Raising the Bar provides fresh, incisive analysis of breaking state and local tax issues from the perspective of four seasoned SALT veterans: Kendall Houghton of Alston & Bird LLP, Joe Crosby of MultiState Associates, and Stephen P. Kranz and Diann L. Smith of McDermott Will & Emery. All four are former Council On State Taxation staffers.

This column is taken from interviews by State Tax Notes legal editor Doug Sheppard. In this edition, the four discuss the Multistate Tax Commission’s proposed revisions to section 18 of the Uniform Division of Income for Tax Purposes Act, the U.S. Supreme Court’s denial of cert in Equifax, and other apportionment issues.

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The U.S. Supreme Court’s denial of certiorari in Equifax (2013 STT 230-21) and the Multistate Tax Commission’s debate over proposed revisions to section 18 of the Uniform Division of Income for Tax Purposes Act are just the latest manifestations of a long-standing debate over apportionment factors.

The MTC on July 30 adopted model revisions to five UDITPA provisions. One day later, the MTC’s Executive Committee approved and is sending to a survey of affected states additional draft language on section 18 that would incorporate in modified form three alternative apportionment provisions recommended by hearing officer Richard Pomp.

The Supreme Court’s rejection of Equifax/1/ has some pondering if the Court will ever take up a state apportionment case regarding a state’s use of discretionary authority -- and what set of facts will be needed. It is here we pick up the discussion, which also touched on the role of state department of revenue officials in audits and the Tennessee Appeals Court’s Vodafone decision.

Stephen P. Kranz: As we said in the first article we wrote about Equifax in State Tax Notes last year, it’s open season on state tax apportionment/2/

Diann L. Smith: We think that to the same extent that tax agencies seem to be making up their own rules as to what is considered income that is fairly attributable to the jurisdiction, taxpayers should have that same opportunity.
Kendall Houghton: So in other words, Diann, if the states are going to engage in results-driven analysis under various sourcing regimes, taxpayers should be permitted to do likewise?

Smith: Exactly. And the classic example that I always use is if you’re a manufacturer and you’re selling into a single-sales-factor state, why not argue: “Hey, it’s not a fair reflection of our income by only showing our sales into that state. We think you should account for our property and payroll that’s all in another state.”

Kranz: If there are no rules for the states, there are no rules for taxpayers; everyone should be looking at what is the position that’s most advantageous to them from a filing perspective.

Joe Crosby: Subsequent to the case, the Mississippi Legislature addressed the issue. What’s your take on whether that remedies it, at least with regard to Mississippi?

Smith: There are two things it fixes. One, it fixes the penalty issue, which is one of the reasons the Equifax case got such notice among state and local tax practitioners. Because the idea of imposing a penalty on a taxpayer for following the law -- for following a statutory rule -- is astounding to me, and yet that’s what the court upheld. So it fixes that, and I think it helps a little bit with the burden of proof issue. But I don’t think it fundamentally changes how section 18 can be used.

Houghton: So obviously, taxpayers and taxpayer representatives have been very disturbed by what happened in Equifax, but we all know that the chances of securing review by the U.S. Supreme Court of a state tax decision are slim to none on a good day. And we learned recently that the Court isn’t going to review this case. Do you guys think that there is an alternative apportionment-type case that the Court will ever be willing to review? I mean, how bad do the facts have to be?

Smith: And I would extend that even further, Kendall, asking: Is there an apportionment case that the Supreme Court is interested in reviewing at this point? I’m pessimistic right now. I’m not telling people they should give up, but...

Crosby: My perspective is looking at alternative ways (no pun intended) to address the problem, and I give great credit to the Mississippi Economic Council and to the folks at COST for responding quickly through the Legislature to the Equifax decision to address the most egregious parts of it. But to me, it begs the question: If it is open season, should taxpayers be thinking about crafting a legislative solution that may change section 18 differently than where the MTC seems to be going?

Kranz: That’s a good question, Joe. Should the legislatures step in and say, “We’ve passed a statute before; now we really mean it. And here’s how we’re going to instruct our tax administrators to implement the law in a way that leaves them less wiggle room than they now believe they have under section 18”?

Crosby: And I think we probably would all agree with the thought that states are aggressively using section 18 right now -- not just Mississippi prior to the Equifax decision -- and that it is not necessarily a two-way street. I mean, some courts have interpreted it that way, but really for many, the taxpayer is at a disadvantage. And right now, we have the MTC looking at modifications; well, of course, that’s the organization that represents the very same folks that we probably agree are pushing the envelope with regard to the existing statutes. So there needs to be some sort of counterbalance, in my perspective.

Houghton: Since you mentioned the MTC, I assume that many of us were tuned in to the recent Uniformity Committee discussions of the section 18 changes that the Executive Committee is essentially directing be made by the Uniformity Committee. But there’s a real resistance to even the very minimal changes that the Executive Committee has recommended. So back to the burden of proof question: If the state wants to deviate from the standard formula, it bears the burden of proof to justify that. The MTC, we tend to think, is an organization that may represent views we don’t agree with -- and here, their members sounded like they were contemplating a mutiny during that particular discussion because the MTC Executive Committee was advocating a position with which taxpayers would agree.
Kranz: Utah State Tax Commissioner Bruce Johnson was the voice of reason trying to get the Executive Committee to encourage the Uniformity Committee down a better path, but I don’t know that one voice of reason in the forest is going to change the course of their ultimate history.

Smith: To take one item in particular that shows what the problem is: This whole issue about if a taxpayer has been filing not following the statutory method -- which is what occurred in the Vodafone/5/ case, for example -- and then the taxpayer discovers that it was not properly filing, so it files amended returns to use the statutory formula, there are people participating in the MTC process that aggressively assert that there should be basically a presumption against a taxpayer trying to correct its returns to follow the statutory method. And the theory seems to be: Since the taxpayer has been filing that way, then the department has accepted it. And thus, any change from that is itself a use of section 18 by the taxpayer.

I think Rick Pomp’s comments (2014 STT 127-12) in his written response to this position are really important. He said: Why wouldn’t a tax department accept the incorrectly filed return if they’re getting more money that way? And we all know that in other areas of tax, just because a tax department has not challenged something on audit doesn’t mean it’s correct. Why should this one area be different?

Houghton: Right. No tax department would view itself as being estopped from making adjustments in a later audit based on the fact that it hadn’t identified an erroneous component (or position that produced less tax) in a return during an earlier cycle.

Crosby: In my layman’s perspective, if a law isn’t what it says, then what’s the point of writing it in the first place? Why do we even have legislatures? Why don’t we just give the authority to the department of revenue to say that tax liability is whatever they say it is on that return?

Kranz: In the same way, if the MTC isn’t about uniformity, why are they writing uniform statutory provisions or uniform regulations if they’re not going to hold their members’ feet to the fire on adoption and implementing them uniformly? We’ve got a fundamental problem here that the MTC is giving lip service to fixing, but they’re not really fixing anything.

Smith: Along those same lines, one of the arguments has been that section 18 should only be used in unique, non-reoccurring circumstances. And I think some of that language actually comes from the MTC’s regulations. There’ve been cases out there that say, “Well, we don’t really mean unique; we don’t really mean non-reoccurring.” As part of these MTC procedures, the issue has come up: Well, if you know that an industry maybe doesn’t fit in well with the standard UDITPA or the state’s standard statutory apportionment formula, shouldn’t it be fixed through regulations or through legislation, not on one-off audits on a prospective basis?

The response from some of the states has been “Well, we only discover that there is a problem on audit.” To me -- and I’m curious about your thoughts, Joe -- that’s not a convincing response. Because OK, fine, you discovered it’s a problem, so you fixed it prospectively. I don’t understand why they think it’s an answer to say, “We have to fix it only through the audit process.”

Crosby: Diann, I completely agree, and I think probably from a fundamental perspective, if the legislature has adopted a statute, and the agency through the legislatively approved Administrative Procedures Act process or whatever process they have to go through to adopt the regulations, and a taxpayer follows that, what right does an individual auditor -- not a supervisor -- or even somebody higher up in the department of revenue have to say that there’s a problem? Isn’t that for the legislature to decide? Or isn’t that something that should then be determined through the regulatory process? Where do they gain the authority to determine that it’s an actual problem that nobody had contemplated before? I just don’t believe that that’s their job; their job is to apply the law to the facts, and if they do discover the problem, to then bring it to the attention of people who have the authority to change the law or to update the regulations.

Smith: It seems to me that they don’t believe in the political process, and that’s why they’re doing this.
Kranz: Or they’ve concluded that policymaking appropriately belongs to an audit function.

Crosby: Absolutely, and I think it’s probably a combination of both. We certainly know there are some administrators out there who have less than a healthy regard for the legislative policymaking process, and others who do think it is part of the audit function. And I understand, looking at it from the business perspective, as you all know, we most frequently find issues that need legislative attention through the audit process. But that’s exactly what we do -- or through litigation if it’s just simply a disagreement over interpretation. We don’t get the unilateral ability just to change things, and it should go both ways.

Kranz: Every tax issue has a life cycle, starting with the return working its way through an audit and controversy and litigation, and if you don’t like what happens at that point, go fix it in the legislative process. That should be the life cycle of a tax issue. The states that are trying to change policy in the middle of the audit stream are not respecting the political process or the adjudicatory process that has been in place and is a fundamental part of our subnational tax system.

Smith: What should taxpayers do now in states like Tennessee that seem to have said, “In these circumstances, we’re going to reject the statutory rule”? If you’re another service provider, you’re not in the same industry, but you know you’re a service provider, what rule are you supposed to follow?

Crosby: And you know no matter what your response is, you’re potentially open to penalties.

Houghton: And therefore, no matter how you file, now you’re going to have to set up a reserve for it because you can never get to the appropriate level of comfort about the correctness of your filing.

Kranz: So take the most advantageous position possible.

Houghton: And plan on being audited and plan on being challenged.

Smith: Another aspect of the Vodafone decision that I found discouraging was the part where the court said, “The other states where the cost of performance occurs, based on their statutes, would not include it in the numerator, so it’s OK if we do.” And I’m having trouble with the concept of taxation based on what the other states are doing.

Houghton: And in particular, the almighty principle of: There shall be no nowhere income -- or receipts in this case.

Crosby: I agree, Diann: The state’s law should be what it is, and the taxpayer’s liability in a particular state should not be referenced by its liability in another state with a different set of laws. And this, to me, goes one step further, and I’ve always had this problem, Kendall, with the full apportionment kind of issue is that if we are to have separate states, then we have to recognize that there will be differences. If the goal really is full apportionment, then we ought to eliminate all state-level, entity-level taxes and simply have the federal government have a pickup piece that gets distributed based on population or some other feature. Because it makes no sense to go through all this -- only then to have some states say, “Well, this other state didn’t tax it, so we’re going to go ahead and take it.”

Kranz: The feds could distribute revenue based on property, payroll, and sales.

Crosby: They could.

Kranz: This is the tax equivalent of “You Can’t Always Get What You Want.”/6/

FOOTNOTES

/1/ See David Sawyer, “U.S. Supreme Court to Answer TIA and 4-R Questions, Lets Equifax Stand,” State Tax Notes, July 7, 2014, p. 7 (Doc 2014-16415).


/6/ See the Rolling Stones, Let It Bleed (1969).

References

Subject Area:
Apportionment;
Compliance;
Corporate taxation;
Legislation and lawmaking;
Litigation and appeals;
Tax system administration