

CO-EDITORS

Nicole L. Johnson Matthew F. Cammarata

STATE + LOCAL TAX GROUP

New York

Craig B. Fields cfields@mofocom
Hollis L. Hyans hhyans@mofocom
Mitchell A. Newmark mnewmark@mofocom
Irwin M. Slomka islomka@mofocom
Philip S. Olsen polsen@mofocom
Michael A. Pearl mpearl@mofocom
Rebecca M. Balinskas rbalinskas@mofocom
Matthew F. Cammarata mcammarata@mofocom
Eugene J. Gibilaro egibilaro@mofocom
Michael J. Hilkin mhilkin@mofocom
Nicole L. Johnson njohnson@mofocom
Eva Y. Niedbala eniedbala@mofocom
Michael P. Penza mpenza@mofocom
Kara M. Kraman kkraman@mofocom

California

Bernie J. Pistillo bpistillo@mofocom
Clara Lim jlim@mofocom
Maureen E. Linch mlinch@mofocom

Washington, D.C.

Philip M. Tatarowicz ptatarowicz@mofocom



STATE TAX REFORM: THE QUEST FOR UNIFORMITY

By [Nicole L. Johnson](#) and [Eva Y. Niedbala](#)

President Donald Trump and U.S. Congressional Republicans recently unveiled a “Unified Framework for Fixing Our Broken Tax Code” in a purported effort to make the federal tax code “simple, fair and easy to understand.”¹ While federal tax reform has been a hot-button issue in many administrations, state tax reform should not be forgotten.

The driving force behind much of state tax reform in the past has been the goal of uniformity among the states. Spurred by the federal Willis Bill, many states adopted the Multistate Tax Compact (“Compact”) or enacted nearly identical legislation so that taxpayers might be comforted by a sense of consistency and predictability in their dealings with the states.²

However, even when states’ tax regimes appear uniform, looks can be misleading. Often taxing agencies and courts in states with apparently identical tax laws have interpreted those laws differently, creating a distinct lack of consistency and a diverging application of law among those states—contrary to the goal of uniformity. As a result, identical

continued on page 2

Upcoming Speaking Engagements

November 29, 2017

66th Annual Tulane Tax Institute
New Orleans, Louisiana

- “Recent State and Local Developments”
Hollis L. Hyans

November 29, 2017

TEI Philadelphia Chapter Seminar
Malvern, Pennsylvania

- “State of the States – State Tax Overview”
Mitchell A. Newmark and Nicole L. Johnson

December 4-5, 2017

New York University’s 36th Institute on State and Local Taxation
New York, New York

- “What Your Mother Didn’t Teach You About Apportionment”
Hollis L. Hyans
- “Due Process – Significant Current Issues” Craig B. Fields
- “What’s Happening Everywhere Today?” Mitchell A. Newmark

December 13, 2017

TEI’s 54th Annual Tax Symposium
New York, New York

- “State Tax Roundup—Significant State and Local Tax Litigation”
Hollis L. Hyans

January 21-26, 2018

COST 2018 SALT Basics School
Austin, Texas

- “Constitutional Restrictions” Mitchell A. Newmark

January 23-24, 2018

27th Annual Ohio Tax Conference
Columbus, Ohio

- “Nexus Wars!!! Is Quill Ripe for Reconsideration? Emerging Issues in State Tax Nexus ... The Most Rapidly Changing Area of Taxation” Craig B. Fields
- “Sales & Use Tax Audits ... Best Practices and Tips”
Mitchell A. Newmark
- “Multistate Apportionment ... Sales Factor, Costs of Performance, Market-Based Sourcing & Alternative Apportionment” Nicole L. Johnson

February 8, 2018

The 2018 National Multistate Tax Symposium
Orlando, Florida

- “Positioning for More Favorable Outcomes: Indirect Tax Controversies” Craig B. Fields

transactions may be treated differently in each state. For example, uniform rules for the sourcing of service receipts for sales factor apportionment purposes have been interpreted differently in the several states. Not surprisingly, with no real glue binding the states, uniformity unravels and disuniformity results.

STATE TAX REFORM AFTER THE WILLIS BILL

Historically, state income tax laws were not uniform. In the 1960s, the U.S. Congress attempted to pass federal legislation intended to remedy this “maze of nonuniformity in the various [income tax] laws and regulations of the states,” which had rendered compliance “too difficult and too costly for multistate business” and which often caused such multistate businesses to be “discriminated against or subjected to duplicative taxation.”³ The proposed legislation, known as the Interstate Taxation Act or the Willis Bill, would

have imposed jurisdictional standards for state taxes, including state corporate income taxes.⁴ In particular, the legislation would have significantly curtailed states’ rights to tax business income.⁵

Fearing an adverse effect on state revenue, the National Association of Tax Administrators (“NATA”) adopted a resolution opposing the Willis Bill.⁶ NATA called the Willis Bill “an unwarranted, unnecessary, and undesirable intrusion into the tax and fiscal jurisdiction of the states . . . [that] would be destructive of the principles of federalism enunciated by our founding fathers.”⁷ The Compact was drafted shortly thereafter.⁸

The purpose of the Compact was to:

1. Facilitate proper determination of State and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes;
2. Promote uniformity or compatibility in significant components of tax systems;

To ensure compliance with requirements imposed by the IRS, Morrison & Foerster LLP informs you that, if any advice concerning one or more U.S. federal tax issues is contained in this publication, such advice is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein.

3. Facilitate taxpayer convenience and compliance in the filing to tax returns and in other phases of tax administration; and
4. Avoid duplicative taxation.⁹

Even though the Compact (and UDITPA) promised consistency among states' tax regimes, disuniformity has resulted.

Recognizing “[t]he need for a uniform method of division of income for tax purposes among the several taxing jurisdictions,” the drafters included the Uniform Division of Income for Tax Purposes Act (“UDITPA”) in Article IV of the Compact, which, as its name suggests, sets forth rules for a uniform division of income for state tax purposes.¹⁰ In addition, the Compact authorized the Multistate Tax Commission (“MTC”) to adopt uniform regulations and tax forms.¹¹ However, states that are parties to the Compact are not obligated to accept the uniform regulations or tax forms and, in many instances, have adopted their own regulations and forms.¹²

Even though the Compact (and UDITPA) promised consistency among states' tax regimes, disuniformity has resulted. A clear example of this is the sourcing of service receipts for sales factor apportionment purposes.

SOURCING OF SERVICES PRIOR TO 2014

Prior to 2014, in determining a corporation's sales factor of the apportionment formula, service receipts were sourced under Section 17 of UDITPA as follows:

Sales, other than sales of tangible personal property, are in this State if: (a) the income-producing activity is performed in this State; or (b) the income-producing activity is performed both in and outside this State and a greater proportion of the income-producing activity is performed in this State than in any other State, based on costs of performance.¹³

Under this method, receipts from the sales of services were sourced to the location where the income-producing activity was performed, based on where costs were incurred in performing those services. The MTC added regulations defining the terms “income-producing activity” and “costs of performance.”¹⁴

For those states that adopted this cost of performance sourcing rule, one could reasonably assume that service receipts earned by a multistate service provider would be sourced the same in those states. However, that was not the case for a multistate telephone company

in Massachusetts and Oregon—states that used cost of performance to apportion service receipts.

In *Commissioner of Revenue v. AT&T Corp.*, the Massachusetts Appeals Court affirmed a decision of the Massachusetts Appellate Tax Board (“Board”), ruling that a multistate telephone company *was not* required to include receipts from interstate and international calls in the numerator of its Massachusetts sales factor.¹⁵ The court found that there was sufficient evidence to support the Board's use of an “operational” approach, rather than a “transactional” approach, to determine the income producing activity of the telephone company for purposes of measuring whether the costs of performance were greater in Massachusetts than in any other state.¹⁶ Under the operational approach, the income-producing activity of the telephone company consisted of the overall operation of a global telecommunications network that was necessary to provide reliable telephone services and the costs of performing that operation were greater in New Jersey than in Massachusetts.¹⁷

This disuniformity in interpretation creates uncertainty for taxpayers.

In contrast, in *AT&T Corp. v. Department of Revenue*, the Oregon Tax Court ruled that the same multistate telephone company was required to include receipts from interstate and international calls in the numerator of its Oregon sales factor.¹⁸ Unlike the Massachusetts court, the Oregon court found that the sourcing rule focused on transactions, not operations, and analyzed the company's incremental costs associated with the long-distance phone calls that originated or terminated in Oregon, rather than all costs incurred to engage in the overall operation of a global telecommunications network.¹⁹

Even though Massachusetts and Oregon adopted a cost of performance sourcing rule, the Massachusetts and Oregon courts had different interpretations of what constituted income-producing activity. This disuniformity in interpretation creates uncertainty for taxpayers. Further, litigation has resulted in other states regarding the appropriate interpretation of cost of performance.²⁰

SOURCING OF SERVICES AFTER 2014

In 2014, the MTC recommended amending Section 17 of UDITPA by changing the sourcing methodology for sales of services from the cost of performance approach to a market-based approach, so that services are sourced as follows:

Receipts, other than receipts [from sales of tangible personal property], are in this State if the taxpayer's market for the sales is in this state. The taxpayer's market for sales is in this state: . . . (3) in the case of sale of a service, if and to the extent the service is delivered to a location in this state.²¹

States vary in their interpretation of what constitutes the market state, which has led to much disuniformity and uncertainty in the application of those statutes.

Under a market-based method, service receipts are sourced to the location of delivery (*i.e.*, the market state). Market-based method draft regulations with amendments were also drafted.²²

Since then, and even before the MTC recommended changing the sourcing rule for sales of services, many states have switched over to a market-based method

for sourcing service receipts.²³ However, states vary in their interpretation of what constitutes the market state, which has led to much disuniformity and uncertainty in the application of those statutes. For instance, in Georgia, the market state is generally defined to be where the customer is located, while in Illinois, it is where the service is received.²⁴ Further, there might be different rules based on the type of service, method of transmittal, or customer involved. These varying interpretations undoubtedly will cause further confusion for taxpayers, much like in the cost of performance provisions, and result in further disuniformity.

These varying interpretations undoubtedly will cause further confusion for taxpayers.

Even though the Compact envisioned uniformity, no such result has been achieved. While uniformity is an admirable goal, it might never be plausible given the freedom each state has to enact and interpret its own laws.

1 See Office of the Press Secretary, The White House, Press Release, *Unified Framework for Fixing Our Broken Tax Code* (Sept. 27, 2017), <https://www.whitehouse.gov/the-press-office/2017/09/27/unified-framework-fixing-our-broken-tax-code> (last visited Oct. 25, 2017).

2 Multistate Tax Commission, MTC History, Timeline of Events in the History of the MTC, <http://www.mtc.gov/The-Commission/MTC-History> (last visited Oct. 25, 2017).

3 Multistate Tax Commission, First Annual Report for the Period Ending December 31, 1968 (Jan. 28, 1969), http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Resources/Archives/Annual_Reports/FY67-68.pdf, at 1, 10 (last visited Oct. 25, 2017).

4 See *id.* at *1.

5 See *id.*

6 Multistate Tax Commission, MTC History, *supra* note 2.

7 *Id.*

8 *Id.*

9 Compact, Art. 1. See also Eugene F. Corrigan, *et al.*, *The Search for Equity and Accountability in State and Local Taxation of Multistate-Multinational Corporations*, 12 *Urb. Law* 553, 554 (1980).

10 UDITPA, Prefatory Note.

11 Compact, Art. VII.

12 Compact, Art. VII.

13 UDITPA, § 17 (prior to 2014).

14 Compact Reg. IV.17.(2); Compact Reg. IV.17.(3).

15 *Comm'r of Revenue v. AT&T Corp.*, 970 N.E.2d 814 (Mass. App. Ct. 2012).

16 *Id.*

17 *Id.*

18 *AT&T Corp. v. Dep't of Revenue*, No. TC 4814 (Or. T.C. Jan. 12, 2012), *aff'd*, 357 Or. 691 (2015).

19 *Id.*

20 See, e.g., *Quest Diagnostics Clinical Labs., Inc. v. Barfield*, No. 2015 CA 0926 (La. Ct. App., Sept. 9, 2016) (laboratory service receipts sourced to Texas where performed); *Matter of Catalyst Repository Sys., Inc.*, DTA No. 826545 (N.Y.S. Div. Tax App. Aug. 24, 2017) (litigation support service receipts sourced to Colorado where performed); *Apollo Educ. Grp., Inc. v. Dep't of Revenue*, TC-MD 150352C (Or. T.C. Magistrate Div. Aug. 24, 2017) (educational service receipts sourced to Oregon based on location of students); *DirecTV, Inc. v. S.C. Dep't of Revenue*, 804 S.E.2d 633 (S.C. Ct. App. 2017) (satellite television subscription receipts sourced to South Carolina based on location of customers).

21 UDITPA, § 17 (after 2014).

22 See Model General Allocation & Apportionment Regulations With Amendments Submitted for Adoption by the Commission (Feb. 24, 2017).

23 Approximately half the states have adopted market-based sourcing. See, e.g., D.C. Code § 47 1810.02(g)(3)(A)(iii); Mass. Gen. Laws ch. 63, § 38(f); Neb. Rev. Stat. § 77-2734.14(3)(a)-(b); Tenn. Code Ann. § 67-4-2012(i)(1)(C).

24 Cf. Ga. Comp. Rules & Regs. 560-7-7-.03(5)(c) with 35 Ill. Comp. Stat. Sec. 5/304(a)(3)(C-5)(iv).

This newsletter addresses recent state and local tax developments. Because of its generality, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. If you wish to change an address, add a subscriber, or comment on this newsletter, please write to Nicole L. Johnson at Morrison & Foerster LLP, 250 West 55th St., New York, New York 10019, or email her at njohnson@mofo.com, or write to Matthew F. Cammarata at Morrison & Foerster LLP, 250 West 55th St., New York, New York 10019, or email him at mcammarata@mofo.com.

MORRISON FOERSTER

STATE + LOCAL TAX

WHAT SEPARATES US FROM THE REST?

OUR EXPERIENCE. We've been doing it longer, have more experience and published decisions, and have obtained a greater number of favorable settlements for our clients than the rest.

OUR TRACK RECORD OF PROVEN SUCCESS. We've successfully litigated matters in nearly every state, and have resolved the vast majority of matters without the necessity of trial.

OUR NATIONAL PERSPECTIVE. We approach state and local tax issues from a nationwide perspective, taking into account the similarities and differences of SALT systems throughout the United States.

OUR DEPTH. Our team is comprised of a unique blend of public and private backgrounds with experience spanning various industries. We're nationally recognized as a leading practice for tax law and tax controversy by *Chambers*, *Legal 500* and *Law360*. In fact, we've been referred to as "one of the best national firms in the area of state income taxation" by *Legal 500 US* and were rated Law Firm of the Year for Litigation – Tax by the 2016 "Best Law Firms" Edition of *U.S. News & World Report – Best Lawyers*.

For more information about Morrison & Foerster's State + Local Tax Group, visit www.mofo.com/salt or contact Craig B. Fields at (212) 468-8193 or cfields@mofo.com.