems Involved

At the present time, those states levying net income taxes or taxes measured by net income have an amazing variety of formulas for allocating income, and these vary not only in respect to the basic factors used, such as property, payroll, sales, and manufacturing costs, but also in respect to the specific details of each factor.[4] Therefore, interstate businesses face the initial problem of accumulating several different kinds of accounting data in order to report their taxes in the several states in which they are doing business. More important, however, is the fact that because of the differences in the formulas, it is possible for interstate businesses to be taxed on more than 100 per cent of their net income or, in some cases, substantially less, depending, of course, on the particular states in which the business is subjected to such taxes.

The uniform act, if adopted in every state having a net income tax or a tax measured by net income, would assure that 100 per cent of income, and no more or no less, would be taxed. It is obvious, of course, that adoption of the uniform act will change the tax revenues of the states in some degree. Undoubtedly, the potential impact will be carefully assessed in each state, and the potentialities involved may have a significant bearing upon the question of whether the uniform act should be introduced. The uniform act will also have the benefit of simplifying the task of tax collecting in the several states since reliance can be placed upon audits of the same data by the tax officials of other states. The benefits in simplification of tax reporting and collecting may mitigate small losses in total revenues that may be experienced in a few states. In my opinion, however, adoption of the uniform act will probably increase the income attributable to most states so that tax revenues will be slightly increased. The reasons for this opinion will be more evident upon examination of the specific sections of the act.

Analysis of Statutory Provisions

Coverage.—Section 2 of the uniform act exempts from its operation three major classes of taxpayers: (1) individuals, to the extent of their income for personal services, (2) financial organizations and (3) public utilities. These major classes of taxpayers were exempted for two reasons. First, generally the treatment of the allocation and apportionment problem for these classes has been fairly adequately handled under existing legislation. Second, there appear to be better methods available for the allocation and apportionment of the income of these classes. For example, the income of railroads could be apportioned on a mileage or other similar basis which would more ac-

[2] See, for example, *Underwood Typewriter Company v. Chamberlain*, 1 STC ¶ 255, 254 U. S. 113 (1920): *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U. S. 271 (1924); *Ford Motor Company v. Beauchamp*, 1 STC ¶ 187, 308 U. S. 331 (1939): *International Harvester Company v. Evatt*, 2 STC ¶ 200-020, 329 U. S. 416 (1947).

[3] *Hans Rees' Sons, Inc. v. North Carolina*, 1 STC ¶ 256, 283 U. S. 123 (1931).

[4] See Altman and Keesling, *Allocation of Income in State Taxation* (Chicago, Commerce Clearing House, Inc., 2d Ed., 1950), and Silverstein, "Problems of Apportionment in Taxation of Multistate Business," 4 *Tax Law Review* 207 (1949).

curately reflect income attributable to a state than the use of a formula designed for manufacturing and merchandising businesses, as is the case in the uniform act. Any state enacting the provisions of the uniform act must, of course, continue their existing law for these classes of taxpayers.

Concept of taxability in other states.—Throughout the uniform act it is assumed that every state in which the taxpayer is doing business levies an income tax, whether it does so in fact or does not. Thus, income is attributable to those states which do not have an income tax if the taxpayer would be subjected to such a tax in that state, if lawfully adopted in that state.[5] In states not having income taxes or taxes measured by net income, other types of franchise taxes are usually imposed. Income is justifiably attributable to these states since these other taxes substitute for the income tax, and it must be recognized that these other states may change their tax structures at any time. In several sections of the uniform act, reference is made to the allocation and apportionment of income on the basis of whether the taxpayer is taxable in another state. As we shall see, the question of allocating and apportioning with reference to this concept of taxability assures that 100 per cent of the income of a multistate business theoretically will be taxed by the several states. It is this concept as used throughout the act that raises the greatest number of objections from certain taxpayers.

Allocation of nonbusiness income.—Sections 4 through 8 of the act provide for the allocation of four types of nonbusiness income to specific states, rather than apportioning on the basis of a formula. The reason for this treatment, which is representative of the existing patterns of legislation, is that it is felt that these items of income can appropriately be attributed to a specific state. The four types of income are (1) rents and royalties from real and tangible personal property, (2) capital gains and losses from sales of real and personal property, (3) interest and dividends and (4) patent and copyright royalties. Rent, royalties, or capital gains and losses from real property are allocated to the state in which the property is located.[6] Rents and royalties from tangible personal property are allocated to the state in which the property is utilized, but if the taxpayer is not taxable in that state, the rents and royalties are allocated to the state of the taxpayer's commercial domicile.[7] Similarly, capital gains and losses of tangible personal property are allocated to the state in which the property had a situs at the time of sale, unless the taxpayer is not taxable in that state, in which case the gains and losses are allocated to the state in which the taxpayer has his commercial domicile.[8] Capital gains and losses of intangible personal property and interest and dividends are allocated to the state of the taxpayer's commercial domicile.[9] Patent and copyright royalties are allocated to the state where the rights are utilized, but if the taxpayer is not taxable in that state, the income is allocated to the state of the taxpayer's commercial domicile.

Except for the feature of allocation to the state of commercial domicile when the taxpayer is not taxable in the particular state to which the specific item of income would otherwise be allocated, these provisions generally follow the prevailing rules now applied by the several states. Because of the allocation to the commercial domicile, however, it can be expected that some taxpayer groups will object to the adoption of the uniform act. They feel that the income should be allocated to the state of situs or utilization, regardless of whether that state has jurisdiction to tax the particular taxpayer.

On its face this argument seems to have considerable merit. However, in my opinion, the ability to avoid reporting of this income to any state whatsoever is not justifiable and, moreover, it leads to discrimination against purely intrastate businesses. A brief hypothetical case will demonstrate the inequities involved.

If X corporation rents tangible personal property to be utilized in state C, and if X corporation is doing business in only state A, all of its income must be reported to state A since the allocation and apportionment formulas are not applicable. If Y corporation has its commercial domicile in state A, is also doing business in state B and rents tangible personal property which is utilized in state C where Y is not taxable, the uniform act allocates the income to state A. If it is not attributed to state A, it readily appears that Y corporation has a tax advantage over X corporation merely because of the fortuitous circumstance that Y corporation also is engaged in business in state B which had no relation to the business

[5] See Sec. 3.
[6] Secs. 5(a) and 6(a).
[7] Secs. 5(b) and 5(c).
[8] Sec. 6(b).
[9] Secs. 6(c) and 7.

transaction. In the opinion of the commissioners, this discrimination against purely local businesses is not equitable and, therefore, the uniform act requires allocation to the state of commercial domicile in this type of case.

The treatment of patent and copyright income raises some special problems. Basically, as indicated above, this type of income is attributed to the state of utilization. In some instances, however, the taxpayer will not be able to make this determination because he has no control over the utilization and is not able to obtain records. In these cases, the income is allocated to the state of the taxpayer's commercial domicile.[10]

Apportionment of business income.—Sections 9 through 17 of the uniform act provide for the apportionment of business income by the use of a three-factor formula consisting of property, payroll and sales. These three factors are the most widely employed today by the states, but a change in some states to the so-called Massachusetts formula will have the tendency to change the relative tax burdens of the taxpayers within the state and may have a material effect on the total tax revenues. Analyses of these effects can be made in each state, however, so that the possible ramifications of adoption of the uniform act can be well understood prior to its enactment. If the total tax revenues would be substantially increased or decreased, and if it is assumed that the total tax revenues should remain the same, adjustments can be made by decreasing or increasing the rate of the tax. However, legislatures probably will remain reluctant to increase tax rates, so considerable opposition to the uniform act may be expected where its adoption would decrease tax revenues. If total revenues are not substantially changed but some individual taxpayers do have marked changes in taxes, opposition can be expected from those who will face increased tax burdens. In some states the apportionment formula has been manipulated so as to increase tax revenues without the necessity of undertaking the more difficult political and legislative task of increasing tax rates. In the opinion of the national conference, uniformity has overriding advantages and, therefore, an apportionment formula which is believed to be equitable should not be revised to increase or decrease tax revenues.

Sections 10 through 12 of the uniform act provide for the computation of the property factor. The factor is a fraction, the numerator of which is the average value of the taxpayer's real and personal property owned or rented and used within the state, and the denominator of which is the average value of all such property owned or rented and used during the tax period. Property owned is valued at its original cost and rented property is valued at eight times the net annual rental rate. The method of valuation and the inclusion of rented property can be expected to cause some opposition.

The national conference believed that original cost should be used because of the varying rates of depreciation allowed under different state laws. If depreciation schedules of each state were allowed, the property factor would vary from state to state. However, original cost, in the light of inflationary trends, seems to favor industries having older property. Nonetheless, it is believed that use of depreciation in respect to that property would tend to distort the factor even more where the property is completely depreciated. Opposition can be expected from those taxpayers whose property factor is increased by use of original cost.

The inclusion of rented property may cause even more objections. Generally, it is contended by those using rented property that it should not be included within the factor because the lessor of the property pays a tax on the rental income. However, the apportionment formula is not determinative of the computation of the tax base; it merely represents a method of determining what proportion of the tax base should be attributed to a particular state. Moreover, businesses which rent appear to be in a better competitive position if such property is not included in the factor. This can be demonstrated by a hypothetical fact situation.

Assume that X and Y corporations do exactly the same amount of business and that each has payroll and sales factors of 50 per cent. If X corporation owns its own building and neither owns or rents property elsewhere, its property factor would be 100 per cent. If Y corporation rented and owned no property in the state and if rented property were not included, its property factor would be zero. As a result, X corporation would apportion two thirds of its income to the state while Y corporation would apportion only one third. This result for competitive businesses appears unsound. However, those who argue that rented property should not be included point out

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[10] Sec. 8.

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that the capital of the business is invested in other manners, such as larger inventories, which are reflected in the property factor. After rather exhaustive deliberations, the national conference felt that on balance the inclusion of rented property would result in a more equitable system than would result from its exclusion.

Sections 13 and 14 of the uniform act provide for the method of determining the payroll factor. Basically the uniform act incorporates the same test that is used for determining which state is to be paid the unemployment compensation tax. Throughout the discussions of the act, there was general agreement that this system was equitable, in addition to the fact that this factor can be rather easily computed by reference to the data collected for unemployment compensation purposes.

Sections 15 through 17 of the act provide for the computation of the sales factor. Two major problems are encountered in respect to these provisions. The first problem arises because, with two exceptions, sales are attributed to the consumer state rather than to the state of sales activity or the place where goods are appropriated to the orders. If the taxpayer is not taxable in the state to which the goods are shipped or if the purchaser is the United States Government, the sales are attributed to the state from which the goods are shipped. Manufacturing states probably would prefer a system attributing sales to the place from which goods are shipped in every case. However, the national conference was of the opinion that such a system would merely duplicate the property and payroll factors which emphasize the activity of the manufacturing state, so that there would tend to be a duplication by such a sales factor. Moreover, it is believed that the contribution of the consumer states toward the production of the income should be recognized by attributing the sales to those states. The exception in the case of the United States Government was included because consumption of such sales cannot be said to occur in a specific state, particularly in the case of shipments to overseas points of embarkation. In the manufacturing states, some opposition to the method of apportioning sales is to be expected, although once again it is believed that the over-all benefits of uniformity and the equities of the situation will mitigate this facet of the act becoming a major enactment hurdle.

Another problem arises in conjunction with sales other than sales of tangible personal property. Section 17 of the uniform act attributes these sales to the state in which the income-producing activity is performed. If the activity is performed in more than one state, the sales are attributed to the state in which the greater proportion of the activity was performed, based upon costs of performance. In many types of service functions, this approach appears adequate. However, there are many unusual fact situations connected with this type of income and probably the general provisions of Section 18 should be utilized for these cases. If we assume that the activity involved is the servicing of industrial equipment, the formula provided in the uniform act could be easily applied and the result appears equitable. In contrast, assume that the sales item involved is advertising revenue received by a national magazine publisher. The state of activity would be difficult, if not impossible, to ascertain, so it would appear that this type of income may well be apportioned on the same basis as subscription income. The national conference considered this problem at length and concluded that for certain types of sales income, exceptions would have to be established by the tax collection agencies, since no formula seemed to be satisfactory for every conceivable factual situation. Generally, it was felt that the provisions of Section 17 were the best that could be designed to cover the greater proportion of the cases.

Section 18 is a general section which permits the tax administrator to require, or the taxpayer to petition, for some other method of allocating and apportioning the income where unreasonable results ensue from the operation of the other provisions of the act. This section necessarily must be used where the statute reaches arbitrary or unreasonable results so that its application could be attacked successfully on constitutional grounds. Furthermore, it gives both the tax collection agency and the taxpayer some latitude for showing that for the particular business activity, some more equitable method of allocation and apportionment could be achieved. Of course, departures from the basic formula should

be avoided except where reasonableness requires. Nonetheless, some alternative method must be available to handle the constitutional problem as well as the unusual cases, because no statutory pattern could ever resolve satisfactorily the problems for the multitude of taxpayers with individual business characteristics.

As in the case of other apportionment formulas, the uniform act gives equal weight to each factor in the formula, and the average of the factors determines the percentage to be apportioned to each state.

Conclusion

The Uniform Division of Income for Tax Purposes Act represents a significant step toward achieving uniformity among the states in the methods of determining the allocation and apportionment of income. However, support for enactment of the uniform act must be found among both taxpaying and tax-collecting groups in order for the act to fulfill its basic purpose of simplifying the task of computing state taxes. The degree of support will depend primarily upon the effect of adoption of the act on the total tax revenues of the state and on the tax burden of the major business entities. The uniform act appears to be equitable in that it represents a compromise between the positions of consumer and manufacturing states. Moreover, the act provides a reasonable method for allocating and apportioning the income of most multistate businesses. The success of the act now depends on its favorable consideration by the state legislatures.

[The End]