

# The ‘Unusual’ Application of UDITPA Section 18

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## Introduction

*All law is universal but about some things it is not possible to make a universal statement which shall be correct. . . . [F]or the error is in not the law nor in the legislator but in the nature of the thing, since the matter of practical affairs is of this kind from the start. . . . Hence the equitable is just, and better than one kind of justice — not better than absolute justice but better than the error that arises from the absoluteness of the statement.*<sup>1</sup>

In 350 B.C. this is how Aristotle described the need for equity and fairness. Aristotle was never a lawyer or legislator, but his ideas on equity certainly have influenced the modern legal system.

In 1957 the framers of the Uniform Division of Income for Tax Purposes Act also recognized that the principles of equity and fairness are paramount in the design of sensible business taxation. Taking up Aristotle’s invitation, UDITPA’s drafters incorporated an “equitable apportionment” provision, codified in section 18, which permits the use of an alternative apportionment, in uncommon circum-

stances, if a prescribed method produces an unfair or inequitable result. Over the ensuing years, most states have either adopted UDITPA’s section 18 or enacted similar provisions permitting adjustments to the standard apportionment formula.<sup>2</sup>

Today, the world of equitable apportionment suffers from an identity crisis. Although section 18 was designed to apply only in limited circumstances involving unusual facts, in recent years state tax authorities have applied it to usual and regular transactions. States are invoking section 18 in many cases simply because use of the standard apportionment provisions produce too little tax.

***The use of section 18 to adjust state apportionment absent an unusual circumstance violates the principles of equity and fairness espoused by UDITPA’s framers.***

The use of section 18 to adjust state apportionment absent an unusual circumstance violates the principles of equity and fairness espoused by UDITPA’s framers. Moreover, the broad application of section 18 may violate state administrative procedure acts that limit a state agency’s ability to rely on ad hoc adjudication when the adoption of a rule is more appropriate.

## A Look Back at Where It All Began

In 1957 the National Conference of Commissioners on Uniform State Laws promulgated UDITPA as part of a nationwide effort to promote uniformity among the states in their methods of allocating and apportioning income of multistate enterprises. As the framers of UDITPA explained, the act was designed to address the basic problem created by the existence of “an amazing variety of

<sup>1</sup>Aristotle, *Nicomachean Ethics*, Book V, Ch. 10, trans. by W.D. Ross (1998).

<sup>2</sup>Jerome R. Hellerstein and Walter Hellerstein, 1 *State Taxation*, para. 9.01 (3rd ed. rev. 2009).

formulas for allocating income, [that] vary not only in respect to the basic factors used, such as property, payroll, sales, and manufacturing costs, but also in respect to the specific details of each factor.”<sup>3</sup> UDITPA’s main objective was to attempt to harmonize state methods for assigning income of taxpayers who were subject to tax in more than one state and prescribe an equitable method that uniformly and fairly represents a taxpayer’s activity in a state.

UDITPA is premised on an equally weighted three-factor method consisting of property, payroll, and sales. The drafters of the uniform act contemplated that the standardized formula may, in some limited situations, lead to unfair or inequitable results. Section 18 of the uniform act provides as follows:

If the allocation and apportionment provisions of [UDITPA] do not fairly represent the extent of the taxpayer’s business activity in the 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, if reasonable:

- (a) separate accounting;
- (b) the exclusion of any one or more of the factors;
- (c) the inclusion of one or more additional factors which will fairly represent the taxpayer’s business activity in the state; or
- (d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer’s income.<sup>4</sup>

### You Say ‘Usual,’ I Say ‘Unusual’

Although section 18 allows for deviation from the standard formula, such deviation is permitted only in narrow circumstances involving unusual facts. UDITPA’s drafters realized the importance of providing for “some alternative method [that] must be available to handle the constitutional problem as well as the unusual cases.”<sup>5</sup> The drafters believed that a narrow interpretation of section 18 is essential to achieve the fundamental purpose of UDITPA.<sup>6</sup> The drafters also made it clear that section 18 was “designed to permit the use of methods different from those prescribed in the Act *only in unusual cases* and in cases where the application of specifically prescribed methods might

be held unconstitutional.”<sup>7</sup> In fact, Prof. William J. Pierce was of the opinion that the fundamental purpose of UDITPA would be seriously undermined if section 18 “were interpreted to give administrators in the different states broad discretion in the selection of alternative methods.”<sup>8</sup> A similar message is embedded in the Multistate Tax Commission’s model apportionment regulations, which, in construing UDITPA, provide that section 18 should apply “only in limited and specific cases . . . where unusual facts situations (which ordinarily will be unique and non-recurring) produce incongruous results under the apportionment and allocation provisions contained [in UDITPA].”<sup>9</sup>

**The drafters believed that a narrow interpretation of section 18 is essential to achieve the fundamental purpose of UDITPA.**

The long-term and severe consequences of a broad interpretation of section 18 were readily predictable in 1967:

There are completely compelling reasons for giving the relief provisions a narrow construction. Under a broad construction the purposes of obtaining uniformity through the adoption of the Uniform Act would be defeated. If a choice of methods is permitted, different administrators in different states inevitably will choose different methods. As a result, even if all the states imposing taxes on or measured by income should adopt the Uniform Act, the chaotic condition heretofore existing would continue to exist.<sup>10</sup>

Historically, state courts have shared Pierce’s and the MTC’s narrow view of the scope of section 18 and have argued that the equitable apportionment provision is “the exception,”<sup>11</sup> and that it should be

<sup>7</sup>*Id.* (Emphasis added.)

<sup>8</sup>*Id.*

<sup>9</sup>Multistate Tax Commission Reg. IV. 18(a).

<sup>10</sup>Keesling and Warren, *supra* note 3, at 171.

<sup>11</sup>*St. Johnsbury Trucking Co., Inc. v. State*, 118 N.H. 209 (1978) (“The alternative formula is the exception . . . Merely because the use of an alternative form of computation produces a higher business activity attributable to [the taxing state], is not in and of itself a sufficient reason for deviating from the legislatively mandated formula.”); *see also Deseret Pharm. Co., Inc. v. State Tax Comm’n*, 579 P.2d, 1326 (Utah 1978) (“Apportionment under U.D.I.T.P.A. is the prescribed method. The use of any method other than apportionment should be exceptional.”); *Donald M. Drake Co. v. Dep’t of Revenue*, 500 P.2d 1041, 1044 (Or. 1972) (“the use of any method other than apportionment should be exceptional”).

<sup>3</sup>William J. Pierce, “The Uniform Division of Income for State Tax Purpose,” 35 *Taxes* 747, 748 (1957). *See also* Frank M. Keesling and John S. Warren, “California’s Uniform Division of Income for Tax Purposes Act,” 15 *UCLA L. Rev.* 156, 158 (1967) (“The fact is that there is an enormous amount of disparity, the existence of which has been a cause of concern to organization and individuals over a period of a great many years.”).

<sup>4</sup>UDITPA, section 18.

<sup>5</sup>Pierce, *supra* note 3, at 781.

<sup>6</sup>*Id.*

applied only in “unusual and limited circumstances.”<sup>12</sup> However, in recent years, state tax authorities appear to have expanded the scope of section 18, claiming that it entitles them to a broad grant of authority.<sup>13</sup> Although states certainly have a “wide latitude to devise formulae” for apportioning and taxing income of a multistate enterprise,<sup>14</sup> state taxing authorities may not rely on section 18 to arbitrarily adjust a taxpayer’s apportionment.

Section 18 is limited to unusual circumstances,<sup>15</sup> but how unusual must the circumstances be to warrant section 18 relief? As explored in Sutherland’s “A Pinch of SALT: Putting the ‘Fair’ Back in Fair Apportionment,”<sup>16</sup> the Tennessee Court of Appeals recently held that the Tennessee Department of Revenue was justified in requiring a multistate company to apportion its advertising revenue based on an alternative to the legislatively mandated cost of performance apportionment method because the circumstances in the case had “unique quality” in that all of the costs of production occurred outside Tennessee.<sup>17</sup> We questioned how the provision of advertising services from outside Tennessee can constitute an unusual fact situation.<sup>18</sup> Regrettably, the court did not provide any further explanation of its reasoning.

The Indiana Department of Revenue also asserted section 18 in ruling that the licensing of broadcasting rights to cable and satellite companies

presents a “limited and unusual situation” warranting the application of an alternative apportionment method.<sup>19</sup> Indiana’s apportionment regulations require that a departure from the standard cost of performance apportionment method is authorized “only in *limited and unusual circumstances* (which ordinarily will be *unique and nonrecurring*) when the standard apportionment provision produces incongruous results.”<sup>20</sup> The department did not explain why the licensing of broadcasting rights to cable and satellite companies for a fee is “unique” and “nonrecurring.” Rather, the department simply concluded that its alternative apportionment method “effectuate[d] a result that more fairly represent[s] taxpayer’s income derived from sources within the state.”<sup>21</sup> Tennessee and Indiana provide just two of many examples in which states have run roughshod over the prerequisites to section 18.<sup>22</sup>

### The Rule-Adjudication Dichotomy

In addition to the limitations found in section 18, state administrative procedure acts (APAs) also place constraints on the ability of revenue authorities to apply alternative apportionment methods to adjust taxpayers’ income.

Many state APAs require tax authorities to issue statements of interpretation and policy by rulemaking. Courts have held that APAs generally limit the discretion of state agencies to formulate policy, and rulemaking is required whenever “an agency seeks to change the law, and establish ‘rules’ of widespread application.”<sup>23</sup> Courts have also held that the use of

<sup>12</sup>*American Tel. & Tel. Co. v. Huddleston*, 880 S.W.2d 682, 691-2 (Tenn. App. 1994) (“the variance provision applies only in unusual and limited circumstances and is to be interpreted narrowly in order to carry out the purpose of uniform apportionment under the act.”); see also *Roger Dean Enterprises v. State, Dep’t of Revenue*, 387 So.2d 358 (Fla. 1980) (“There is a very strong presumption in favor of normal . . . apportionment and against the applicability of relief provisions . . . . The relief provision should be used where the statute reaches arbitrary and unreasonable results . . . . Departures from the basic formula should be avoided except where reasonableness requires.”); *Union Pacific Corp. v. Idaho State Tax Comm’n*, 139 Idaho 572, 576 (2004) (“There is a very strong presumption in favor of a normal three-factor apportionment and against the applicability of the relief provisions.”).

<sup>13</sup>See generally *HMN Financial, Inc., and Affiliates v. Comm. of Revenue*, No. A09-1164 (Minn. 2010).

<sup>14</sup>*Allied-Signal, Inc. v. Dir., Div. of Taxation of New Jersey*, 504 U.S. 768, 779 (1992); see also *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978) (upholding the constitutionality of a single-sales-factor apportionment formula); *Underwood Type-writer Co. v. Chamberlain*, 254 U.S. 113 (1920) (upholding the validity of a single-property-factor apportionment formula).

<sup>15</sup>Hellerstein and Hellerstein, *supra* note 2, para. 9.20[3].

<sup>16</sup>Pilar Mata, Richard C. Call, and Matthew P. Hedstrom, “A Pinch of SALT: Putting the ‘Fair’ Back in Fair Apportionment,” *State Tax Notes*, Jan. 4, 2010, p. 51, *Doc 2009-28024*, or 2010 *STT 1-4*.

<sup>17</sup>*Bellsouth Advertising & Publishing Corp. v. Chumley*, 2009 Tenn. App. LEXIS 576 (Tenn. Ct. App. 2009).

<sup>18</sup>*Supra* note 16, at 52.

<sup>19</sup>Indiana Letter of Findings No. 04-0398, Indiana Dep’t of Revenue (Sept. 1, 2006).

<sup>20</sup>45 IAC 3.1-1-62. (Emphasis added.)

<sup>21</sup>*Id.*

<sup>22</sup>See *Kan. Dep’t of Revenue Office of Admin. App.*, Docket No. WFD-P2007-1 (Jan. 8, 2007); *Microsoft Corp. v. Franchise Tax Bd.*, 39 Cal. 4th 750 (Calif. 2006) (sale of investment securities by company’s treasury function). Indiana Letter of Findings 01-0063, Indiana Dep’t of Revenue (Oct. 1, 2002) and *In re Wal-Mart Stores, Inc.*, No. 06-07, New Mexico Taxation and Revenue Dep’t (May 1, 2006) (licensing of trademarks by an intangible holding company to its parent).

<sup>23</sup>See, e.g., *Ford Motor Co. v. FTC*, 673 F.2d 1008, 1009 (1981); see also *New World Commc’ns of Tampa, Inc. v. Akre*, 866 So.2d 1231 (Fla. App. 2Dist., 2003). Most state APAs define the term “rule.” For instance, Florida defines the term as an “agency statement of general applicability that implements, interprets, or prescribes law or policy or describes the procedure or practice requirements of an agency and includes any form which imposes any requirement or solicits any information not specifically required by statute or by an existing rule.” Fla. Stat. section 120.52(16). New Jersey defines the term to encompass “each agency statement of general applicability and continuing effect that implements or interprets law or policy, or describes the organization, procedure or practice requirements of any agency.” N.J. Stat. section 52:14B-2(e).

alternative apportionment absent a formal rulemaking process may constitute ad hoc rulemaking in violation of state administrative laws.<sup>24</sup>

Similar to the goals of UDIPTA's drafters, administrative rules serve to limit arbitrariness and capriciousness in the application of policy in individual cases and promote clarity and uniformity of the law.<sup>25</sup> For those reasons, the U.S. Supreme Court has held that "rulemaking is generally a better, fairer, and more effective method" of announcing a new rule than ad hoc adjudication.<sup>26</sup>

Of course, rulemaking cannot account for every eventuality. Although general standards are designed to promote fairness and uniformity, their application may lead to a rigid disregard for differences in particular cases. Thus, in unusual cases, ad hoc adjudication may be appropriate; however in more general cases, rules should be adopted.<sup>27</sup>

**State agencies typically are given the freedom to choose between rulemaking and ad hoc adjudication to carry out their mandate; however, their discretion may be abused.**

State agencies typically are given the freedom to choose between rulemaking and ad hoc adjudication to carry out their mandate;<sup>28</sup> however, their discretion may be abused. For example, in *CBS Inc. v. Comptroller of the Treasury*,<sup>29</sup> the Maryland Court of Appeals held that the comptroller's attempt to use an alternative apportionment method was an impermissible administrative regulation. Following the statutorily mandated apportionment rules, CBS included all its income from network advertising receipts in its total apportionable business income. Because its advertising receipts were attributed to states other than Maryland, CBS included its receipts in the sales factor denominator but not in the numerator of its Maryland sales factor. The comp-

troller adjusted the sales factor applying the "audience share," based on Maryland's network audience, to total network audience, and reasoned that the audience share method had become an accepted approach for apportioning broadcast fees.

The court of appeals held that Maryland's use of the audience share factor was an inappropriate attempt to change the Maryland apportionment rules.<sup>30</sup> The court went on to hold that such a change constituted a "new policy" of general application that could not be accomplished by ad hoc adjudication. Rather, the change had to be promulgated in accordance with the rulemaking procedures of Maryland's APA.<sup>31</sup> The court elaborated:

This mode of procedure adds an aspect of fairness when an agency intends to make a change in existing law or rule. That fairness is produced by prospective operation of a new rule and by the public notice, public hearing, and public comment processes that accompany rulemaking, but that are sometimes absent from administrative adjudication.<sup>32</sup>

The court of appeals explained that although "the equitable adjustment provision clearly allows for a 'quick-fix' on a case by case basis in certain instance[,] the Administrative Procedure Act tempers this approach." According to the court, the commissioner's flexibility under section 18 cannot be free of any constraints to permit her to reconfigure a taxpayer's liability ad hoc because a holding to the contrary would defeat the fundamental purpose of UDIPTA.<sup>33</sup>

The Montana Supreme Court delivered a similar message when the Department of Revenue, invoking its section 18 authority, attempted to modify the statutorily prescribed, miles-based apportionment formula applicable to airline carriers by including miles attributed to nonstop flyovers.<sup>34</sup> The court concluded that although the department may have been otherwise free to impose that method, absent appropriate statutory language and a duly enacted administrative rule, the department's adjustment was not authorized under the existing statutes or administrative rules.<sup>35</sup>

For many of the same reasons that the drafters of UDIPTA required that alternative apportionment only be invoked in unusual circumstances, state legislators have required that the adoption of rules is generally preferable to ad hoc adjudication. And

<sup>24</sup>See, e.g., *CBS Inc. v. Comptroller of the Treasury*, 319 Md. 687 (1990); *Northwest Airlines, Inc. v. State Tax Appeal Bd.*, 221 Mont. 441 (1986); *Metromedia, Inc. v. Director, Div. of Taxation*, 97 N.J. 313 (1984).

<sup>25</sup>Arthur E. Bonfield, "The Federal APA and State Administrative Law," 72 Va. L. Rev. 297 (1986).

<sup>26</sup>*Community Television of S. Calif. v. Gottfried*, 459 U.S. 498 (1983).

<sup>27</sup>*HMN Financial, Inc., and Affiliates*, A09-1164 (Minn. 2010) (holding that the commissioner does not have section 18 authority to disregard the business structure of an enterprise when the enterprise complies with all the relevant tax statutes).

<sup>28</sup>See, e.g., *S.E.C. v. Chenery Corp.*, 332 U.S. 194 (1947).

<sup>29</sup>319 Md. 687 (1990).

<sup>30</sup>*Id.* at 697 (upholding the Maryland Tax Court's decision in *CBS Inc. v. Comptroller of the Treasury*, Income Tax No. 2300 A&B (Md. Tax Ct. 1988)).

<sup>31</sup>*Id.* at 699-700.

<sup>32</sup>*Id.* at 695.

<sup>33</sup>See also *Metromedia, Inc.*, 97 N.J. 313.

<sup>34</sup>*Northwest Airlines*, 221 Mont. 441.

<sup>35</sup>*Id.* at 445.

state courts have recognized that although state tax administrators are afforded substantial latitude to administer tax laws, absent rulemaking, tax authorities should limit their ad hoc adoption of alternative apportionment to specific and nonrecurring circumstances.

### Conclusion

As a result of persistent state and local budget deficiencies it appears the use of section 18 may become one of the “next best things” to increase tax revenue. However, state and local tax authorities should be mindful of the policies of equity and fairness that underlie the use of section 18. The use of alternative apportionment on an ad hoc basis, absent unusual circumstances, is neither fair nor just and results in bad tax policy. Although increased use of section 18 may raise revenue in the short term, in the long term it undermines taxpayers’ confidence in the tax system and creates a negative business climate that over the long term may erode the states’ tax base.

“Eighteen  
I get confused every day  
Eighteen  
I just don’t know what to say  
Eighteen  
I gotta get away.”<sup>36</sup>

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<sup>36</sup>Alice Cooper, “I’m Eighteen” (*Love It to Death*, 1971).