Statement of

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Before the

Subcommittee on Commercial and Administrative Law

Committee on the Judiciary

United States House of Representatives

State Taxation: The Role of Congress in Developing Apportionment Standards

May 6, 2010

NOTE: This testimony was originally prepared by The Honorable Navjeet Bal, Commissioner of Revenue of the Commonwealth of Massachusetts, to be presented on behalf of the Federation of Tax Administrators at a hearing originally scheduled for March 11, 2010. When the hearing was rescheduled to this day and Commissioner Bal could not be present, she graciously allowed her testimony to be delivered by Mr. Eads. The Federation of Tax Administrators is an organization of the state tax agencies of all fifty states, as well as the District of Columbia and New York City.

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Navjeet K. Bal

Commissioner of Revenue

Commonwealth of Massachusetts

Appearing on behalf of the

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Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to appear before you today. My name is Navjeet Bal, and I am the Commissioner of Revenue for the Commonwealth of Massachusetts. I am honored to be here today, representing tax administrators from across the country, and the Federation of Tax Administrators. The FTA is an organization of the state tax agencies of all fifty states, as well as the District of Columbia and New York City.

As you know, we gather at an extraordinary time for state governments. The same "Great Recession" that has taken its toll on our citizens and increased the demand for state services has caused record declines in state tax revenues. The most recent report by the Rockefeller Institute of Government noted that state tax revenues have declined across all tax types – personal income tax, sales tax and corporate tax – for a record-breaking five consecutive quarters, and are expected to remain weak at least through the first quarter of 2010[1]. States have had to respond

[1] "State Revenue Flash Report", Lucy Dadayan, Rockefeller Institute of Government, February 23, 2010.

by cutting services, laying off state workers, drawing down on rainy-day funds and, in some instances, raising taxes. The Federal government has been a vital partner to states, providing increased federal financial assistance during this critical time, which has allowed states to meet their balanced budget requirements, without deeper budget cuts. As the states prepare their budgets for the upcoming fiscal year, which for many of us starts on July 1, it appears that state revenues are no longer in a free-fall. State budgets, however, still face enormous challenges as the additional federal assistance recedes, demand for state services remains strong and state revenues are well below their pre-recession levels.

You have asked this panel to discuss the general issue of apportionment of corporate income for state tax purposes, and specifically to address the question of what the role of Congress should be, if any, in developing apportionment standards. This discussion is a follow up to a hearing that was held last month on nexus issues and state taxation. I would echo the request of my distinguished colleague from Utah, Bruce Johnson, and respectfully ask that Congress continue to respect the sovereignty of the states and refrain from federal legislation in the area of apportionment for state tax purposes. Apportionment is a means to attribute a business entity's income to and among the various states in which the entity does business. Apportionment methodologies have been developed, over time, by the states in response to changes in the American economy. That responsiveness and flexibility have been critical to the states' ability to respond to changes in business, forms of commerce and means of corporate income creation.

While there are still challenges, and likely always will be, states are the best laboratories for the evolution of apportionment structures. State tax administrative agencies are confronted daily with issues related to state corporate taxation, and they have the knowledge, experience and expertise to craft workable solutions to challenges to the apportionment structure. Furthermore, state tax agencies already have the authority and are best positioned to work with the business community, governors and state legislatures in developing statutory and regulatory changes necessary to respond to changes in business. Working either on their own, or through national organizations such as the Uniform Law Commission or the Multistate Tax Commission, states have been able to adjust their apportionment statutes in a deliberative and granular manner as business models have developed.

State income taxation of corporations has evolved over the decades as commerce and industry in America have grown and expanded beyond state lines. Taxation of corporate activity that occurs solely within a state's borders has been a relatively simple affair. That corporate entity's net income, derived from its business activity, is subject to taxation by its state of domicile, in accordance with that state's corporate tax structure and rates. That remains true to this day. Once commerce began to cross state lines, however, such as with railroads and common carriers, questions arose about the level of activity that subjected a corporation to taxation within a state (i.e. *nexus*), and once that was determined, how to divide that corporation's income amongst the states with a claim to it (i.e. *apportionment*). In today's modern economy -- with corporate structures that span the globe, the prevalence of electronic commerce, and the growing importance of the service economy and the sale and licensing of intellectual property and other intangibles -- these questions have grown in complexity.

In response to the need to determine how best to apportion business income amongst the states, states developed a widely-accepted formula that ascertains the amount of property, payroll and sales of a given company within a given state against the amount of property, payroll and sales of that company everywhere. After weighting these factors, the resulting percentage is then multiplied against the company's taxable net income producing apportioned net income that is then taxed in accordance with the given state's corporate tax structure. This so-called three-factor apportionment (a type of formulary apportionment) has its origins in my home state of Massachusetts back at the beginning of the last century, and has developed, been codified and evolved over time in response to changes in the American economy. Apportionment is a complex and elegant arrangement that has provided stability to states and business taxpayers, and yet has proven to be flexible and subject to change as needed to best reflect how and where business income is generated. Federal imposition of an apportionment structure would prove to be cumbersome and inflexible in responding to changes in the economy and in how and where corporate income is created and where it should be subject to taxation.

Constitutional limitations

The Commerce Clause of the United States Constitution is the source of federal limitations on state taxation of corporations. Article 1, Section 8, Clause 3 of the Constitution

empowers Congress "to regulate Commerce with foreign Nations, and among several States and with the Indian Tribes." While states are free to regulate commerce within their borders, their ability to regulate interstate and foreign commerce is limited by the Commerce Clause. In *Complete Auto Transit Inc.v. Brady* (1977), the United States Supreme Court held that state income taxes on companies engaged in interstate commerce were not, *per se*, unconstitutional, and that businesses engaged in interstate commerce could be required to shoulder their share of the burden of state taxations. The Court also identified four criteria to judge the constitutionality of state tax law pursuant to the dormant Commerce Clause:

(1) The tax must be applied to an activity with substantial ***nexus*** with the state;
(2) The tax must be ***fairly apportioned*** to activities carried on by the taxpayer in the state;
(3) The tax must ***not discriminate*** against interstate commerce; and
(4) The tax must be ***fairly related*** to services provided by the state.

Apportionment

Formulary apportionment has been widely accepted by the states and by the business community as a method to approximate the extent of a business's activity within a state, and thereby to reflect the portion of its business income that is taxable in that state. While the earliest apportionment formulas used only property to measure the amount of a business's income attributable to a particular state, the states soon recognized that this approach favored the so-called "production states" at the expense of the so-called "market states," a tension that continues to this day. The property, payroll and sales factors that comprise the three-factor apportionment formula are proxies for the extent of the capital, labor and markets that a business has within a state.

In 1957, the National Conference of Commissioners on Uniform State Laws (NCCUSL) issued the Uniform Division of Income for Tax Purposes Act (UDITPA), which adopted the Massachusetts three-factor formula. UDITPA also distinguished business income, which is subject to the apportionment formula from non-business (or investment) income, which UDITPA treated as allocable to a particular state. In 1967, the Multistate Tax Compact was established which incorporated UDITPA into its model apportionment provisions. The Compact also created the Multistate Tax Commission (MTC) to promulgate regulations interpreting UDITPA. States joining the Compact have to adopt UDITPA (or offer it as an alternative method). Thirty-

six states and the District of Columbia have now adopted UDITPA, either on its own or as part of the Compact or both. Formulary apportionment, and the concepts reflected in UDITPA have held up well over the past fifty years in part because the states have been able to adapt the formulary apportionment approach to address developments in the economic marketplace and changes in the nature of business.

The Supreme Court has upheld a variety of apportionment formulas under the Commerce Clause, including three-factor apportionment. Indeed, in *Moorman Mfg. Co. v. Bair* (1978), the Supreme Court recognized that states may have different apportionment formulas (such as single sales factor in Iowa and three-factor apportionment in Indiana) that may result in taxation by the states in the aggregate of more or less than the full amount of income of a particular business taxpayer. The Court did not, however, find that the Iowa's single sales factor apportionment structure was unconstitutional simply because it might lead to an overlap in taxation with Indiana's more traditional, three-factor formula. The Court was reluctant to engage in "extensive judicial law-making" by applying the Commerce Clause to test particular state apportionment structures. Subsequent Court cases have, in recognition of the difficulties inherent in perfectly determining an apportionment percentage, required a taxpayer seeking to contest the application of a state's apportionment percentage to prove by "clear and cogent evidence" that the application of the percentage is "out of all proportion" to the business of the taxpayer as conducted in the state.

Apportionable vs. Allocable income. As a threshold matter, one must decide whether a taxpayer's business income (that is, its income derived from its trade or business) is subject to taxation in more than one jurisdiction, and therefore should be apportioned between the multiple jurisdictions. So, for example, in Massachusetts, our apportionment statute (M.G.L. c. 63 §38) states that all of a corporate taxpayer's taxable net income is allocated to Massachusetts if the taxpayer does not have income from business activity that is taxable in another state. A business is taxable in another state if it is subject to tax in that state or if the state has jurisdiction to impose a net income tax on that business, regardless of whether it actually does. If a taxpayer does have business income that is taxable in another state, then it must apportion that income. Most corporations taxable in Massachusetts are required to use the three-factor apportionment formula (with a double-weighted sales factor) to determine the amount of its income that is

taxable in Massachusetts. Manufacturing corporations and certain mutual fund service corporations use a single sales factor formula in Massachusetts.

The three-factor apportionment formula. The UDITPA/three-factor formula multiplies a corporation's net taxable income by a fraction, the numerator of which is the property factor, plus the payroll factor plus the sales factor, and the denominator of which is 3. The apportionment formula was developed at a time when commerce consisted mostly of manufacturing and mercantile businesses, and the production and sale of tangible goods, and gave equal weight to each of the three factors. The property and payroll factors represented the contribution of the so-called "production" states where a taxpayer's manufacturing plant or retail store would be located. The sales factor was meant to recognize the contribution of the so-called "market" states in providing a market for a taxpayer's goods. As the American economy has changed over the past century, the property and payroll factors have remained fairly constant. The sales factor, however, has come under pressure to adapt to the rise of the service economy as well as the sale and licensing of intangible property (e.g. patents, know-how, trademarks and copyrights). Over time, many states have moved to a double-weighted sales factor or even a single sales factor to place greater emphasis on the importance of a taxpayer's market in the generation of its income. In addition, a number of state statutes and regulations have modernized their sales factor provisions as they relate to services and intangibles, to place emphasis on where the services and intangibles are actually used or consumed.

Property factor. The property factor is a fraction itself, the numerator of which is generally the average value of a corporation's real and tangible personal property owned or rented and used in a state during the taxable year and the denominator of which is the average value of all the corporation's real and tangible personal property owned or rented and used during the taxable year.

In order to minimize inconsistencies caused by different depreciation schemes amongst the states, the average value of property is generally defined to be its original cost, increased to reflect capital additions or improvements, and decreased to reflect portions of the property that are sold or disposed of during the year, with no adjustments made for depreciation.

In limited circumstances, states may include certain intangible property in the property factor. For example, under Massachusetts law (which is based on an MTC model statute) the

property factor for financial institutions includes the average value of the financial institution's loans and credit card receivables that are located within the Commonwealth during the applicable taxable year in the numerator, and includes the value of loans and credit card receivables everywhere in the denominator. Both loans and credit card receivables are valued at their outstanding principal amounts, giving recognition to the value of these types of intangible property for financial institutions.

Payroll factor. The payroll factor is the simplest and least controversial of the three factors. The payroll factor is a fraction, the numerator of which is the total amount paid by a corporation in a state as compensation, and the denominator of which is the total amount of compensation paid by the corporation.

Specific provisions under the payroll factor address employees who work in multiple jurisdictions, independent contractors, "leased" employees and temporary employees. While the payroll factor has been the simplest to administer, even here we see the importance of providing flexibility to the states to respond to new business models, such as the growth of employee leasing companies.

Sales factor. The sales factor has been the subject of the most scrutiny and change over the last fifty years. The purpose of the sales factor is generally to recognize the contribution of the market in creating income for corporations, and this has the effect of spreading income from production states to market states. While the sales factor was developed in the context of an economy that was predominantly composed of manufacturing and the sale of tangible goods, the sales factor typically encompasses all "gross receipts" generated as business income (i.e. not investment income), including, among other things, receipts from the sale of goods, income derived from services, rental income and income from the sale and licensing of intangibles.

Sale of tangible goods. Prior to UDITPA, there were three different rules used for the sourcing of sales of tangible goods for purposes of the sales factor. The "origin rule" allocated sales to where the orders for goods were filled. The origin rule duplicated the property and payroll factors and was subject to manipulation as taxpayers would maintain inventories in low-tax or no-tax states. The "destination rule" allocated sales to where the goods were shipped or where the purchaser is located, thereby recognizing the contributions of the market. The

"solicitation rule" allocated sales to the place where the employee activity occurred that was responsible for the sale.

UDITPA adopts the destination rule for determining where sales are made. The destination rule balances the property and payroll factors which favor the production state, and gives credit to the market state in the creation of corporate income. UDITPA has two important exceptions to this rule.

The first is for sales to the U.S. government, which can be thought of as present in all fifty states. Such sales are allocated to the location of the office, warehouse or factory from where the goods were shipped.

The second exception is instances in which a taxpayer is not subject to taxation (because it does not have sufficient nexus) in the destination state. In that case, UDITPA "throws back" the income to the origin state, and thereby avoids "nowhere" income that is not taxable in any state. Because the throwback rule may be viewed as overweighting the contributions of the origin state (which may also be where the property and payroll factors are higher), some states have adopted a "throw out" rule with eliminates the sale from both the numerator and the denominator, thereby allocating the net income from that sale amongst the several states.

Sales of intangibles and services. Section 17 of UDITPA states that sales other than sales of tangible property are generally attributed to a state based on where the income-producing activity is conducted. If such activity occurs in multiple states, then sales are attributed to the state with the greater proportion of the income-producing activity based on where the costs of performance are predominantly incurred. This tends to duplicate the payroll and property factors, and is distortive because it allocates all of the sales to the state that has the largest percentage of the income-producing activity, even if that percentage is only slightly larger than the state with the next largest amount of income-producing activity. Further difficulties arise in identifying the relevant "income-producing activity," as well as its cost and location.

Given the move by most states to either a double weighted sales factor or a single sales factor, the distortion caused by the cost of performance rule in over-emphasizing the production states, and under-counting the contributions of the market states, and the growth of the service economy, more and more states have been moving away from the strict cost of performance rules. Instead, states are looking to where the benefit or service is received, where the service is

performed or using a proportional cost of performance measure to more fairly apportion the sales factor related to services.

Alternative Apportionment Methods. The generally applicable apportionment factors described above work well as applied to a majority of taxpayers. States, however, have the authority to issue alternative apportionment regulations for particular industries, and particular business taxpayers have the ability to request alternative apportionment treatment, in both cases to address distortions caused by the apportionment factors as they are applied to a particular situation. It is this flexibility that is critical to states' ability to respond to changes in the marketplace and developments in how corporate income is created.

In some instances, states have adopted alternative apportionment regulations, based often on model statutes or regulations issued by the MTC, to address particular industries such as financial institutions, telecommunications, airlines, railroads, trucking companies and television and radio broadcasting. The MTC, through its working groups and sub-working groups, has developed these model alternative apportionment statutes or regulations to address particular distortions in the apportionment formula as it is applied to a particular industry. Representatives of the business community attend the MTC working group meetings, and provide input, although they are not voting members. Once the model statutes or regulations have been approved in accordance with MTC's procedures, states may adopt them in response to their own needs. It should be noted that states embrace, for the most part, uniformity in how the apportionment factors are developed, although they may differ on the weighting of the three factors within the apportionment formula.

In other cases, states have developed their own statutory or regulatory responses to developments in business. For example, Massachusetts has specific provisions dealing with the determination of the sales factor and the licensing of intangible property. Massachusetts law states that the income-producing activity related to the licensing of intangible property shall be considered to be in Massachusetts if the intangible property is used in Massachusetts. Intangible property includes copyrights, patents, trademarks, tradenames and similar intangibles where the use of the property may be transferred separately from ownership.

Royalties or other licensing fees paid for marketing intangibles such as service marks, trademarks or tradenames, are apportionable to Massachusetts to the extent that the goods or

services employing such marketing intangibles are sold to Massachusetts customers, again recognizing the "use" of those intangibles. Licensing fees for intangibles not used in the marketing of other goods, such as the license of a patent for use in a manufacturing process, are attributed to the Commonwealth to the extent that such patent is actually used in the state.

While these licensing provisions are not part of an MTC model provision, at least six other states have particular provisions addressing the apportionment of income from the licensing of intangible property rights for purposes of the sales factor. States have been able to respond to the vast increase of the importance of the intangible property sector of the American economy, and the increasing role that income from the sale or licensing of such intangible property plays in the creation of corporate taxable income. This is an instructive example of the importance of flexibility and control for states over the apportionment factors to respond to changes in the economy.

UDITPA update. In 2006, in an effort to promote greater uniformity and ease of compliance in the treatment of sales of services and the sale and licensing of intangible property, the MTC initiated an effort to update and revise Section 17 of UDITPA to reflect the changes in the American economy. The Uniform Law Commission (ULC), as successor to NCCUSL, also participated in this effort, as the UDIPTA is a ULC model statute. While the ULC ultimately decided that UDITPA should be revisited in its entirety, the MTC has focused on a limited number of issues, with the most prominent being an update and revision of Section 17. There has been significant resistance from the business community to any efforts to update and standardize UDITPA and promote greater uniformity with respect to Section 17. The MTC is nevertheless moving forward with its efforts to modernize Section 17 and other limited provisions of the Compact.

Creating Workable Solutions

The fair apportionment of corporations' taxable income amongst the states is a complex and challenging one. For the better part of fifty years now, the states have found a workable solution through the application of formulary apportionment that has served as a stable and widely accepted means to approximate the extent of a business's activity within a state, and has proven sufficiently flexible to address the changing economy. Formulary apportionment has

been seen as a fair way to apportion income derived from business between the production states and the market states through the property, payroll and sales factors. As the American economy as evolved towards a service and information economy, states have responded by adjusting their apportionment formulae and also by adopting alternative apportionment regulations for particular industries. There has been an organic development of the alternative apportionment provisions through the MTC and within the states, giving states the flexibility to respond to changes in industry. The proliferation of states adopting a double-weighted sales factor or single sales factor (or both, in the case of Massachusetts) is further evidence of the responsiveness and flexibility of the current apportionment structure, which allows governors and legislators to respond to the nature of the economy and the interests of the business community within their borders. The MTC and the ULC each provide a deliberative forum for the states and business interests to consider potential changes to UDITPA and the Compact, and to achieve greater uniformity in state approaches.

Given the diversity and complexity of the American economy, and the rapid changes that it is undergoing, it is imperative for both the business community and the states to maintain the flexibility they need to adjust the apportionment formula to address particular industries or to respond to business needs within a particular state. Any type of federal intervention in this effort would have a deleterious effect on the flexibility that is in the current apportionment structure, and would in all likelihood have unintended consequences resulting in distortions in how and where business is conducted. Given their expertise, motivation and their on-the-ground relations with the business community, the states are best positioned to revise formulary apportionment as it applies to state taxation of interstate commerce.

I thank you for your time and for your consideration of this important issue.