McDermott
Will&Emery

New York

MEMORANDUM

Date: April 29, 2008

To: Drafting Committee to Revise the Uniform Division of Income for Tax Purposes Act, Uniform Law Commission

From: Peter L. Faber

Re: UDITPA Issues to Consider for Revision

I have the following comments on the paper listing issues for consideration in revising UDITPA that was distributed on April 25. I prepared these comments and they are submitted in my personal capacity and not on behalf of McDermott Will & Emery LLP or any of its clients or of any other organization.

Section 1

I would oppose amending UDITPA to tax income on an apportioned basis to the extent permitted by the United States Constitution. I know that several states have adopted that approach, but I believe that it is wrong as a matter of tax policy.

Corporations are entitled to have specific rules that they can read, interpret, and follow. A state legislature should make a judgment as a matter of policy as to what income should be apportioned and what income should be specially allocated to a particular state.

The scope of constitutional restrictions on apportionment is unclear in many cases, and the Supreme Court's reluctance to take cases in this area has added to the uncertainty. In most cases, with respect to most types of income, the extent to which income can be apportioned constitutionally will not be known. It should not be necessary for a corporation to hire a constitutional lawyer to prepare and file an income tax return.

This approach presents particular problems with respect to establishing tax reserves on financial statements. If it is adopted, a publicly-held company may have to hire constitutional lawyers to prepare a financial statement.

Taking a narrower approach in trying to clarify the existing language is worth pursuing. The amount of litigation that has developed interpreting "acquisition, management, and disposition" demonstrates the need to change that formulation.

I believe that the opponents of the "functional" test have the better of the argument under present law, but if the statute is to be changed that argument becomes irrelevant. As a matter of tax policy, I think that a persuasive case could be made that income from the sale of assets that are used in a business should be business income. Presumably, their value depends on their

ability to generate business income and the gain on their sale in a sense represents the present value of business income that the company could have generated from those assets if it had not sold them. Rather than changing the word "and" to "or" it might make sense to consider a completely different formulation. One approach, for example, would be to say that income from the sale of any asset used in the company's business is business income without getting specific about the nature of that use.

With respect to whether gain that has accrued over a period of time should be apportioned based on factors during the period of its use, I think that that would be too complicated. I would rather use the factors in the year of disposition, recognizing that the department of revenue can make adjustments pursuant to Section 18 in appropriate cases.

Broadening the payroll factor to include independent contractors could be tricky, because that could include services provided by outside professional firms. I am not sure how you would draft a statute that would try to cover independent contractors directly involved in the corporation's revenue-generating activities. I can see a theoretical case for doing this, but I am not sure how it could be done. It may be worth exploring.

Section 3

Any corporation that has apportionment factors in other states should be allowed to apportion its income. Whether the company is taxable in another state should be irrelevant. In my view, a state should be allowed to tax only its fair share of a corporation's income and whether other states tax it should not affect that determination.

Section 6

I would not retain a commercial domicile rule for tangible property. If the theory is that tangible property should be sourced to the state of its location, that should be controlling regardless of whether the corporation is taxable in that state.

Section 7

I would oppose replacing commercial domicile by the state where the intangible property is "managed." The concept of managing intangible property is too vague to be administrable. Are securities managed where broad investment policy is developed? where specific buy and sell decisions are determined? where records are kept? In general, interest and dividends from securities benefit the whole company and commercial domicile seems to me to be a logical place to source the resulting income.

Section 9

I would definitely change the word "allocation" to "apportionment." That is the terminology that is generally used.

I would favor eliminating a factor if its denominator is zero. If the denominator is zero, that shows that the factor does not contribute to the generation of the corporation's income, and I see no reason why it should be taken into account.

Section 13

I would not include management fees paid to related corporations. To the extent that income can be diverted by using a management corporation, the states can address this through combined returns and transfer pricing adjustments. If a management company is formed specifically to distort the payroll factor, the problem can be addressed by departments of revenue under Section 18.

I would favor taking deferred compensation and stock options into account when they are deductible by the corporation, leaving it up to Section 18 adjustments to deal with situations in which this is distortive.

Section 16

Throwback and throwout rules should not be permitted. The purpose of an apportionment formula is to measure the taxing state's fair share of a corporation's income. That amount is not affected by whether some other state chooses to tax the corporation.

Proponents of throwout and throwback rules have argued that otherwise "nowhere" income can escape taxation entirely. This, I would submit, is a red herring. If a corporation does all of its business in South Dakota, which does not impose an income tax, none of its income will be subject to state taxation. There is nothing wrong with this result. If, instead, the corporation has 99% of its operations in South Dakota and 1% of its operations in New Jersey (which now has a throwout rule), New Jersey should not have the right to tax 100% of its income.

In the interest of full disclosure, I currently represent Pfizer Inc. in challenging the constitutionality of New Jersey's throwout rule. Nevertheless, this represents my personal view.

Section 17

An origin-based standard is inconsistent with the destination principle that is used for sourcing sales of tangible personal property, but a destination-based test would present different issues. It is not at all clear in many cases where services are used by the buyer and I am not sure that a destination-based approach to receipts from services is administrable. The difficulties that Florida had with this concept several years ago illustrate the point. I would favor the cost of performance approach.