Alternative Apportionment: Fairness Is Not the Only Factor

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Alternative apportionment is a statutory device that provides taxpayers and tax administrators with a means to obtain ad hoc relief when the application of a state's standard apportionment formula fails to reflect a taxpayer's business activities in the state. It has its roots in a series of U.S. Supreme Court cases that established a narrowly applied constitutional analysis that provided for substantive limitations designed to ensure that practicality and certainty were not sacrificed in favor of fairness in apportionment cases, except in the most egregious circumstances. However, because state statutes that permit alternative apportionment and administrative and judicial interpretations of these provisions are ambiguous, many of these constitutional limitations were not carried over to the states in their individual alternative apportionment statutes.

The narrow application of these constitutional limitations has in recent years resulted in more frequent use of alternative apportionment by both taxpayers and tax administrators, which, in turn, has caused many states to place significant obstacles in the path of taxpayers seeking the benefits of alternative apportionment. Consequently, taxpayers are often faced with an inequitable apportionment outcome with no way to achieve relief from that result in a practical, certain manner. As a means to correct this problem, perhaps the statutory alternative apportionment analysis should be shifted back toward its constitutional progenitor.

Constitutional and statutory basis for alternative apportionment

The historical basis for alternative apportionment lies in the U.S. Constitution, which, pursuant to the Due Process and Commerce Clauses, requires state income tax on interstate commerce to be apportioned in a manner that reasonably approximates the relationship between a taxpayer's income attributed to a state and the taxpayer's business activities in that state.[1]

The Supreme Court has determined that a state's standard apportionment formula adequately reflects the required relationship if the apportionment formula is internally and externally consistent both facially and when applied to a particular taxpayer's facts and circumstances.[2] Under the internal consistency test, a state's standard apportionment formula is constitutionally valid if, when applied in every taxing jurisdiction, "it would result in no more than all of the unitary business' income's being taxed."[3] The external consistency test looks "to the economic justification for the State's claim upon the value taxed, to discover whether a State's tax reaches beyond that portion of value that is fairly attributable to economic activity within the taxing State."[4]

Where a state's standard apportionment formula fails either the internal or external consistency test for a particular taxpayer, that taxpayer is entitled to challenge, on an original or amended return or via appeal, the constitutionality of the standard apportionment formula as applied to the taxpayer, and seek the application of an alternative apportionment formula. A taxpayer that makes such a challenge bears the burden of proving, by clear and cogent evidence, that the standard apportionment formula leads to a grossly distortive result, and that the requested alternative apportionment method alleviates that distortion in a manner that more fairly represents the taxpayer's business activities in the state.[5]

This ad hoc relief is intended to ensure fairness when a state's standard apportionment formula yields the most egregious and nonsensical results, while requiring a high burden of proof and placing other limitations on a challenging taxpayer acknowledges "the practical impossibility of a state's achieving a perfect apportionment of expansive, complex business activities"[6] and the importance of tax certainty as a policy consideration.

Most states have enacted statutory relief provisions that adopt the judicial doctrine of alternative apportionment, with the addition that alternative apportionment may be used by both taxpayers and tax administrators. Largely, these statutes mirror, or are patterned after, Uniform Division of Income for Tax Purposes Act (UDITPA) Section 18, which provides:

> 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.[7]

One of the problems with UDITPA Section 18 is that it does not clearly state whether it is merely an extension of the constitutional alternative apportionment analysis to tax administrators or represents an additional extra-constitutional relief mechanism. William Pierce, one of the primary drafters of UDITPA Section 18, recognizing this problem, stated the following more than a half century ago:

> [UDITPA 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

1 *Hunt-Wesson, Inc. v. Franchise Tax Bd.*, 528 U.S. 458 (2000). See also *International Harvester Co. v. Evatt*, 329 U.S. 416 (1947); *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977); and *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

2 Id. See also *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995); *Hans Rees' Sons Inc. v. North Carolina*, 283 U.S. 123 (1931).

3 *Container Corp.*, 463 U.S. at 169.

4 *Jefferson Lines*, 514 U.S. at 185.

5 *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978), citing *Hans Rees' Sons*, 283 U.S. at 135, and *Norfolk & Western R.R. Co. v. Missouri State Tax Comm'n*, 390 U.S. 317 (1968).

6 *International Harvester Co. v. Evatt*, 329 U.S. 416 (1947), citing *Illinois Cent. R.R. Co. v. Minnesota*, 309 U.S. 157 (1940).

7 UDITPA §18.

as the unusual cases because no statutory pattern could ever resolve satisfactorily the problems for the multitude of taxpayers with individual business characteristics.[8]

Pierce's explanation of the reasoning behind the adoption of UDITPA Section 18 acknowledges the policy issues considered by the Supreme Court in shaping the judicial doctrine of alternative apportionment and reflects the legitimate concern that loosening the standards for applying alternative apportionment could result in a "'free for all' of ad-hoc tax adjustments, undermining the goals of predictability and uniformity."[9] However, Pierce clearly indicated that UDITPA Section 18 is intended to both (1) extend alternative apportionment powers under the Constitution to tax administrators and (2) operate in circumstances where a state's standard apportionment formula yields unfair results but gross distortion (which is constitutionally prohibited) does not exist. Most state courts have followed this approach and view extra-constitutional alternative apportionment as a new basis for applying an alternative apportionment formula that is separate from, and broader than, the Supreme Court's judicial doctrine.[10]

If not gross distortion...

When a party makes a constitutional argument, the first step is to prove that the state's standard apportionment formula produces a grossly distortive result. When a party makes an extra-constitutional argument, the first step is to prove that the state's standard apportionment formula is unfair. Gross distortion clearly does not enter into the analysis when it is not constitutionally based;[11] however, state courts have historically been reluctant to enumerate what a taxpayer or tax administrator must prove before alternative apportionment applies if not gross distortion.[12]

More recently, some states have begun to tackle this issue. Tennessee has taken a somewhat aggressive approach, and its courts have upheld application of an alternative apportionment formula as more fairly representing a company's activity in the state without articulating clear standards that would limit the state's ability to apply alternative apportionment to any activity.[13] New York has taken this approach as well, applying a population factor to sales of internet advertising, resulting in a factor that would generate more state revenue from out-of-state advertising companies.[14]

California courts, on the other hand, have established a framework under which taxpayers and tax administrators can prove unfairness outside of the external consistency and gross distortion tests.[15] In this framework, California will allow its alternative apportionment statute to apply if applying the standard apportionment statute results in quantitative and qualitative distortion. Quantitative distortion exists when the amount of business income and profit margin from an activity is substantially different from the gross receipts generated by that activity, relative to other activities the taxpayer engages in.[16] Qualitative distortion exists when the activity is substantially different from the taxpayer's main line of business, regardless of whether the activity is an integral part of that business.[17]

Although California's two-pronged test, as applied thus far, is not perfectly suitable for all instances in which a taxpayer or tax administrator might seek to use alternative apportionment, it provides greater certainty and fairness than the "method" applied by Tennessee and New York, and is a start toward a workable uniform standard for determining when the standard apportionment formula has unfair results.

8 Pierce, "The Uniform Division of Income for State Tax Purposes," 35 Taxes 747, 781 (1957). As a primary drafter of UDITPA, Pierce, in his official commentary, provides a great deal of insight into the intent of the drafters in writing UDITPA.

9 Id. at 749. See also Multistate Tax Commission Memorandum, *Proposal to Amend MTC Model Regulation IV.18.(A) to Expand Permissible Application of Equitable Apportionment Formulas Under UDITPA Section 18* (3/9/07).

10 See, e.g., *Twentieth Century-Fox Film Corp. v. Department of Rev*, 700 P.2d 1035 (Ore.1985); *Montana Dep't of Rev. v. United Parcel Serv.*, 830 P.2d 1259 (Mont. 1992); *Union Pacific Corp. v. Idaho State Tax Comm'n*, 83 P.3d 116 (Idaho 2004). But see *Unisys Corp. v. Pennsylvania*, 812 A.2d 448 (Pa. 2002), in which the Pennsylvania Supreme Court held that the state's alternative apportionment statute merely allowed the tax administrator to challenge the application of the state's statutory apportionment formula, and that, in all other ways, the constitutional analysis was undisturbed. See also Fla. Admin. Code §12C-1.0152 and 86 Ill. Admin. Code §100.3390(c), both of which require gross distortion to support applicability of their respective state alternative apportionment statutes.

11 *Union Pacific Corp.*, 83 P.3d at 122.

12 See *Twentieth Century-Fox Film Corp.*, 700 P.2d at 1043, where the Oregon Supreme Court stated that, instead of gross distortion, a taxpayer or tax administrator must show "whether the statutory apportionment formula fairly represents the extent of the taxpayer's business activity in this state."

13 *BellSouth Advertising & Pub. Corp. v. Chumley*, 308 S.W.3d 350 (Tenn. Ct. App. 2009).

14 N.Y. Dep't of Tax. & Fin. TSB-A-02(3)C (4/18/02); TSB-A-09(8)C (6/16/09). But see *JRS Distrib. Co. v. Department of Treas.*, LC No. 09-000107-MT (Mich. Ct. App. 2012), in which the Michigan Court of Appeals declined to allow the tax administrator to apply a population factor in lieu of standard sales sourcing.

15 *Microsoft Corp. v. Franchise Tax Bd.*, 39 Cal. 4th. 750 (Cal. 2006). See also *Montgomery Ward LLC v. Franchise Tax Bd.*, No. GIC802767 (Cal. Super. Ct. 2007) (minute order); *The Limited Stores, Inc. v. Franchise Tax Bd.*, 62 Cal. Rptr. 3d 191 (Cal. Ct. App. 2007); *Square D Co. v. Franchise Tax Bd.*, Dkt. No. CGC 05-442465 (Cal. Super. Ct. 2007); and *General Mills v. Franchise Tax Bd.*, 172 Cal. App. 4th 1535 (2009).

16 *Microsoft Corp.*, 39 Cal. 4th. 750, finding that quantitative distortion exists when business income and gross receipts from an activity represent 2% of total business income and 73% of total gross receipts, and operational profit was 167 times greater than profit from the activity in question. But see *Appeal of Home Depot*, SBE-298683 (Cal. State Bd. of Equalization 12/18/08), which ruled that quantitative distortion did not exist where the activity represented 6.6% of total gross receipts, and operational profit was 18 times greater than profit from the activity in question.

17 *General Mills*, 172 Cal. App. 4th 1535.

It seems reasonable enough

When a taxpayer or tax administrator shows that the standard apportionment formula produces unfair results, the next issue is whether the proposed alternative method is reasonable. On audit, this can often turn into a string of proposals and counterproposals, whereby a taxpayer and tax administrator trade formulas to arrive at an acceptable compromise. When the reasonableness issue cannot be settled and proceeds to court, the following three factors are generally considered:

- Whether the proposed alternative apportionment formula fairly represents the business activity in question and, if applied uniformly, results in taxation of no more or no less than 100% of the taxpayer's income;
- Whether the division of income creates or fosters a lack of uniformity; and
- Whether the division of income reflects the economic reality of the taxpayer's in-state business activity.[18]

The problem with this three-factor approach is that it is nothing more than a requirement that the alternative apportionment formula meet the internal consistency and external consistency tests with scant attention to uniformity. This creates substantial uncertainty, since it is highly subjective and leaves open the possibility that an alternative formula will be considered reasonable as long as it does not result in gross distortion. Applying California's two-pronged test would relieve some of these concerns.

And the burden of proof is . . .

From the perspective of the U.S. Supreme Court's judicial doctrine, alternative apportionment is a relief mechanism for taxpayers only, and, as such, a taxpayer challenging an apportionment formula bears the burden of proving by "clear and cogent evidence" that an alternative apportionment formula should be applied. Extending alternative apportionment powers to tax administrators should not change this approach, and a tax administrator making an argument based on gross distortion should bear the same burden of proof as a taxpayer. While this issue has not been directly addressed, state case law strongly suggests that this approach is correct.[19]

However, because constitutionally required alternative apportionment and alternative apportionment based on fairness are analytically different, there is a question whether the Supreme Court's other limitations on the judicial doctrine of alternative apportionment apply in a situation where a taxpayer or tax administrator is making an extra-constitutional argument. In general, state courts have placed the burden of proof on the party seeking alternative apportionment[20] and have set that burden at a high level.[21] However, a recent decision by the Indiana Supreme Court calls this approach into question by holding that the tax administrator's notice of proposed assessment was "prima facie evidence" of the assessment's validity.[22] This holding creates a nearly insurmountable presumption in favor of the tax administrator if an audit report is, in and of itself, prima facie evidence; thus, in effect, this shifts the burden of proof to the taxpayer, which would not benefit from the lower standard.

The burden of proof standards should be the same for both sides; Indiana's prima facie evidence rule upsets that balance. It is inherently inequitable and encourages the tax administrator to apply alternative apportionment through the audit process regardless of whether the standard apportionment formula is unfair and the proposed alternative method is reasonable. If more states follow in Indiana's footsteps, alternative apportionment on a taxpayer-by-taxpayer and year-by-year basis could replace standard apportionment, signaling the death knell of certainty.[23] The Indiana approach should not be applied elsewhere.

Obstruction is not the answer

Alternative apportionment under the constitutional standard is limited in application but flexible as to timing. An argument for constitutional alternative apportionment can be asserted on an original or amended return, at audit, or on appeal. As long as a taxpayer meets its filing deadlines, state law cannot curtail the taxpayer's access to the constitutional remedy. However, when a taxpayer cannot prove gross distortion and a taxpayer seeks to use alternative apportionment on another basis under a state's alternative apportionment scheme, timing could become crucial.

18 *Twentieth Century-Fox Film Corp.*, 700 P.2d at 1044.

19 *Unisys Corp.*, 812 A.2d 448.

20 See, e.g., *Twentieth Century-Fox Film Corp.*, 700 P.2d at 1042.

21 *Microsoft Corp.*, 39 Cal. 4th. 750, finding that the level of proof required to support the application of alternative apportionment is "clear and convincing evidence." See also *British Land (Maryland) Inc. v. New York Tax App. Trib.*, 85 N.Y.2d 139 (N.Y. Ct. App. 1995), finding that the level of proof required to support the application of alternative apportionment is "clear and cogent evidence."

22 *Department of State Rev. v. Rent-A-Center East, Inc.*, 963 N.E. 2d 463 (Ind. 2012), rev'g and remanding 952 N.E.2d 387 (Ind. Tax Ct. 2011) (quoting Ind. Code §6-8.1-5-1(c): "[t]he notice of proposed assessment is *prima facie evidence that the department's claim for the unpaid tax is valid.* The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made" (emphasis supplied by court).)

23 This result would be particularly painful for public companies, which would be hard-pressed to justify not reserving for possible alternative apportionment risks even when filing using the standard apportionment method.

A number of states, generally through administrative guidance, have put into place substantial precertification requirements that limit a taxpayer's right to use an alternative apportionment formula for original returns and, even then, only with the express permission of the tax administrator.[24] Other states require a taxpayer to file a petition requesting to use an alternative apportionment formula prior to the due date of the original return, file the original return applying the standard apportionment formula, and then file an amended return claiming a refund.[25] Further, some state courts have held that a taxpayer that fails to comply procedurally forfeits its right to alternative apportionment.[26] Finally, these limitations may impair a taxpayer's ability to assert a different alternative apportionment formula as an affirmative defense against a tax administrator's use of alternative apportionment on audit.

These kinds of purely mechanical bars against taxpayers' making an alternative apportionment argument, without similar bars against the tax administrator, operate to limit taxpayer accessibility to alternative apportionment and ignore the equitable principles that underlie alternative apportionment without demonstrably improving certainty or practicality. A better path would be to limit or eliminate mechanical boundaries against taxpayers that assert an alternative apportionment argument, and to put taxpayers and tax administrators on an even playing field in terms of timing.

Conclusion

The Constitution requires a tax on interstate commerce to be fairly apportioned. Although a state's standard apportionment may generally pass constitutional muster, it may fail to achieve a fair result for a particular taxpayer. In this situation, alternative apportionment may be applied to achieve an equitable result without substantial sacrifice to tax certainty or practicality. However, alternative apportionment has moved from Supreme Court judicial doctrine to state statutory authority, and limitations on alternative apportionment have shifted from being evenhanded to strongly favoring aggressive application of the doctrine by state tax administrators. As a result, the level of fairness achieved by applying the doctrine has waned, tax certainty has suffered, and the practicality of the doctrine has been impaired. These problems can best be restored by shifting the applicability of the doctrine back toward its constitutional roots.

24 See, e.g., Cal. Franchise Tax Bd. Notice No. 2004-5 (Aug. 6, 2004), requiring a taxpayer to obtain prior approval from the FTB before filing a return using an alternative apportionment formula. See also Mich. Comp. Laws §§206.667(1) and (4).

25 See, e.g., N.M. Admin. Code §3.5.19.9.

26 See, e.g., *Sidney Frank Importing Co. v. Michigan Dep't of Treas.*, No. 383623 (Mich. Tax Trib. 10/5/11). But see *Media General, Inc. v. South Carolina Dep't of Rev.*, 694 S.E.2d 525 (S.C. 2010); and *Carmax Auto Superstores West Coast, Inc. v. South Carolina Dep't of Rev.*, 725 S.E.2d 711 (S.C. 2012), both of which held that, in response to a request for, or imposition of, an alternative apportionment formula, a party could affirmatively assert that another alternative apportionment formula is more reasonable.

Tax Adviser editor notes

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