CURRENT LEGISLATION

TAXATION

THE UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT

In 1957, the Commissioners on Uniform State Laws approved the Uniform Division of Income for Tax Purposes Act[1] in an attempt to remedy the inequities in apportionment of the income of multi-state corporations. Apportionment is the method by which a state computes that segment of a business' net income taxable in more than one state which is attributable to the activities of that business within the state's boundaries.[2] In order to analyze and evaluate the act, a preliminary examination of the problems in the area of apportionment must be made.

The first problem is the diversity in the methods of apportionment used by the states.[3] These methods have been developed without congressional regulation, and are restricted only by the constitutional requirement that they bear a reasonable relation to the amount of business which the corporation conducts in the state.[4] Because of this lack of control, the states have been free to develop highly individualized methods of apportionment.[5] Although each of these methods may be fair when considered separately, a single method never operates alone, for by definition apportionment is applied only when the taxpayer is taxable in more than one state. This interaction of separate apportionments has never been regulated by Congress nor ruled on by the

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1 9A U.L.A. 448 [hereinafter cited as UDITPA].

2 Lynn, Formula Apportionment of Corporate Income for State Tax Purposes: Natura Non Facit Saltum, 18 Ohio St. L.J. 84 (1957).

3 Every income-taxing state uses some method of apportionment. Ala. Code tit. 51, § 402.13 (Supp. 1965); Alaska Stat. §§ 43.20.050-.150 (Supp. 1962); Ariz. Rev. Stat. Ann. § 43-135(g) (1956); Ark. Stat. Ann. §§ 84-2055 to -2073 (Supp. 1965); Cal. Rev. & Tax. Code §§ 25120-39; Colo. Rev. Stat. Ann. § 138-1-28 (1963); Conn. Gen. Stat. Ann. § 12-218 (1960); Del. Code Ann. tit. 30, § 1903 (1953); D.C. Code Ann. § 47-1580a (Supp. IV, 1964); Ga. Code Ann. § 92-3113 (Supp. 1965); Hawaii Rev. Laws § 121-14 (1955); Idaho Code Ann. § 63-3027 (Supp. 1965); Ind. Ann. Stat. § 64-3219 (Supp. 1966); Iowa Code Ann. § 422.33 (1949); Kan. Gen. Stat. Ann. §§ 79-3217 to -3219 (1949), as amended, § 79-3218 (Supp. 1961); Ky. Rev. Stat. Ann. § 141.120 (Supp. 1966); La. Rev. Stat. §§ 47:244-:245 (1950); Md. Ann. Code art. 81, § 316 (1965); Mass. Gen. Laws Ann. ch. 63, § 38 (1958); Minn. Stat. § 290.19 (1961); Miss. Code Ann. § 9220-12 (Supp. 1964); Mo. Ann. Stat. § 143.040 (1952); Mont. Rev. Codes Ann. § 84-1503 (1966); N.J. Stat. Ann. § 54:10A-6 (1960), as amended, N.J. Sess. Laws 1966, ch. 134, § 2.6; N.M. Stat. Ann. §§ 72-15A-16 to -36 (Supp. 1965); N.Y. Tax Law § 210.3; N.C. Gen. Stat. § 105-134 (1965); N.D. Cent. Code §§ 57-38-12 to -14 (1960); Okla. Stat. Ann. tit. 68, § 2306 (1966); Ore. Rev. Stat. §§ 314.605-.675 (1965); Pa. Stat. Ann. tit. 72, § 3420b (1964); R.I. Gen. Laws Ann. § 44-11-14 (Supp. 1965); S.C. Code Ann. § 65-279 (1962); Tenn. Code Ann. §§ 67-2706 to -2715 (1955); Utah Code Ann. § 59-13-20 (1963); Vt. Stat. Ann. tit. 32, § 5903 (1959); Va. Code Ann. §§ 58-131.1-.17 (Supp. 1966); Wis. Stat. Ann. § 71.07 (1957), as amended, § 71.07 (Supp. 1965).

4 General Motors Corp. v. District of Columbia, 380 U.S. 553, 561 (1965).

5 See Special Subcomm. on State Taxation of Interstate Commerce of the House Comm. on the Judiciary, State Taxation of Interstate Commerce, vol. 2, H.R. Rep. No. 1480, 88th Cong., 2d Sess. A233-364 (1964) [hereinafter cited as H.R. Rep. 1480].

Supreme Court. An examination of a hypothetical situation will illustrate precisely how the interaction of varied methods of apportionment results in tax inequity.

Corporation X, doing business only in States A, B, and C, all of which are income-taxing states, has a net profit before taxes of $20,000. It owns a $50,000 plant in State A, employing seven people there for a total payroll of $50,000. The president, who lives in State A, is paid $20,000. One salesman is based at the plant and is paid $10,000. $50,000 worth of goods are sold in State A, and all are shipped from the plant. State A, employing an apportionment formula based upon the sum of property value, plus manufacturing costs, plus sales of goods through sales offices in State A,[6] taxes $^{701}/_{1230}$ of X's $20,000 net income, which is $11,398.[7]

State B is the location of a sales office leased for $2,000 per annum and the home of a $10,000 a year salesman. Sales to purchasers in State B total $150,000. State B, applying a property plus payroll plus destination-sales formula[8] to X's income, taxes it on $^{122}/_{615}$ of $20,000 or $3,967.[9] Corporation X also maintains a sales office in State C, which it leases for $2,000. One salesman is based there and paid $10,000. Sales into that state total $300,000. The formula employed by State C is a one-factor destination-sales formula.[10] Therefore, State C taxes $^{3}/_{5}$ of X's total net income or $12,000.[11]

The result, after each state has computed the tax due, is that Corporation X has been taxed as if its net income had been $27,365. The same company engaged in purely intrastate business, however, would have been taxed on only $20,000. It is important to note that this is merely an example and that a similar corporation doing the same amount of business might be taxed, under different formulas, on approximately $20,000, or substantially less than $20,000.

It is clearly the diversity of the methods of apportionment, and not the unreasonableness of any one of them, which has resulted in the plight of Corporation X. If the same formula were applied by each of these states,

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6 E.g., Wis. Stat. Ann. § 71.07(2)(b) (1957).

7 $$\left(\frac{\$50{,}000}{\$82{,}000} + \frac{1}{1} + \frac{\$\ 50{,}000}{\$500{,}000}\right) \div 3 \times \$20{,}000 = \frac{701}{1230} \times \$20{,}000 = \$11{,}398.$$

$82,000, the denominator of the property factor, is derived by adding $50,000, the value of property in State A, $16,000, the value of property in State B, and $16,000, the value of property in State C. The $16,000 figures are derived by multiplying the rent-payment on the sales offices ($2,000) by 8, the method used for valuing such property by UDITPA § 11. $500,000 is the total of the sales in all three states.

8 E.g., Cal. Rev. & Tax. Code § 25128.

9 $$\left(\frac{\$16{,}000}{\$82{,}000} + \frac{\$\ 10{,}000}{\$100{,}000} + \frac{\$150{,}000}{\$500{,}000}\right) \div 3 \times \$20{,}000 = \frac{122}{615} \times \$20{,}000 = \$3{,}967.$$

$100,000, the denominator of the payroll factor, is derived by adding all compensation paid to employees in State A ($80,000) to all compensation paid in State B ($10,000) and State C ($10,000).

10 E.g., Iowa Code Ann. § 422.33(1)(b) (1949).

11 $$\frac{\$300{,}000}{\$500{,}000} \times \$20{,}000 = \frac{3}{5} \times \$20{,}000 = \$12{,}000.$$

there could be nothing but one hundred per cent taxation of this corporation, and, since one hundred per cent taxation is basic tax equity, uniformity will achieve that equity. As early as 1917, Professor T. S. Adams of Yale told the National Tax Association: "What is most needed is a uniform rule. Just what rule shall be selected is less important than the general selection of the same rule by competing jurisdictions."[12]

Since it offers a uniform formula, UDITPA is a practical solution to the problem. Alaska adopted the act in 1959,[13] and eight other states have followed suit.[14] This acceptance has raised the hope that the remaining twenty-nine income-taxing states will see fit to adopt the act. If they do, the inequities caused by diversity will have been erased.

Although a uniform system of apportionment is the solution to the problem of diversity, there is also the critical matter of what the system of apportionment should be. Ideally, the system should attempt to establish the exact value of the taxpayer's income-producing activities in the state; however, the ideal of exactness must be balanced with the burden that excessive record-keeping will place on the taxpayer.[15] There are three basic methods from which to choose: (1) separate accounting; (2) specific allocation; and (3) formulary apportionment.[16] Separate accounting requires that the taxpayer keep its books on a state-by-state basis, as if its activities in the state were entirely separate from the rest of its operation.[17] For a few businesses, this method is practicable,[18] but for most there is no such separability of operations by state, and the burden of separate accounting would be extremely heavy.[19] For this reason, most states have seen fit to sacrifice the exactness of the method and make little use of separate accounting.[20]

The specific allocation method also seeks an exact determination of in-state income by requiring that the income from each transaction be apportioned to the state where the transaction took place.[21] Although extremely practical for certain types of transactions, when specific allocation is applied to all the transactions of a business, it effectively results in a separate accounting.

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[12] Adams, The Taxation of Business, 1917 Proceedings, Nat'l Tax Ass'n 185, 194 (1918).

[13] Alaska Stat. §§ 43.20.050-.150 (Supp. 1962).

[14] Ark. Stat. Ann. §§ 84-2055 to -2073 (Supp. 1965); Cal. Rev. & Tax. Code §§ 25120-39; D.C. Code Ann. § 47-1580a (Supp. IV, 1964); Idaho Code Ann. § 63-3027 (Supp. 1965); Ky. Rev. Stat. Ann. § 141.120 (Supp. 1966); N.M. Stat. Ann. §§ 72-15A-16 to -36 (Supp. 1965); Ore. Rev. Stat. §§ 314.605-.670 (1965); Va. Code Ann. §§ 58-131.1-.17 (Supp. 1966).

[15] See Dane, A New Look at State Taxation of Income From Interstate Commerce, 52 A.B.A.J. 651 (1966).

[16] Lynn, supra note 2, at 85.

[17] Legislation, An Analysis of the Net Income Provisions of the Interstate Taxation Act (H.R. 11798), 19 Vand. L. Rev. 523, 531 (1966).

[18] H.R. Rep. 1480, vol. 1, at 162.

[19] See id. at 163-67.

[20] Hellerstein, Allocation and Nexus in State Taxation of Interstate Businesses, 20 Tax L. Rev. 259, 266 (1965).

[21] Legislation, supra note 17, at 532.

Formulary apportionment differs from the other two methods in that it seeks a rough determination of the portion of business activity which the taxpayer conducts in the state.[22] The formula is a series of fractions which correspond to exact ratios of in-state to total activity in certain specific income-producing areas, such as sales, the paying of wages, etc. These exact ratios are averaged, thus producing an approximate ratio of the corporation's in-state activities to total activities. This average ratio represents the portion of the corporation's total taxable income which the state may tax. Because of the simplicity of formulary apportionment, every income-taxing state uses it in at least some cases.[23]

UDITPA makes use of both specific allocation and formula apportionment: the former for non-business income, the latter for business income. The particular types of non-business income to which the act applies specific allocation are rents, royalties, interest, dividends, and capital gains and losses from the holding, renting, or sale of real and tangible or intangible personal property, and royalties from patents and copyrights.[24] These types of income are peculiarly suited to specific allocation, for they are allocated only when they do not arise in the regular course of business and are then usually recorded separately.

As noted, the Uniform Act employs a formula for apportioning income earned in the regular course of business.[25] By ruling out specific allocation for business income, the Commissioners on Uniform State Laws avoided burdening corporations with the excessive record-keeping attendant upon the use of that method. The formula which was chosen is basically similar to those used by twenty-eight of the income-taxing states[26]—a three-factor formula of property, payroll, and sales.

The property factor is a fraction—the value of the real and tangible personal property owned or rented and used in the state, divided by the value of all such property owned or rented and used by the taxpayer.[27] The two main problems in this area are how to allocate the value of movable property and how to value property. Some of the states solve this first problem by requiring the calculation of the "extent of utilization" of movable property in the state,[28] thus effectively making the determination one of specific allocation. But the act solves this problem by providing that valuation of property be made by its location at the beginning and at the end

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22 H.R. Rep. 1480, vol. 1, at 168.

23 See statutes collected note 3 supra. Those states whose statutes do not specify the formula nevertheless make provision for administrative discretion as to what formula to use.

24 UDITPA §§ 5-8.

25 UDITPA §§ 9-17.

26 H.R. Rep. 1480, vol. 1, at 116-17. Two states have adopted the three-factor formula since 1963. D.C. Code Ann. § 47-1580a (Supp. IV, 1964); N.M. Stat. Ann. § 72-15A-25 (Supp. 1965).

27 UDITPA § 10.

28 La. Income Tax Reg. 245.2C, as noted in H.R. Rep. 1480, vol. 2, at A289. To determine the extent of utilization of an article of movable property one must multiply the value of that property by a fraction, the numerator of which is the number of days of use in the state and the denominator of which is the total number of days in the tax period.

of the tax period.[29] To avoid any inequities in this method, it permits the tax administrator to allow or require that this valuation be made once a month. The amounts of these two or more assessments are averaged, and the resultant values are used in determining the numerator and denominator of the fraction.[30] The other major problem with property factors has been the method of depreciating the value of the property included in the factor.[31] The act resolves this problem by providing that all property owned by the taxpayer be valued at original cost and all property leased by him be valued at eight times the net annual rental rate, thus completely eliminating depreciation.[32] Since it is merely a fraction and not the tax which is being calculated, there can be no inequities in the elimination of depreciation.[33]

The payroll factor is also a fraction: the numerator is the amount of wages paid to employees within the state and the denominator is the total amount of wages paid by the taxpayer to all his employees.[34] The problem here is deciding when a person is employed in a state. Some payroll factors divide the income of those who work in more than one state between the states where the employee works,[35] but this is difficult to compute. The uniform act always allocates each employee's entire wage to one state, preferably the state where the work is principally done; if that is impossible to determine, it will be allocated either to the state which houses the base of operations or point of control, or to the state of the employee's residence if the base of operations is not in any state in which the employee resides.[36] These provisions have been derived from the Model Unemployment Compensation Act, and the figures used for both numerator and denominator of the payroll factor will be exactly those used for determining total payroll under that act.[37] Therefore, computation and record-keeping problems have been minimized.

The sales factor is a fraction determined by dividing the corporation's sales in the taxing state by its total sales.[38] "Sales in the taxing state" is defined as sales in which goods are sent into the state or sales in which goods are sent from a point within the state to a state which has no jurisdiction to tax the corporation.[39] Thus, each sale is apportioned to one state and one only, and the result is one hundred per cent taxation. This, of course, requires a separate recording of the destination of each sale, and seems to be precisely the burden on multi-state business which was avoided in each of the other factors. Nevertheless, the burden of keeping such a record is slight, for all that need be recorded is the total amount of sales at each business location

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29 UDITPA § 12.

30 Ibid.

31 E.g., Conn. Gen. Stat. Ann. § 12-218(3)(b) (1960); Pa. Stat. Ann. tit. 72, § 3420b(2)(c)(1) (1964).

32 UDITPA § 11.

33 UDITPA § 11, Commissioners' Note.

34 UDITPA § 13.

35 E.g., La. Rev. Stat. § 47-245(f)(3) (1950).

36 UDITPA § 14.

37 UDITPA § 14, Commissioners' Note.

38 UDITPA § 15.

39 UDITPA § 16.

and the destination of sales which are shipped from that location to another state, records which a business must keep in some form and now must merely recompile on a state-by-state basis.

These three fractions are added together and divided by three to obtain an average fraction which is multiplied by the total taxable income of the taxpayer.[40] This portion of the net income is the tax base for the state.

It has been said that the property and payroll factors alone give a sufficiently fair representation of the amount of business done in a state.[41] But the primary income-producing activity of any business is the sale of goods or services, and it is submitted that the state which provides a market for the business deserves equal consideration with the state which houses the seller's property and provides his labor force.[42] It has been further argued that the two-factor formula is fair because there is no basic distinction between market-states and producer-states, and that therefore a two-factor formula will yield almost the same tax base as a three-factor formula.[43] But if the actual results achieved under a two-factor formula are compared to those under one with a third factor—a destination-sales factor—it will be found that this argument is unsound, since the two-factor formula would enormously favor five heavily industrialized states: Pennsylvania would gain more than $7 million in taxes,[44] Connecticut $2 million,[45] and Indiana,[46] Massachusetts,[47] and New Jersey[48] $1½ million each. Four states would be greatly discriminated against: New York would lose $13 million in taxes,[49] and Colorado,[50] Georgia,[51] and Oregon[52] $1 million each. Finally, of the remaining 29 income-taxing states, 4 would be slightly favored and 25 slightly disfavored by the two-factor formula.[53] Whatever the trend in erasing the distinction between market-states and producer-states may be, it certainly cannot be said that this distinction is non-existent. In view of this fact, it is submitted that the addition of the third factor to the formula used by UDITPA will achieve a balance between the activities of producing and those of selling, thereby achieving a balance between producer- and market-states.

The UDITPA formula, however, even if adopted by all the states, is not absolute insurance of one hundred per cent taxation. Mathematically,

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40 UDITPA § 9.

41 Barnes, State Taxation of Interstate Commerce: Nexus and Apportionment, 48 Marq. L. Rev. 218, 223-24 (1964). H.R. 16491, 89th Cong., 2d Sess. (1966), the latest bill proposed as a result of the work of the Special Subcommittee, provides at § 201 that no state may tax more of a multi-state corporation's income than it could have taxed under a two-factor formula.

42 See Hellerstein, supra note 20, at 273-76.

43 See H.R. Rep. 1480, vol. 1, at 530-34.

44 H.R. Rep. 1480, vol. 2, at A503.

45 Id. at A484.

46 Id. at A489.

47 Id. at A493.

48 Id. at A497.

49 Id. at A499.

50 Id. at A483.

51 Id. at A486.

52 Id. at A502.

53 See id. at A479-509.

of course, if there is a denominator of more than zero for each factor, the formula must result in one hundred per cent taxation. But if the denominator of one of the factors is zero, *e.g.*, if the taxpayer is a closely-held corporation which employs no one and pays its owners in the form of dividends, the result will be less than one hundred per cent taxation of the taxpayer. The act makes no provision for the possibility that a factor might be zero. This failing could easily be rectified by adding a paragraph stating that if the denominator of any factor is zero, it shall not be used, and by substituting for the present provision, which provides that the sum of the factors is to be divided by three, one for their division by the total number of factors used.[54]

Section 18 of the act states that if the provisions of the act do not "fairly represent the extent of the taxpayer's business activity in the state," the tax administrator may require or allow the use of separate accounting, the exclusion or inclusion of any factor, or the use of any other method which will be equitable. It must be remembered, of course, that if UDITPA is adopted in all the income-taxing states with the suggested provision concerning zero denominators, the formula will always result in fairness to state and taxpayer alike. Uniformity insures one hundred per cent taxation of all multi-state businesses, and therefore any over-apportionment to a particular state cannot result in over-taxation of a particular individual. The formula further insures that if the state applies it to all the multi-state businesses operating within its borders, the state's total tax base will be sufficiently broad. Therefore, it is submitted that, once the act is universally adopted, any alteration of the formula, whether it results in a greater or lesser apportionment to the particular state, can only destroy the uniformity which is the keystone of the act's fairness. However, since only nine income-taxing states have adopted the act, and twenty-nine continue to apply their own methods of apportionment, it would seem that there may be equitable reasons for the tax administrator's changing of the method of apportionment or the formula. Nevertheless, in a given situation there are only two possibilities: that the act has apportioned either too little or too much of the taxpayer's income to the state. If too little has been apportioned in an individual case, it need only be pointed out that the three-factor formula guarantees that the total tax base of the state is fairly apportioned to it, and the state should take no note of this individual case. On the other hand, if the formula has apportioned too much to a state, this over-apportionment can only be determined if the taxpayer is taxed on more than one hundred per cent of his income. It is, however, impossible to tell which state's formula is causing the over-taxation. But it would appear that the state which is employing UDITPA is far less likely to be over-taxing than a state which employs its own method of apportionment. Consequently, a readjustment in the method of apportionment should be made by the tax administrator of one of these latter states, rather than the tax administrator of the state which has enacted UDITPA. In short, when the interest of business in one hundred per cent taxation is balanced with the state interest in a fair total tax base, and when the inequity of non-uniformity is considered, there seems

54 See H.R. 16491, supra note 41, § 204.

to be no purpose in allowing the discretion of a tax administrator to destroy uniformity. This section of the act should be eliminated.

It might be argued that the elimination of administrative discretion will raise more problems than it solves, for there may be ambiguities in the act when it is applied to particular situations which require a certain amount of bargaining between taxpayer and tax administrator. The removal of section 18, however, will not affect the problem-solving procedures in the states. This is made clear by the Commissioner's Note following section 18: "This section does not spell out the procedure to be followed in the event of a disagreement between the taxpayer and the tax administrator."

As previously noted, UDITPA is concerned only with those situations in which a corporation is taxable in more than one state. The fair operation of UDITPA requires that both the domiciliary state of the taxpayer and the states in which it does business as a foreign corporation reach the same conclusion as to whether it is taxable in the foreign state. A difference of opinion by the tax administrators of these states will result in over-taxation or under-taxation of the corporation, possibly initiating a long litigation costly to state and taxpayer alike.[55] UDITPA defines "taxability in another state" as subjection to that state's jurisdiction to tax income.[56] Thus, if jurisdiction were uniformly defined by the states, there would be a uniform application of the act; but there is no such uniformity.[57] Not only is there diversity between the states, but almost every state, in determining when one of its domiciliaries is taxable in another state (reverse-nexus) uses a standard different from the one it uses for determining when a foreign corporation is taxable by it (nexus).[58] This lack of uniformity and consistency can only lead to the very inequities which UDITPA was intended to solve: over-taxation and under-taxation.

It should be noted that jurisdiction problems will not arise in every case, for there are many situations in which there is no dispute as to whether a foreign state may tax a given corporation. It is in the gray area, where the foreign state's assertion of jurisdiction is based on sales, occasional leasings of property, the presence of salesmen, or the maintenance of sales offices in the foreign state, that disputes arise.[59] UDITPA should add a section clearly defining the outer limits of nexus and equating them with reverse-nexus.

In conclusion, it is submitted that on its face UDITPA provides a system of apportionment which is equitable both to state and taxpayer. Some consideration should be given to the adoption of the three suggestions made above: (1) a provision eliminating any factor with a denominator of

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[55] If State A, the state of domicile, decides that Corporation X is taxable in State B, and State B decides that Corporation X is not taxable in State B, Corporation X will apportion in State A and pay no taxes in State B, and will therefore be under-taxed. On the other hand, if State A decides that Corporation X is wholly taxable by it, and State B decides that Corporation X is taxable by it, Corporation X will pay taxes on one hundred per cent of its income in State A, will apportion in State B, and thus will be over-taxed.

[56] UDITPA § 3.

[57] See H.R. Rep. 1480, vol. 1, at 147-51.

[58] Compare id. at 148-49 with id. at 240-41.

[59] See Hellerstein, supra note 20, at 261-62.

zero, and a provision for dividing the sum of the factors by their *total* number rather than the prescribed number three; (2) the elimination of section 18 of the act which grants the tax administrator discretion to change the method of apportionment; and (3) a clear definition of "taxability in another state." The incorporation of these three provisions will result in a broader tax base for the states and, more importantly, will insure uniformity in the application of the act and equality in the taxation of multi-state business.

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