Putting the 'Fair' Back in Fair Apportionment

by Pilar Mata, Richard C. Call, and Matthew P. Hedstrom

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The Tennessee Court of Appeals' recent decision in *BellSouth Advertising & Publishing Corp. v. Chumley*[1] (*BAPCO*) raises an important question: What procedures and requirements should be in place to ensure that taxpayers and taxing authorities are on a level playing field when seeking to deviate from the standard apportionment formula? In this Pinch of SALT, we evaluate a fair application of equitable apportionment from the perspective of both taxpayers and tax administrators.

BAPCO

BellSouth Advertising & Publishing Corp. is a subsidiary of BellSouth Corp. that sold advertising and compiled, published, and distributed Yellow Pages telephone directories. Ninety-five percent of BAPCO's revenue was derived from the sale of advertising to individuals and businesses that advertised in these directories.

All of BAPCO's representatives responsible for selling advertising were located outside Tennessee.[2] Also, all of BAPCO's production offices were located outside the state. BAPCO transferred the finished directories to an affiliate located outside Tennessee to be printed and bound, and an unrelated party distributed the directories to Tennessee residents.

Tennessee law requires taxpayers to source "gross receipts from transactions other than sales of tangible personal property" in the numerator of the sales factor only if "the earning producing activity is performed within and without this state but the greatest proportion of the earnings producing activity is performed in this state, based on cost of performance."[3] Earnings-producing activity is defined as "the transactions and activity directly engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit."[4]

Because all the transactions and activities related to BAPCO's advertising activities were conducted outside Tennessee, BAPCO excluded its receipts from advertising from its Tennessee sales factor numerator.

The Tennessee auditor acknowledged that BAPCO's direct costs were incurred entirely outside Tennessee. However, the auditor asserted authority under the state's equitable apportionment provision. Tennessee law contains an equitable apportionment provision based on section 18 of the Uniform Division of Income for Tax Purposes Act. Tenn. Code. Ann. section 67-4-2014 authorizes a taxpayer or comissioner to apply an alternative apportionment method if the "standard" method does not "*fairly* represent the extent of the taxpayer's business activity in this state."[5] Tennessee's regulations further provide that section 67-4-2014 "permit[s] a departure from the allocation and apportionment provisions only in limited and specific cases" and that it may be invoked "only in specific cases where *unusual fact situations* (which ordinarily will be *unique and nonrecurring*)

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[1]2009 Tenn. App. LEXIS 576 (June 25, 2009). (For the decision, see *Doc 2009-19531* or *2009 STT 167-28*.)

[2]BAPCO's local advertising was secured by representatives employed by a separate company that was subject to Tennessee tax.

[3]Tenn. Code Ann. section 67-4-2012(i). For the years at issue, the Tennessee statutory provision was codified in Tenn. Code Ann. section 67-4-811.

[4]Tenn. Comp. R. & Regs. 1320-6-1-.34(2).

[5]Emphasis added.

produce incongruous results under the apportionment and allocation provisions contained in the Franchise and Excise Tax Laws."[6]

The Tennessee Court of Appeals upheld the variance and BAPCO's resulting assessment.[7] The court referenced the commissioner's argument that in 1957 the drafters of UDITPA had commented that the costs of performance method might require a variance in some circumstances, including when the sales at issue were dervived from advertising revenue. The court rejected BAPCO's argument that the company's case did not present an unusual fact situation, saying:

> The unusual fact situation in this case is that all of the costs of production occurred outside of Tennessee, but the revenue derived from the end product only occurred when the product was distributed in Tennessee which only then obligated the purchasers to pay the revenue proceeds to the producer for the sale of the advertising. Certainly, the circumstances of this case have a unique quality, and while the process can be recurring, the "ordinarily" qualifier under the rule does not proscribe the issuance of a variance in all such cases.

In applying this "fairness" standard, the state court was moved by the amount of Tennessee tax BAPCO was paying under the standard appotiontment method, stating that "BAPCO has paid only $296,140 in Tennessee excise and franchise tax but derived advertising income from the distribution of 23,715,829 directories in Tennessee of $897,488,193 during the five years at issue."

The appeals court's application of the fairness standard is troubling for several reasons.[8] Tennessee law requires the application of the costs of performance method for sourcing receipts from intangibles and services, using an "all or nothing basis," to the state where the greatest proportion of the earnings-producing activity is performed. The commissioner's complaint is premised on a perceived inherent unfairness in this statutory method. However, the legislature's decision to create an "all or nothing" apportionment method does not justify the application of a deviation from the standard apportionment formula unless there is some unusual fact pattern that requires an alternative formula to avoid unfair treatment.

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Moreover, we disagree with the court of appeals' conclusion that *BAPCO* presented an unusual fact situation justifying the use of an alternative apportionment method. One must question how the provision of advertising services can constitute an unusual fact situation, particularly because the drafters of UDITPA in 1957 identified any potential problems associated with receipts from advertising receipts.

Criteria for a Level Playing Field

The purpose of UDITPA is to provide a uniform system for dividing the state corporate income tax base among the states. Section 18 should serve as a relief valve that would provide for an alternative apportionment method when the standard apportionment formula produces a nonsensical result.[9] We maintain that the following factors are necessary to ensure that alternative apportionment is administered in a fair and equitable manner.

Ensuring That the Alternative Apportionment Provision Is the Exception, Not the Rule

Equitable apportionment should be limited in its application: It should be the exception, not the rule. Without that restriction, the general apportionment formula will be winnowed away to the point that a state's apportionment method is nothing more than an amalgamation of one-off, industry-specific (or taxpayer-specific) formulas. Section 18 was meant to be applied in "limited and specific" cases and thus may be invoked only when "unusual fact situations (which ordinarily will be unique and nonrecurring) produce 'incongruous results.'"[10]

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[6]Tenn. Comp. R. & Regs. 1320-6-1-.35 (emphasis added).

[7]The court of appeals rejected the commissioner's argument that BAPCO's use of the costs of performance method was correct, but held that the earnings-producing activity that generated BAPCO's advertising revenue was the provision and distribution of directories in Tennessee. The commissioner thus sought to ignore all the so-called preliminary work that BAPCO performed in other states. The court of appeals held that BAPCO's "earnings producing activity is a series of integrated, interdependent steps to the satisfaction of the advertisers from whom BAPCO derives its income. Without these numerous steps BAPCO would have no advertising to include in its directory, regardless of the mode of delivery."

[8]It is anticipated that BAPCO will appeal to the Tennessee Supreme Court and may sucessfully challenge the appelate court's holding.

[9]Jerome Hellerstein and Walter Hellerstein, *State Taxation*, para. 9.20[3][a0] (3d ed. 2001-2009); Diann L. Smith and Richard C. Call, "MTC Section 18 Regulations: Recurring Challenges to the Nonrecurring Rule," *State Tax Notes*, Apr. 6, 2009, p. 67, *Doc 2009-7059*, or *2009 STT 64-8*.

[10]MTC Allocation and Apportionment Regulations, Section IV.18(a).

Imposing the burden of proof on the party seeking relief, and ensuring that the hurdle for applying equitable apportionment is significant, ensure that the alternative provision remains the rather than the rule. That requirement is commonly mandated by statute or regulation. For example, Georgia requires the taxpayer to use "clear and cogent evidence" to prove its right to alternative apportionment.[11] The requirement also may be mandated by court decisions, as in California, where the California Supreme Court has held that the party requesting the variance must prove its entitlement to equitable relief by "clear and convincing evidence."[12]

Ensuring That the Alternative Apportionment Provision Serves Its Purpose

Though we caution against an overbroad application of section 18, our wish to ensure that the alternative apportionment provision remains the exception rather than the rule should not be construed as an attempt to unduly restrict a state's or a taxpayer's right to seek relief. Indeed, we maintain that to serve its purpose, an alternative apportionment method should be made available even if the level of distortion does not rise to constitutional magnitudes. That line of reasoning has been validated by the courts and supported by leading authorities.[13]

Thus, the U.S. Supreme Court's decision setting forth the standard for a constitutional violation in *Hans Rees' Sons, Inc. v. North Carolina*[14] — in which the court held that a statutory apportionment percentage apportioned nearly 80 percent of the taxpayer's income to North Carolina, and the facts showed that only about 21 percent of the taxpayer's income should, at most, be attributed to in-state standards — serves as an outer limit for determining whether an alternative apportionment method is warranted. Otherwise, tax administrators and taxpayers alike will have no recourse against "unfair" but constitutional limitations.

We further maintain that states should not be entitled to place onerous procedural restrictions on a taxpayer's right to seek relief under section 18. Examples of procedural hurdles we find troubling include Georgia's, whose procedure requires taxpayers to file a petition to use an alternative apportionment method *before* the date the return is due (including extensions).[15] Other states require that the petition be filed on or before the due date of the return or be attached thereto.[16] Iowa requires that the taxpayer pay the tax due under the standard apportionment formula and file a petition for relief after the return is filed to request a refund.[17]

> ***An alternative apportionment method should be made available even if the level of distortion does not rise to constitutional magnitudes.***

In our view, those restrictions undermine the intent of section 18. The purpose of an alternative apportionment provision is to provide relief when the standard formula fails to reflect the extent of the taxpayer's activities within the state. Onerous restrictions thwart that goal and have no purpose other than to deny a taxpayer its right to fair apportionment, thereby increasing the state's revenue.

The Door Must Swing Both Ways

Tax administrators, though quick to assert the right to claim alternative apportionment methods, are notoriously reluctant to agree to taxpayers' requests to vary from the statutorily prescribed apportionment formula. That reluctance cannot be squared with the plain language of section 18, which entitles the "taxpayer to petition for or the [tax administrator] to require" the use of an alternative apportionment formula. Equitable apportionment is not simply the tax administrator's tool for correcting perceived abuses; rather, both taxpayer and tax administrator should be equally able to use it.

Consider the following hypothetical. One of BAPCO's competitors, Taxpayer A, conducts virtually the same business as BAPCO in essentially the same manner — except that Taxpayer A operates from within Tennessee and delivers its directories to residents of Virginia. Based on the standard costs of performance rule, almost all of Taxpayer A's sales should be sourced to Tennessee. If Taxpayer A filed a petition seeking to source its receipts from advertising sales to Virginia (consistent with the holding in *BAPCO*), thereby reducing its sales factor to near zero, Tennessee should grant Taxpayer A its variance from the standard costs of performance sourcing rule.

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[11]Ga. Reg. 560-7-7-.03(5)(e)3; *see also* N.C. Gen. Stat. section 105-30.4(t1) (requiring clear, cogent, and convincing proof).

[12]*Colgate-Palmolive, Inc. v. FTB*, 10 Cal. App. 4th 1768 (Cal. Ct. App. 1992); *Microsoft Corp. v. Franchise Tax Bd.*, 139 P.3d 1169 (2006).

[13]*See Union Pac.*, 139 Idaho 572, 83 P3d 116, 122 (2004); J. Hellerstein and W. Hellerstein, *State Taxation*, para. 9.20[3][a0], p. 8-61 (3d ed. 2001-2005).

[14]283 U.S. 123 (1931).

[15]Ga. Reg. 560-7-7-.03(5)(e)3.

[16]Tenn. Comp. R. & Regs 1320-6-1.35(c); W.Va. Code section 11-24-7(h)(1)(D); 63 Ma. Gen. Laws section 42; N.Y. Reg. 4-6.1.

[17]Iowa Admin. Code Rule 701-54.9 (422).

One wonders whether Tennessee would grant that request for relief, particularly in light of the Tennessee Department of Revenue's 1995 correspondence referenced in *BAPCO* that said that a taxpayer similar to BAPCO should use the costs of performance provisions. However, equal application of the alternative apportionment provisions is critical to ensuring fairness and protecting taxpayers from double taxation.

Providing Taxpayers With Predictability

One of the most important features of a level playing field is to provide taxpayers with predictability regarding the state's administration of its alternative apportionment provisions. That goal can be achieved through published guidance articulating the standards or analysis to be conducted when evaluating the right to alternative apportionment. Better yet, the tax community would be well served if taxpayers were given advance rulings as to whether alternative apportionment is appropriate under their specific facts.

> ***Equitable apportionment is not simply the tax administrator's tool for correcting perceived abuses; rather, both taxpayer and tax administrator should be equally able to use it.***

The California Supreme Court's decision in *Microsoft Corp. v. Franchise Tax Board*[18] provides a good example of the benefits that result from reliable published guidance. *Microsoft* addressed the proper manner for treating receipts from the redemption of marketable securities. The court held that the sales factor must include the gross proceeds from redemptions of marketable securities. The court then analyzed whether section 25137 of the California Revenue and Taxation Code (the state corollary to section 18) entitled the Franchise Tax Board to invoke alternative apportionment.

The state supreme court held that the FTB was required to prove its right to relief with "clear and convincing evidence." The court also articulated a two-pronged test for evaluating distortion, on a qualitative and quantitative basis.

Under the qualitative test, the court evaluated whether the gross receipts generated through the treasury function were qualitatively different from the receipts generated from the taxpayer's principal business. The court concluded that Microsoft's treasury function was qualitatively different from its software business. In contrast, the court said that qualitative distortion was not present in an earlier case comparing Merrill Lynch's treasury function with its business of buying and selling securities.[19]

Under the quantitative analysis, the court compared Microsoft's profit margin from treasury activities with its profit margin from nontreasury activities, the amount of treasury income versus nontreasury income, and the amount of gross receipts from treasury functions with the amount of gross receipts from nontreasury functions. The court concluded that based on that analysis, quantitative distortion was established.

Although one may question how some activities of a taxpayer that give rise to the taxpayer's unitary business income may be qualitatively different from the taxpayer's "principal" business and want more guidance regarding the degree of distortion that will entitle the FTB or taxpayer to relief under alternative apportionment provisions, the tests established by the California Supreme Court at least have provided a point of reference for other taxpayers litigating the treasury receipts (and its variations) problem in California.[20] Thus, while imperfect, the *Microsoft* decision has provided some order and predictability, and thus a higher degree of fairness and consistency, to taxpayers litigating the treasury receipts issue.

Predictability can also be achieved by enabling taxpayers to acquire advance rulings. Although many states have enacted statutes that provide taxpayers with the right to seek letter rulings, state tax administrators often shy away from ruling on

[18]*Microsoft Corp. v. Franchise Tax Bd.*, 139 P.3d 1169 (2006). (For the decision, see *Doc 2006-15737* or *2006 STT 162-3*.)

[19]*Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 89-SBE-017 (Calif. State Board of Equalization, June 2, 1989).

[20]The authors do not attempt to justify the validity of the *Microsoft* court's analysis. Rather, we suggest the factors outlined by the court for determining distortion have provided guidance that adds predictability to these types of cases in California. *See, e.g.*, *Montgomery Ward LLC v. FTB*, Minute Order, Case No. GIC802767 (Calif. Sup. Ct., Dec. 10, 2007) (holding that the FTB failed to meet its burden of showing quantitative distortion for one of the years at issue); *The Limited Stores, Inc. v. FTB*, 62 Cal. Rptr. 3d 191 (Calif. Ct. App. 2007) (articulating the two-pronged analysis from *Microsoft* and applying that analysis to find distortion); *Square D Co. v. FTB*, Dkt. No. CGC 05-442465 (Calif. Sup. Ct. 2007) (holding that the taxpayer's inclusion of treasury receipts in the sales factor constituted distortion based on a quantitative analysis because its operational margin was 74 times higher than its margin on treasury receipts).

difficult fact situations[21] such as alternative apportionment. That failure to issue letter rulings requires taxpayers to undergo the costly and difficult task of proving their right to alternative apportionment through an adversarial process, which may take years. We propose that a necessary element of alternative apportionment is the departmental willingness to engage with a taxpayer in determining whether equitable apportionment is appropriate before a taxpayer files a return.

Conclusion

State apportionment rules should be fair. They should seek to achieve a rough approximation of a taxpayer's in-state activity. However, the standard apportionment rules do not succeed for every taxpayer, in every situation. The relief valve — equitable apportionment — should be applied in an even-handed and predictable manner for states and taxpayers. Failure to do so only exacerbates the unfair treatment stemming from an unsupportable apportionment result. ✰

[21]Ariz. Rev. Stat. Ann. section 42-211 provides for the issuance of letter rulings. However, the Department of Revenue has informally indicated to Sutherland that it typically does not issue rulings on difficult factual issues such as apportionment.

Pilar Mata, Richard C. Call, and Matthew P. Hedstrom are associates with Sutherland Asbill & Brennan LLP's State and Local Tax Practice.

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