2017

A New Theory of Equitable Apportionment

David Gamage

Indiana University Maurer School of Law, dgamage@indiana.edu

Darien Shanske

University of California, Davis

A New Theory of Equitable Apportionment

by David Gamage and Darien Shanske

David Gamage

Darien Shanske

David Gamage is a professor of law at Indiana University Maurer School of Law, and Darien Shanske is a professor at the University of California, Davis, School of Law (King Hall).

In this edition of Academic Perspectives on SALT, the authors discuss the purpose of equitable apportionment, arguing that it remains coherent in the context of single-sales-factor apportionment regimes.

There is a lot of ferment surrounding equitable apportionment under section 18 of the Uniform Division of Income for Tax Purposes Act.[1] The Multistate Tax Commission has made revisions to section 18 and is considering more,[2] and there are many recent controversial equitable apportionment cases — most notably *Vodafone* in Tennessee.[3] Issues in controversy include who bears the burden of proof, what that burden is, and how and whether to deal with specific industries and issues.[4]

At least in theory, equitable apportionment provides state tax authorities with a crucial tool for combatting taxpayers' attempts to game multistate apportionment formulas.[5] According to Lee A. Sheppard of Tax Analysts: "Section 18 was intended to be a broad grant of authority to state tax administrators to change the apportionment method for a taxpayer whose method did not fairly reflect in-state activity. It is meant to be applied sparingly. But there is a fear that the single-sales-factor rules adopted by many states are causing more alternative adjustments."[6]

Here, we address a single but broad question: What is the purpose of equitable apportionment in the age of the single sales factor? Contrary to what has been suggested by some other leading state tax experts, we argue that equitable apportionment remains coherent and useful even within the context of single-sales-factor apportionment regimes.

But first, let us consider contrary views. Notably, SALT luminary Richard Pomp of the University of Connecticut Law School, author of the MTC hearing officer's report that contained many of the sensible proposals to reform section 18, stated in that report that "from a tax policy perspective, the single sales factor is virtually indefensible."[7]

---

[1] *See, e.g.*, Roxanne Bland, "UDITPA Section 18 and Alternative Apportionment Formulas," *State Tax Notes*, May 15, 2017, p. 675; and Christopher T. Lutz et al., "Trends and Developments in Alternative Apportionment of State Income," *State Tax Notes*, May 8, 2017, p. 559.

[2] Amy Hamilton, "MTC Restarts Work on Alternative Apportionment Model Regulations," *State Tax Notes*, Sept. 12, 2016, p. 850.

[3] *Vodafone v. Roberts*, 486 S.W.3d 496 (Tenn. 2016). For critical discussion see Lutz et al., *supra* note 1; and Peter L. Faber, "Inequitable Apportionment: A Bad Precedent in Tennessee," *State Tax Notes*, Apr. 25, 2016, p. 277.

[4] *See, e.g.*, Lutz et al., *supra* note 1.

[5] It is also a tool for taxpayers to counter unreasonable results. Though that aspect of equitable apportionment is not the focus of this article, we do not mean to suggest that it is less important. We hope to return to considering equitable apportionment from the taxpayer's perspective in a future article.

[6] Sheppard, "News Analysis: Shoring Up UDITPA Section 18," *State Tax Notes*, Aug. 4, 2014, p. 310.

[7] Report of the Hearing Officer [Richard Pomp] Multistate Tax Compact Article IV [UDITPA], at 14 (Oct. 25, 2013).

To a substantial degree, we consider Pomp's argument to be both empirically and theoretically compelling. As an empirical matter, it is certainly the case that states did not shift to single sales factor to more accurately locate multistate businesses' income. Rather, states have adopted single sales factor because of the belief that this would make their home industries more competitive.[8]

Moreover, as a matter of theory, it is hard to understand how single sales factor could be an improvement on ascertaining where income is produced. It would be one thing to quibble with how much a company's payroll contributes to its income relative to its sales, but it is quite another to give payroll no weight at all. How could it make sense for a state that housed all of a corporation's payroll to have no income apportioned to that state simply because all of the corporation's sales are in other states? So, if Pomp is correct in arguing that formulary apportionment using the single sales factor is indefensible on policy grounds, what is there for equitable apportionment to correct if a state has adopted single sales factor?

Accordingly, as reported by Tax Analysts' Amy Hamilton, "former MTC Chair Bruce Johnson, now with Taxometry LLC, said section 18 'really doesn't work anymore' because it speaks in terms of factors that fail to fairly reflect a company's business activity in a state. In a state that has gone to single-sales-factor apportionment, he said, it would be easy to put an economist on the stand and say that a formula that completely disregards all of a company's property and payroll does not fairly reflect the business activity in the state."[9] Rick Handel, another prominent commentator, then takes the next logical step and argues that states should be prepared to default back to the traditional three-factor formula in some section 18 cases.[10]

Nevertheless, contrary to those views, we argue that single-sales-factor apportionment is not incoherent and that therefore, there is a proper use for equitable apportionment within single-sales-factor apportionment regimes. To develop our argument, we need to step back and consider just what kind of tax the state corporate income tax (CIT) has become in the era of single-sales-factor apportionment. Building on a seminal argument made by Charles McLure,[11] one of us (Shanske) has argued elsewhere that there is an important way in which the double shift to single sales factor and market-based sourcing of sales, including services and intangibles, has changed the nature of the CIT.[12] The simple version of that argument is as follows: The more a corporation — say Amazon.com — sells in a state, the more of its income will be taxable in that state. Say that the state is California and that the relevant CIT rate is 10 percent. Then Amazon would be paying a 10 percent tax on the net income from its sales into California.

To be sure, matters are not that simple. The analytic core of the argument (developed in more depth elsewhere[13]) is that, based on reasonable assumptions, corporations experience increased CIT liability at the margin as a product of increased sales, rather than as a product of increased profits.

Here is an example to illustrate the point. Imagine that Corporation Z has a 10 percent sales factor in California and earns a $20

[8] *See, e.g.*, the ballot argument for California's Proposition 39, which instituted mandatory single-sales-factor apportionment.

[9] Hamilton, "MTC Alternative Apportionment Group Grappling With Sourcing Issues," *State Tax Notes*, Mar. 7, 2016, p. 705.

[10] Handel, "Using UDITPA Section 18 in South Carolina and Beyond," *State Tax Notes*, July 27, 2015, p. 349. Philip Morris recently petitioned California's Franchise Tax Board for the use of a more traditional formula, arguing that the single sales factor did not fairly represent the sources from which the taxpayer derived its income. The petition was heard on June 15, 2017. The petition and the FTB response are available at https://www.ftb.ca.gov/law/meetings/06152017/8.pdf. Our understanding is that the petition was rejected. The argument of this essay strongly suggests that this was the right result, at least in the abstract.

[11] Charles E. McLure Jr., "The State Corporate Income Tax: Lambs in Wolves' Clothing," *In the Economics of Taxation*, edited by Henry J. Aaron and Michael J. Boskin (1980), at 327; and Shanske, "A New Theory of the State Corporate Income Tax: The State Corporate Income Tax as Retail Sales Tax Complement," 66 *Tax Law Review* 305 (2013).

[12] Shanske, *supra* note 11, at 321-22.

[13] *Id.* at 344-48.

million profit on $100 million of sales nationally. Assuming California has a 10 percent CIT rate, then Corporation Z's tax liability in California is $200,000. Now suppose that Corporation Z makes $1 million in new sales in California, on which it will earn $100,000 in net income (a return of 10 percent). What happens to Corporation Z's CIT liability to California? It is now $218,911 (10.89 percent [higher sales factor] x $20.1 million [higher net income] x 10 percent). If not for the single sales factor, how much would Corporation Z owe California? Only $201,000 or (10 percent x 10 percent x $20.1 million). And so almost 95 percent of Corporation Z's higher liability to California is attributed to its new sales in California and not to its higher profits. This makes sense because the full value of its new sales went into the sales factor relative to the net income from the sale. The final assumption here is that the corporation can and will pass this additional cost on to the consumer, as it would a sales tax.

It is also worth noting that in the age of *Quill*, a CIT with single-sales-factor apportionment reaches a good portion of sales that the retail sales tax does not, at least for states with a substantial economic presence test for the CIT. And there is another reason that the new CIT reaches more sales than retail sales taxes: Sales of services and intangibles count toward the sales factor, even though those sales are often not subject to state retail sales taxes.

To be sure, the CIT with single-sales-factor apportionment is — at best — a poorly designed consumption tax merged with a poorly designed business income tax. There is no good reason why a corporation with high profit margins (that is, high income) should in effect be pushing more tax onto its consumers relative to a low (that is, low income) corporation. And why should only consumption through corporations be taxed?

Those problems should not be minimized. Yet consider the typical state retail sales tax by comparison. The typical retail sales tax does not reach huge swathes of consumption — namely services and intangibles — and overtaxes some sectors because of pyramiding. Nevertheless, commentators do not say that those flaws mean that the retail sales tax is not a consumption tax. Rather, they say that retail sales taxes are poorly designed consumption taxes.[14] We say that the same is true of CITs with single-sales-factor apportionment.

What are the implications? One, a CIT with a single sales factor is clearly not incoherent, but just another poorly designed state-level consumption tax. Second, there is nothing inherently problematic with an origin state having no income apportioned to it. This means that a corporation should not be able to object if, for instance, a large amount of its income is apportioned to a market state — much larger than what the three-factor formula would permit. Of course, most states are also origin states, so a single-sales-factor state should not be able to use equitable apportionment to undo a result that apportions much of a domestic corporation's income to a market state.

That explains what equitable apportionment should not do in the age of single sales factor, but what should it do? For one, equitable apportionment should continue to do many things it has always done, such as permitting taxpayers or administrators to separate lines of business in some cases.[15] Further, equitable apportionment should be used in cases in which there is something anomalous going on as to the location of sales without consideration of the location of the other factors.

For example, consider the Colorado district court's analysis in *Target Brands Inc. v.*

[14] Or, as a leading casebook puts it, the retail sales tax is structurally flawed. Walter Hellerstein et al., *State and Local Taxation*, at 655 (10th ed. 2014).

[15] *See, e.g.*, *Microsoft Corp. v. Franchise Tax Board*, 139 P.3d 1169 (Cal. 2006) (permitting calculating receipts from treasury function differently from other business functions for purposes of the sales factor).

Department of Revenue.[16] Because the taxpayer, an intangible holding company, had no factors in Colorado, it owed no CIT, which was an anomalous result given the large royalties it earned from the use of its intellectual property in Colorado. The court permitted the state to invoke section 18.[17] The state proposed an alternative apportionment method in which it would rely on the sales factor — and only the sales factor — of the parent corporation, Target. Of course, as the court noted, use of just the sales factor would not give any credit to the contributions that the holding company employees made to the production of income; thus, the court found the alternative unreasonable.[18]

From our perspective, the court's holding on this issue was half right. For part of the period in question, Colorado used a traditional three-factor formula. As to that period, at least in the abstract, the court's analysis seems correct. Yet for the last tax year under review, the state had moved to single sales factor. Once the state had already shifted to single sales factor, we do not think that evaluating its alternative formula based on whether every factor's contribution was fairly assessed is relevant. The state had decided that only the location of sales matters, and that is what both the state and taxpayers should then have to live with. Thus, for the tax year when Colorado used single sales factor, we think — at least in theory[19] — that Colorado's proposed alternative was reasonable.

A new approach to equitable apportionment is just one result that follows from reconceiving the state corporate income tax as a flawed consumption tax.[20] We plan to explore others in future articles. One particularly important question is: Given that most states now have at least[21] two deeply flawed consumption taxes, what would it take for states to make incremental steps toward better taxing consumption overall?[22] ■

[16] *Target Brands Inc. v. Department of Revenue*, No. 2015CV33831 (Denver Dist. Ct. filed Jan. 27, 2017).

[17] Permitting the state to use equitable apportionment at all is controversial because the Colorado statute would seem to apportion all income from royalties to the origin state because the income was from the sale of intangible property. *See* Clark R. Calhoun and Matt P. Hedstrom, "Target Brands: Both the Best and Worst Alternative Apportionment Analysis Yet," *Bloomberg BNA*, Apr. 19, 2017. We understand why that is a close issue, as it was in *Vodafone*, but in *Target Brands*, unlike *Vodafone*, we think there was another factor that weighed in the court's decision. Target is (primarily) in the business of selling tangible personal property, and as such its sales are subject to the usual apportionment rules. Target Brands was a holding company for Target's intellectual property. Those holding companies, as the court observed in passing, are a well-known tool for tax avoidance. *See Target Brands* at *80 (citing Xuan-Thao N. Nguyen, Holding Intellectual Property, 39 *Ga. L. Rev*. 1155, 1157 (2005) (the IP holding company tax avoidance scheme "has been widely and quietly utilized in the last twenty years")). We are not claiming that the use of a holding company had no legitimate business purpose, but we are observing that using equitable apportionment essentially to treat a taxpayer as in the business it is in appears as an easier case than a case like *Vodafone*. Vodafone is in the business of selling other than tangible property; and it did not alter its business structure to make it appear (in part) otherwise.

[18] *Target Brands* at *83.

[19] *Target Brands* is a complicated case with complicated facts. It could well be that the state's alternative is not reasonable in this case given facts that we are not considering. Our concern is wholly with the theoretical question whether relying on only the sales factor is reasonable once the state has shifted to use of the single sales factor.

[20] For those who want to dig deeper into equitable apportionment questions, see Shanske, "Equitable Apportionment and the State Corporate Income Tax: Past, Present and Possible Future," forthcoming. Please contact author for working draft.

[21] Gross receipts taxes might be viewed as a third form of deeply flawed consumption tax within the few states that levy gross receipts and similar taxes.

[22] For some of our prior academic work on why it is in the national interest for state governments to better tax consumption through firm and vendor level taxes, *see, e.g.*, Gamage and Shanske, "Tax Cannibalization and Fiscal Federalism in the United States," 111 *Northwestern University Law Review* 295, at 362-369 (2017) (arguing that the federal government should assist state governments in improving their vendor- and firm-level consumption taxes); and Gamage, "The Case for Taxing (All of) Labor Income, Consumption, Capital Income, and Wealth," 68 *Tax Law Review* 355 (2015) (arguing that the U.S. tax system should include a vendor- or firm-level consumption tax — like a value-added tax).