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Current Developments in State and Local Tax

Correcting the Distortion Created by Single-Factor Sales Apportionment

By Mary F. Bernard, Mark L. Nachbar, and Brian Vincent

Prior to the 1957 adoption of the Uniform Division of Income for Tax Purposes Act's (UDITPA's) three-factor apportionment formula, many states had apportioned taxable income based on a single-factor apportionment formula or assessed tax based on geographic accounting. This methodology was understandable, as at that time much of the economy was locally based. After World War II, fueled by growing transportation networks and increased technology, the U.S. economy became more national and global in nature. States began to extend their reach to out-of-state business enterprises and tax their income.[1] Concerned that states would be emboldened to tax out-of-state business under divergent methods of apportionment, the U.S. Congress recognized the necessity to study and evaluate the way states apportioned income for tax purposes and appointed the Willis Commission. One result of the study was a recommended apportionment formula, which was to be applied on a national basis. The Commission issued its report in 1965, which, in part, proposed a two-factor apportionment formula based on in-state payroll and property over total payroll and property. The Commission believed that this formula would properly reflect the benefits that a business and its employees received from the government, which the taxes support. Other lawmakers and economists were more in favor of a consumption-based element represented by a sales factor. In the end, to preempt federal intervention in the state tax arena, the predecessor to the Federation of Tax Administrators formed the Multistate Tax Commission (MTC). The MTC and member states adopted UDITPA, which included the equally weighted three-factor apportionment formula, precluding federal intervention.

In the 2010s, the pendulum has shifted to a single-factor sales apportionment formula in the attempt to shift taxes to out-of-state taxpayers.[2] In enacting Proposition 39 in 2012, California specifically points out that while enactment

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of a single-sales apportionment formula will raise state revenue by more than $1 billion, California-based businesses will not see an increase. The official voter information guide for the 2012 general election points out that only multistate businesses will see an increase in their California income taxes.

The most recent case of distortion is the Michigan Supreme Court decision in *Vectren Infrastructure Services Corp. v. Dep't of Rev.*[3] Unfortunately, in late 2023, the United States Supreme Court denied *certiorari*[4] in this case and let the Michigan decision stand. In this case, Minnesota Limited, Inc. (MLI) was a family corporation that had grown over 50 years and was headquartered in Minnesota. MLI was in the business of constructing, maintaining, and repairing oil and gas pipelines as well as providing HAZMAT response. In 2010, the two owners decided to sell the business. While the business was for sale, they were contacted by Enbridge Energy to assist with a severe pipeline spill in Michigan. This was quite unusual for MLI. First, their business was very seasonal, and they were usually in their off-season when Enbridge contacted them. In addition, prior to this contract, most of their services were performed in Minnesota, Iowa, Wisconsin, and North and South Dakota. This was MLI's first significant contract in Michigan. On March 31, 2011, while services were being provided to Enbridge, MLI's owners sold their stock to Vectren. The sale was treated as an asset sale under a Code Sec. 338(h)(10) election.

MLI filed a Michigan modified business tax (MBT) return for the short year January 1, 2011, and March 31, 2011. On the return, MLI included the sale of the "assets" in its tax base and also included those sales in the denominator in the sales-only apportionment factor used to apportion sales to Michigan. The income from the Enbridge engagement was included in the numerator of the Michigan sales factor. This calculation resulted in approximately 15% of the income being apportioned to Michigan. However, this method of apportionment did not follow the statutory apportionment for Michigan as only sales out of the "stock in trade… primarily for sale to customers in the ordinary course of business," are to be included in the sales factor.[5] Under the statutory apportionment factor, the resulting apportionment percentage to Michigan is approximately 70%.

The Michigan Court of Appeals[6] sided with Vectren and remanded the case for the parties to determine an alternative method of apportionment. However, the Michigan Supreme Court held that including the gain on the sale in the tax base did not violate the U.S. Constitution, nor did the plaintiff demonstrate by clear and cogent evidence that the statutory apportionment formula created a grossly disproportionate result in reaching Michigan taxable income. What appears to be one of the fatal flaws in the case is *Vectren's* affirmative use of an alternate apportionment formula without asking the Department of Treasury to use an alternate form of apportionment.[7]

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The four-justice majority opinion met with a vehement dissent by the remaining three justices. While one may disagree with the outcome, both the majority opinion and dissent contain a rich description and history of cases that discuss the constitutionality of apportionment formulas.[8] Interestingly enough, in relying on the same cases, the majority and dissent reach different conclusions because each of these cases relies on the distinguishingly different fact patterns presented in each case. The compelling fact patterns that allowed justices to reach the conclusion that the apportionment factor did not clearly represent in-state business (*i.e.*, *Underwood Typewriter*, *Hans Rees' Sons*, and *ASARCO*) were absent in *Vectren* and the other cases cited below. The cases that prevailed clearly and convincingly displayed that the apportionment resulting from the statutory formula was grossly out of proportion to the business transacted in the state. While it would certainly appear that apportioning 70 percent of a gain that accrued over a number of years to a state in which the average sales over time to Michigan were seven percent would appear to be all out of proportion to the activity that took place in the state, when selectively looking only to the short period

that included the sale, the facts presented would support the 70-percent apportionment rate. It is only after *Vectren* had filed the short period return, affirmatively asserting the alternative apportionment formula, that it then tried to negotiate a more reasonable assessment based on historic data. *Vectren* may have had the business analytics and facts to support the alternative method after they filed the short-period return. However, since the Michigan Department of Treasury must grant a taxpayer the right to use an alternative method of apportionment, those facts should have been brought to Treasury's attention in a request prior to the filing of the return.

In conclusion, as states have migrated from a traditional equally weighted three-factor apportionment formula to a single-sales marketplace apportionment formula, taxpayers have been concerned that the new formula does not accurately represent the situs of their business income. Those taxpayers might consider an economic/functional analysis of their business.

A similar finding for a lack of supporting evidence was the conclusion of the U.S. Supreme Court in *Moorman*, *id.* The Court in *Moorman* repeatedly states that there was no showing of evidence that the income taxed was out of all proportion to the business undertaken in Iowa. "The record does not contain any separate accounting analysis, showing what portion of appellant's profits was attributable to sales, to manufacturing or to any other phase of the company's operations."[9]

However, when the results of an apportionment formula were overturned in *Hans Rees' Sons*, the taxpayer had made painstaking efforts to demonstrate that the profit that was being taxed resulted from activities and equipment in another state. "The petitioner also offered evidence to the effect that the income from the business was derived from three sources, to wit: (1) buying profit; (2) manufacturing profit; (3) selling profit."[10] This demonstration of value and profit analysis seems to be persuasive evidence to show by clear and cogent evidence that the statutory factor results in the apportionment of income out of all proportion to the income earned in a state.

These *Hans Rees' Sons* concepts are similar to those contained in a functional analysis of the business, often called an economic analysis. This type of business analytics focuses on the functions performed, assets employed, and risks associated with each business segment. In other words, the focus is on the value drivers of a business. These are the same value drivers that were accepted by the U.S. Supreme Court in *Hans Rees' Sons* to allow an alternative form of apportionment. An economic analysis of a business can be used to support business property valuations, damages, transfer pricing, and other income tax purposes, including to support alternative apportionment requests.

Transfer pricing is normally used by the IRS and foreign revenue authorities to allocate profits between a controlled group of taxpayers based on the allocations of functions, assets, and risks between parties to controlled transactions. Economic analyses of a business are not unique or new concepts. From a federal income tax perspective, transfer pricing concepts and rules have been in place since 1928. The current transfer pricing rules have been in place since the addition of Code Sec. 482 in 1954. While the purpose of this code section is to prevent the evasion of taxes and to clearly reflect the income of each party to a controlled transaction, it does not need to be limited to that purpose alone. Reg. §1.482-1(d)(3)(i) describes the role of functional analysis in the context of determining comparable transactions. In part, that section reads, "a functional analysis that identifies and compares the economically significant activities undertaken, or to be undertaken, by the taxpayers." The regulation goes on to enumerate eight functions that should be considered in an economic analysis. The list is not exhaustive and can be summarized as follows[11]:

1. The products and services that are offered to customers or clients (and how those products and services are designed or developed);
2. The source of supply of the materials, labor, and overhead that is needed to produce those products and services (including sourcing dependence and sourcing logistics issues);
3. How the products and services are manufactured or otherwise produced;

4. How the products and services are differentiated, promoted, priced, and sold (including advertising and branding issues);
5. How the inventory of products and services (including raw materials, work in process, and finished goods/services) are created, packaged, and stored;
6. How the products and services are delivered (including shipping, transportation, and other delivery logistics issues);
7. The assets that are utilized to perform the functions within the business entity (including working capital assets, tangible assets, and intangible assets);
8. How profits are earned in the business enterprise (including the cost/volume/profit relationships with regard to both (a) production/service creation cost of sales and (b) production/service delivery revenue recognition);
9. How the accounting, finance, human resources, management information, marketing, sales, and other administrative activities operate within the subject entity; and
10. How the subject entity is organized, managed, and capitalized (legally and administratively), including both (a) the relationship between the entity owners and the entity operators/managers and (b) the relationship between the entity and its sources of capital.

One of the many reasons to perform an economic analysis of a business is to analyze "the relative contribution of the various functions performed either (1) within the subject entity or (2) between the related (or associated) parties in a controlled transaction."[12] This is the very point that the alternative apportionment statutes point to in supporting a request. "If the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for, or the tax administrator may require, in respect to all or any part of the taxpayer's business activity … the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."[13]

In conclusion, as states have migrated from a traditional equally weighted three-factor apportionment formula to a single-sales marketplace apportionment formula, taxpayers have been concerned that the new formula does not accurately represent the situs of their business income. Those taxpayers might consider an economic/functional analysis of their business. Such analyses are likely to involve detailed fact-finding efforts and analyses of profitability and other financial ratios as a means of carefully examining the profits reported by various controlled entities relative to the value-added functions they do/do not perform. If the results of that study determine that some states are taxing too much of their income, while other states are taxing too little based on the relative values created by those business units, they might want to consider contacting the states that are misrepresented with an application for alternative apportionment. Such a study should open the door with the state department of revenue as to what might be done to more fairly reflect the value generated in that state for state income tax purposes.

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ENDNOTES

1. Exemplified in *Northwest States Portland Cement Co. v. Minnesota*, SCt, 358 US 450, 79 SCt 357 (1959).
2. Minnesota House Research "Short Subjects Single Sales Apportionment of Corporate Franchise Tas" (2015).
3. *Vectren Infrastructure Servs. Corp. v. Dep't of Treas.*, 512 Mich. 594 (2023).
4. *MMN Infrastructure Services LLC v. Michigan Dep't of Treas.*, U.S., (No. 23-443), review denied (November 20, 2023).
5. MCL 208.1115.
6. *Vectren Infrastructure Services Corp. v. Dep't of Treas.*, 331 Mich. App 568 (March 12, 2020).
7. 512 Mich. at 647.
8. *Underwood Typewriter Co v. Chamberlain*, SCt, 254 US 113, 41 SCt 45 (1920); *Hans Rees' Sons, Inc. v. North Carolina*, SCt, 283 US 123, 51 SCt 385; (1931); *Butler Bros v. McColgan*, SCt, 315 US 501, 62 SCt 701 (1942); *Moorman Mfg Co v. Bair*, SCt, 437 US 267, 98 SCt 2340 (1978); *Exxon Corp. v. Dep't of Rev.*, 447 US 207, 100 SCt 2109 (1980); *Mobil Oil Corp. v Comm'r of Taxes*, SCt, 445 US 425, 100 SCt 1223 (1980); *ASARCO Inc v. Idaho State Tax Comm'n*, 458 US 307, 102 SCt 3103 (1982); *Container Corp of America v. Franchise Tax Bd.*, 463 US 159, 103 SCt 2933 (1983); *Trinova Corp v. Dep't of Treas.*, 433 Mich. 141, (1989) (Trinova I) and *Trinova Corp v. Mich. Dep't of Treas.*, SCt, 498 US 358, 111 SCt 818 (1991) (Trinova II).
9. *Id.* at 272.
10. *Id.* at 894.
11. This list was developed by Robert Schweihs and Robert Reily, both managing directors of Willamette Management Associates, and appeared in their publication *Insights,* Winter 2021, entitled Performing a Functional Analysis as Part of a Valuation, Damages, or Transfer Pricing Analysis.
12. *Id.*
13. Article IV, Section 18 as contained in the Multistate Tax Compact.

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