Redrawing the Lines: The Evolution of Alternative Apportionment

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Abstract

This Article traces the constitutional and statutory foundation of fair apportionment and the evolution of the Uniform Division of Income Tax Purposes Act (UDITPA) Section 18 as a statutory mechanism for addressing fair apportionment. Section 18 was originally considered as a constitutional safety valve, an equitable remedy, for cases in which the standard apportionment formula failed to represent the taxpayer's business activities in the taxing jurisdiction. Over time, shifts in business models, changes in the structure of apportionment schemes and the expansion of the corporate income tax base to include foreign source income have transformed the operation and meaning of alternative apportionment. Section 18 has been increasingly invoked to respond to economic asymmetrical structural inequities and the limitations of the standard apportionment formulas. This Article analyzes the judicial and administrative developments shaping the modern use of Section 18 and examines the emerging trend of using alternative apportionment as a "proxy" for combined reporting. The analysis raises the question of whether the evolving apportionment landscape coupled with the complexities of multistate/multinational state tax environment call for a renewed commitment to principled, tax-transparent and constitutionally sound apportionment practices.

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I. Introduction

The principle of fair apportionment is a cornerstone of state corporate income taxation, ensuring that a state taxes no more than its fair share of a multistate enterprise's income. For decades, the three-factor apportionment formula of property, payroll, and sales provided a relatively stable and uniform framework for sourcing income. However, the modern economy, characterized by the rise of intangible assets, the globalization of business operations, and the expansion of the corporate tax base to include foreign source income, has placed unprecedented strain on this traditional model. Standard apportionment formulas increasingly fail to reflect the economic realities of how multistate and multinational corporations generate value, leading to disputes over distortion and fairness. In this evolving landscape, alternative apportionment has shifted from a rarely used remedy to a central battleground in state taxation.

At the heart of this transformation is Section 18 of the Uniform Division of Income for Tax Purposes Act (UDITPA). Originally conceived as a "constitutional safety valve," Section 18 was intended to provide an equitable remedy in rare cases where the standard formula produced a constitutionally suspect result. Yet, over time, its application has broadened dramatically. State tax administrators and taxpayers alike now invoke Section 18 not only to correct for gross distortion but also to address perceived structural inequities in apportionment, respond to asymmetrical tax treatment of income streams, and, in some jurisdictions, as a de facto mechanism to achieve the effects of combined reporting. This Article argues that, while this evolution reflects a necessary adaptation to economic change, it has also led to a fracturing of uniformity and a departure from the principled application of apportionment rules. The growing complexity of the multistate tax environment demands a renewed commitment to tax-transparent and constitutionally sound apportionment practices to prevent further erosion of the foundational principles of fairness and consistency.

To explore this evolution, this Article proceeds in six Parts. Part II begins by tracing the historical and constitutional foundations of formulary apportionment, from the Supreme Court's early examination of the allocation of unit value in property tax cases to the modern standards of internal and external consistency. Part III then examines UDITPA Section 18, in terms of both its original purpose as a constitutional "safety valve" and the role that the Multistate Tax Commission (MTC) has played in expanding its interpretation through model regulations. Part IV analyzes the key triggers for invoking alternative apportionment, discussing the varying standards of proof across states, and the critical principle of symmetry between the tax base and apportionment factors, with a focus on the taxation of dividends, royalties, and intangible-related income. Part V surveys the acceptable alternative apportionment methods, including factor modification approaches like the "August Formula" and "Detroit Formula," and scrutinizes the emerging and controversial trend of using Section 18 as a "proxy" for mandatory combined reporting. Finally, Part VI concludes by synthesizing these developments and calling for a return to clear, uniform, and constitutionally grounded principles to guide the application of alternative apportionment in the modern era.

II. Background

A. *History of Formulary Apportionment*

The U.S. Supreme Court's development of the fair apportionment theory has its roots in early property tax cases. When the Supreme Court approved the "unit rule of assessment" in cases such as *Union Pacific Railway Co. v. Ryan*, *Western Union Telegraph Co. v. Massachusetts*, and *Adams Express Co. v. Ohio State Auditor*,[1] it sanctioned formula apportionment, the use of some indirect measure to determine the proportion of assets that could be included in the measure of tax by the taxing state. In doing so, the Supreme Court created the need for a theory under which courts could ensure that no state

[1] Union Pac. Ry. Co. v. Ryan, 113 U.S. 516 (1885); W. Union Tel. Co. v. Massachusetts, 125 U.S. 530 (1888); Adams Express Co. v. Ohio State Auditor, 165 U.S. 194 (1897).

included, in the measure of tax, a share of assets out of proportion to the assets used in the state.

Addressing an Indiana property tax, the Court refused to allow the value of out-of-state bonds and real estate that was not related to the Indiana business to be apportioned to Indiana.[2] Similarly, in *Union Tank Line Co. v. Wright*, the Court disallowed the use of a mileage formula to apportion the value of tank cars to Georgia where on average there were 57 such cars in the state each day, while according to the mileage formula there was an average of 357 cars in the state each day (a difference of 526 percent).[3] The Court in *Union Tank* recognized that because absolute accuracy was impossible it would sustain apportionment methods that were approximately correct.[4] However, if the apportionment method was arbitrary and the resulting valuation was grossly excessive the apportionment method would be struck down as conflicting both with the Commerce and the Due Process Clauses.[5]

The Court in the 1920s continued to refine its fair apportionment theories in *Wallace v. Hines*.[6] In *Wallace*, the Court struck down a North Dakota assessment on the property of a railroad because the railroad's property was apportioned to North Dakota using a mileage formula that included stocks and bonds owned out of state.[7] These assets, per the Court, did not add to the value of the roads or rights exercised by the railroad in North Dakota.[8] Additionally, the Court concluded the formula did not accurately reflect the railroad's value because the value of a mile of North Dakota track was considerably less than the value of a mile of track in a more densely populated region and the mileage formula did not properly reflect or allocate the value of the large terminals that were located in other states.[9]

In the same year that the Court decided *Wallace*, the Court, relying on its earlier decisions involving railway, telegraph, and express company operations, approved the use of interstate apportionment for corporate income tax purposes.[10] In *Underwood*, the Court rejected the taxpayer's argument that formula apportionment based on the ratio of the value of Connecticut tangible property to all such property wherever located resulted

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[2] Fargo v. Hart, 193 U.S. 490, 501-02 (1904).

[3] Union Tank Line Co. v. Wright, 249 U.S. 275, 280 (1919).

[4] *Id.* at 278.

[5] The Court stated that it "sustained methods of appraisement producing results approximately correct . . . [b]ut if the plan pursued is arbitrary and the consequent valuation grossly excessive it must be condemned because of conflict with the commerce clause of the Fourteenth Amendment or both." *See id.* at 278.

[6] Wallace v. Hines, 253 U.S. 66 (1920).

[7] *Id.* at 69.

[8] *Id.*

[9] *Id.* at 70.

[10] Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920).

in the apportionment of income earned outside the state.[11] It was Underwood's burden to show that 47 percent of its income was not derived from manufacturing in Connecticut.[12] Because Underwood had not attempted to make such a showing, the Court concluded there was nothing in the record "to show that the method of apportionment adopted by the state was inherently arbitrary, or that its application to this corporation produced an unreasonable result."[13] This decision signaled that the Court's analysis in *Union Tank Lines*, dealing with alleged distortion in apportioning values for property tax purposes, would also apply in the corporate income tax context.

The Court eleven years later in *Hans Rees' Sons, Inc. v. North Carolina*, resolved the first and only case in which it determined that an otherwise constitutional formula for apportioning income could operate in a distortive and unconstitutional manner.[14] North Carolina used an apportionment formula identical to that approved by the Court in *Underwood*.[15] However, in *Hans Rees'*, because the tangible property that was used in computing the apportionment formula was disproportionately located in North Carolina, the formula caused income to be over-apportioned to North Carolina and under-apportioned to New York where the taxpayer had a sales operation.[16] In analyzing the constitutionality of the formula, the Court used language similar to that used in *Union Tank Line*, saying, "[t]he difficulty of making an exact apportionment [in the case of a unitary business] is apparent, and hence, when the state has adopted a method not intrinsically arbitrary, it will be sustained until proof is offered of an unreasonable and arbitrary application in particular cases."[17] The Court concluded with the statement that the apportionment formula attributed to North Carolina "a percentage of income out of all appropriate proportion to the business transacted by

[11] *Id.* at 121.

[12] *Id.*

[13] *Id.*

[14] Hans Rees' Sons, Inc. v. North Carolina, 283 U.S. 123, 135-36 (1931).

[15] *Id.* at 128-29.

[16] *Id.* at 134-35.

[17] *Id.* at 133. The analysis of the distortion issue in the income tax context was influenced by the analysis that had long been used in cases dealing with allegations of distortion in the apportionment of the property of railroads, express companies, etc., was made clear by the Court in *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983), when, in the same sentence, the Court cited *Hans Rees'* for the proposition that an apportionment formula would be struck down if the taxpayer could show by clear and cogent evidence that the formula attributed income to a state out of all appropriate proportion to the business done in the state, and *Norfolk and Western Railway Co. v. Missouri Tax Commission*, 390 U.S. 317 (1968), for the proposition that the formula would be struck down if it led to a grossly distorted result. *Container*, 463 U.S. at 170. *Norfolk and Western* dealt with the apportionment of railway rolling stock for property tax purposes. *Norfolk & W. Ry. Co.*, 390 U.S. at 320.

appellant in that state."[18] Effectively, the apportionment formula did not reflect how the business was conducted in North Carolina.

These early decisions laid the groundwork for the conclusion that an apportionment formula need not obtain absolute accuracy to be sustained. Although absolute accuracy is not required, these early decisions also established that an apportionment formula must reasonably reflect both the value and the business activities derived in the taxing state.

B. *Constitutional Standards*

Income attribution is inherently a statutory function. However, that function is subject to constitutional restraints. The underlying constitutional principles must be incorporated into any analysis of an apportionment formula. Under Due Process Clause principles, a state may not tax a corporation's property, income, or gross receipts unless there is "some definite link, some minimum connection" between the state and the corporation's activities within the state.[19] Thus, income cannot be subject to tax if the state lacks a "minimum connection" or "definite link" with the taxpayer's activities and the income related to those activities in the taxing jurisdiction.[20] The Commerce Clause also limits a state's ability to tax the income of a multistate and/or multinational corporation. To satisfy the Commerce Clause requirements, a tax must: (a) be applied to an activity with a substantial nexus with the taxing state; (b) be fairly apportioned; (c) not discriminate against interstate commerce; and (d) be fairly related to the service provided by the state.[21]

Fifty-two years after the decision in *Hans Rees'*, the Court recognized the arduous nature of dividing income of a unitary business.[22] While the Court recognized the difficulty in apportioning income, it did articulate the standards for an acceptable apportionment formula and conversely what must be shown to demonstrate that an apportionment formula is distortive.[23] The Court in *Container* set out a three-factor test for evaluating an acceptable apportionment formula.[24] First, the formula must pass the internal consistency test; it must operate so that if it were used by every state, no more than 100 percent of the income of the taxpayer would be apportioned to the

[18] *Id.* at 135.

[19] Miller Bros. v. Maryland, 347 U.S. 340, 344-45 (1954).

[20] *Id.*; *see also* Wisconsin v. J.C. Penney Co., 311 U.S. 435, 444 (1940).

[21] Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 274 (1977).

[22] "Allocating income among various taxing jurisdictions bears some resemblance . . . to slicing a shadow. In the absence of a central coordinating authority, absolute consistency, even among taxing authorities whose basic approach to the task is quite similar, may just be too much to ask." *Container*, 463 U.S. at 192.

[23] *Id.* at 169-71.

[24] *Id.* at 170.

states.[25] If a formula results in taxation of more than 100 percent of the income of a multistate/multinational business while taxing only 100 percent of the income of an intrastate business, it will have the effect of discriminating against interstate commerce.[26] The internal consistency requirement is in keeping with the second prong of the *Complete Auto* test.[27]

Second, the apportionment formula must pass the external consistency test; the formula's factors must reflect "a reasonable sense of how income is generated."[28] This means that there must be a rational relationship between the taxpayer's business activity in the state and the formula's factors so that the formula reflects the activities that generate the taxpayer's income in the state.[29] The external consistency test is related to the Due Process requirement that the income attributed to a state be rationally related to the taxpayer's values or activities within the taxing state.[30] The external consistency test is applied to determine constitutional distortion in keeping with the fourth prong of the *Complete Auto* test.

Third, the apportionment formula must not discriminate against interstate or foreign commerce, either facially or in its effect.[31] In the context of foreign commerce, the test for determining whether a formula impermissibly discriminates against foreign commerce starts with the test for determining whether a formula discriminates against interstate commerce and adds two additional components related to the need for the United States to speak with one voice in foreign affairs and whether there is an increased risk of multiple taxation in the international sphere.[32] In analyzing the acceptability of a formula under the Foreign Commerce Clause, the Court used the same tools that it used under the Due Process and Commerce Clauses.[33]

The Court in analyzing the apportionment methodology recognized that there is a permissible "margin of error inherent in any method of attributing income among the components of a unitary business."[34] The issue is what is

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[25] *Id.* at 169.

[26] *Id.* at 170.

[27] *See* Armco, Inc. v. Hardesty, 467 U.S. 638, 644 (1984); Tyler Pipe Indus., Inc. v. Washington Dep't of Revenue, 483 U.S. 232, 247 (1987).

[28] *Container*, 463 U.S. at 169.

[29] *Id.* at 169-70.

[30] *See Norfolk & W. Ry. Co.*, 390 U.S. at 325.

[31] *Container*, 463 U.S. at 170.

[32] Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434, 446-49 (1979).

[33] Mobil Oil Corp. v. Comm'r of Taxes of Vt., 445 U.S. 425, 447 (1980). The Court stated: "A discriminatory effect on foreign commerce as a result of multiple state taxation is just as detectable and corrigible as a similar effect on commerce among the States. Accordingly, we see no reason why the standard for identifying impermissible discrimination should differ in the two instances." *Id.*

[34] *Container*, 463 U.S. at 184. The Court in *Container* recognized that the Constitution does not require that a state's method of taxation be perfect, nor that it capture with complete accuracy

the proper standard for determining the magnitude of the error or distortion and what is a permissible margin of error. The Court, in comparing the method used by the state of California in *Container*, with that used by the state of North Carolina in *Hans Rees'*, set forth the methodology for determining the percentage of error or distortion. The methodology developed by the Court involves comparing the percentage difference between the apportionment percentage derived by using the apportionment method at issue with the apportionment percentage derived using some other and better method.[35] The Court's analysis then looked not at the absolute difference between the methodologies but rather the relative difference between the income assigned to the state under the competing methodologies.[36] The Court made it clear that the "substantial margin of error" test applied in the interstate commerce context also applies in the foreign commerce context to determine the fairness of an apportionment formula; that is, the formula will stand unless it apportions an amount of income to the taxing state that is "out of all appropriate proportions to the business transacted in that State."[37]

In the foreign commerce context, it is important to note an apportionment scheme need not favor the commerce of the taxing state to impermissibly discriminate against foreign commerce.[38] The Court, in *Kraft*, stated:

> [A] State's preference for domestic commerce over foreign commerce is inconsistent with the Commerce Clause even if the State's own economy is not a direct beneficiary of the discrimination. As the absence of local benefit does not eliminate the international implications of the discrimination, it cannot exempt such discrimination from Commerce Clause prohibitions.[39]

The Court in *Barclays Bank PLC v. Franchise Tax Board Of California*,[40] reiterated that the test for discrimination in the foreign commerce context is the same as the test in the interstate commerce context. In denying Barclays the requested relief, the Court stated the taxpayer had not demonstrated a "lack of a 'rational relationship between the income attributed to the State and the intrastate values of the enterprise.' "[41]

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the actual income attributable to the state. *Id.* at 164; *see also* Moorman Mfg. Co. v. Bair, 437 U.S. 267, 274 (1978) (referring to the analysis in *Underwood Typewriter* that the Constitution does not require that a state's method of taxation be perfect. It requires only that the method not be inherently arbitrary or unreasonable.).

[35] *Container*, 463 U.S at 183.

[36] *Id.* at 183-84.

[37] *Id.* at 170.

[38] Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue & Fin., 505 U.S. 71, 79 (1992).

[39] *Id.*

[40] 512 U.S. 298 (1994).

[41] *Id.* at 312 (quoting *Container*, 463 U.S. at 180-81).

To establish constitutional distortion a taxpayer must show: (1) that the apportionment formula if applied by all relevant states will result in double taxation by subjecting more than 100 percent of the income of the taxpayer to taxation, (2) that the formula does not rationally reflect the relationship between the business's values/activities within the taxing state or (3) that the formula discriminates against interstate or foreign commerce. The only circumstance when the Court's three-part analysis would not apply is when the taxing scheme in which the formula operates, or the formula itself, facially discriminates against interstate or foreign commerce.[42]

C. *Application of the Constitutional Standards*

With respect to the apportionment of income, the Court has only found distortion requiring action under the Constitution in one case: *Hans Rees'*.[43] In that case, the single factor formula used by North Carolina apportioned 80 percent of the taxpayer's income to North Carolina while the formula proffered by the taxpayer would have apportioned 21.7 percent of its income to the state, a difference of more than 250 percent, as the Court observed in *Container*.[44] Because the single factor formula did not reflect the manner in which the business earned its income and because a 250 percent deviation in the apportionment percentage was out of all appropriate proportion to the business done in the state by the taxpayer, the North Carolina single sales factor formula was struck down by the Court.[45]

Although the Court struck down a single factor apportionment formula in *Hans Rees'*, the use of a single factor to apportion income is not per se unconstitutional. In *Moorman Manufacturing Co. v. Bair*, the Court allowed the use of a single sales factor apportionment formula by Iowa although the singles sales formula apportioned 48 percent more income to the taxing state than would have been apportioned using the three factor formula previously approved by the Court.[46] The Court found the taxpayer failed to establish that the single sales factor formula did not reasonably reflect its business activity in Iowa.[47]

In *Colgate-Palmolive Co. v. Franchise Tax Board*, the court provided some additional guidance on the degree of distortion requiring action under the

[42] *Kraft*, 505 U.S. at 75. As discussed in greater detail in Section II.A., absent a showing of facial discrimination the taxpayer must also take the additional step and show that the alternative formula is reasonable and the results of utilizing the standard method are outside the bounds of the "rough approximation" permitted by the Constitution.

[43] *Hans Rees'*, 283 U.S. 123.

[44] *Id.* at 134; *see also Container*, 463 U.S. at 184.

[45] *Container*, 463 U.S. at 183-84.

[46] *Moorman Mfg. Co.*, 437 U.S. at 280. The Court approved the use of the three-factor payroll, property, and sales formula in *Butler Bros. v. McColgan*. 315 U.S. 501, 509 (1942).

[47] *Id.* at 272.

Constitution.[48] The taxpayer argued that the standard apportionment formula over-apportioned the company's income to California by 70 percent.[49] The court stated that Colgate's figure of 70 percent "is not comparable to the 250 percent tally in *Hans Rees*. Colgate has not met the steep burden imposed by the constitutional distortion principle of 'external consistency.'"[50]

When an apportionment formula does not fairly reflect how income is generated, it will be struck down under the Constitution if it apportions to the taxing state a percentage of the taxpayer's income that is "out of all appropriate proportion" to the business transacted in that state by the taxpayer. Because in an apportionment context the constitutional requirements only come into play when a state over-apportions income to itself, it may be argued that the constitutional standards for determining impermissible distortion only apply in cases of asserted over-apportionment and the resulting double taxation, thus raising the question: is there a constitutional standard for what constitutes actionable distortion where the standard formula creates "nowhere income" or for the potential distortion that may exist when a corporation does business in a state, but the standard formula does not apportion any income to that state?

III. The Constitutional Safety Valve—UDITPA Section 18

Prior to the promulgation and adoption of the Uniform Division of Income for Tax Purposes Act (UDITPA), a statutory provision like Section 18, a provision that allowed for the use of alternative methods, typically was not needed because under the pre-UDITPA apportionment statutes state revenue agencies were given wide discretion to select the apportionment formula that best reflected the way in which the taxpayer carried out its business operations.[51] One of the goals of UDITPA was to establish uniformity among the states. Thus, with that goal in mind the drafters of

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[48] Colgate-Palmolive Co. v. Franchise Tax Bd., 13 Cal. Rptr. 2d 761 (1992).

[49] *Id.* at 772.

[50] *Id.* In *Colgate-Palmolive Co.*, the court noted that the test under the constitution for determining whether the asserted distortion requires action differs from the test under California Revenue and Taxation Code section 25137. *Id.* at 773. Under the Constitution, the test is whether the income apportioned to the state is "out of all proportion" to the business done in the state, while under section 25137 the test is whether given the flows of value in a unitary business the formula unfairly represents the business activities of the taxpayer in the state. This raises the question whether the numerical standards are also different.

[51] The Uniform Division of Income for Tax Purposes Act was drafted by the National Conference of Commissioners on Uniform Laws and approved at its meeting in July 1957. The American Bar Association approved the Act on July 16, 1957. *See* Household Fin. Corp. v. Franchise Tax Bd., 41 Cal. Rptr. 565 (Cal. Ct. App. 1964); Amoco Prod. Co. v. Armold, 518 P.2d 453 (Kan. 1974); Donald M. Drake Co. v. Dep't of Rev., 500 P.2d 1041 (Or. 1972); Kennecott Copper Corp. v. State Tax Comm'n, 493 P.2d 632 (Utah 1972).

UDITPA prescribed a uniform three-factor apportionment formula based on the ratio of payroll, tangible property, and sales, identical to the formula approved by the Court in *Butler Bros. v. McColgan*.[52] Because the uniform statute prescribed a standard formula that, although constitutional in its usual application, might be unconstitutional as applied in a specific case, it was necessary to have a statutory safety valve to enable revenue agencies to avoid constitutional problems. UDITPA Section 18 is that safety valve.

UDITPA Section 18 provides that, if the allocation and apportionment provisions of UDITPA do not fairly represent the extent of the taxpayer's business activity in a 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, the use of separate accounting, the exclusion of any one or more of the factors, the inclusion of one or more additional factors, or the employment of any other method that will result in "an equitable allocation and apportionment of the taxpayer's income."[53] The drafter's Section 18 comments make clear the section is intended to give broad authority to tax administrators to vary the apportionment formula and vary the systems of allocation where the provisions of the Act do not fairly represent the taxpayer's business activities in the state.[54] The comments also make it clear that UDITPA did not foreclose the use of one method for some business activities and another method for different business activities.[55] Additionally, as indicated by the comments, Section 18 allows tax administrators to substitute factors in the formula.[56]

In his 1957 article explaining UDITPA, William J. Pierce, one of the UDITPA drafters, explained that Section 18 was intended to be used when the standard formula reached "arbitrary or unreasonable results so that its application could be attacked successfully on constitutional grounds. . . . [D]epartures from the basic formula should be avoided except where reasonableness requires."[57] Pierce went on to say, "Nonetheless, some alternative method must be available to handle the constitutional problem as well as the unusual cases, because no statutory pattern could ever resolve satisfactorily the problems for the multitude of taxpayers with individual business characteristics."[58] The "as well as" clause found in Section 18 implies that it could be used even if the standard formula did not result in actionable distortion under the Constitution. If the act can apply in "unusual cases" as

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[52] 315 U.S. 501 (1942).

[53] UNIF. DIV. OF INCOME FOR TAX PURPOSES ACT § 18 (UNIF. L. COMM'N 1957).

[54] *Id.* at § 18 cmt. 1.

[55] *Id.*

[56] *Id.*

[57] William J. Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 TAXES 747, 781 (1957).

[58] *Id.*

well as those in which the standard formula will reach an unconstitutional result, then by the terms of the statute both the taxpayer and the taxing administrator should have the right to seek application of the Section 18 relief in the appropriate case.[59]

A. *Multistate Tax Commission and UDITPA*

The Multistate Tax Commission (MTC) has played a central role in the development, promotion, and maintenance of UDITPA.[60] UDITPA is incorporated into Article IV of the Multistate Tax Compact (Compact), which is the foundational agreement among member states. Article IV of the Compact outlines the rules for allocating and apportioning income of multistate businesses to ensure fair and consistent taxation.[61] The MTC has developed model allocation and apportionment regulations that interpret and implement Article IV. These model regulations date back to 1971 and provide guidance both on how to classify income as apportionable or allocable income and then how to apportion that income among the states.[62] While the initial intent of the drafters of UDITPA was to utilize Section 18 to avoid gross distortion, the MTC has adopted a broad interpretation of Section 18. The MTC under its broad interpretation of Section 18 asserts the regulations do not provide appropriate procedures for apportioning the income of certain industries. As a result, the MTC has adopted special rules for construction contractors, airlines, railroads, trucking companies, television and broadcasters, publishing and financial institutions.[63]

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[59] In *Appeal of New York Football Giants, Inc.*, Cal. St. Bd. of Equalization, February 3, 1977, the Board of Equalization emphasized the goal of UDITPA set forth in Revenue and Taxation Code section 25138 to "make uniform the law of those states which enact it" and said, "[i]n order to insure that the Act is applied as uniformly as possible, we hold that the party who seeks to deviate from the statutory formula, whether the taxpayer or the taxing agency, will bear the burden of proving that such exceptional circumstances are present." The Board sustained the action of the Franchise Tax Board in assigning the wages of New York based football players to California for payroll factor purposes when one of their games was played in this state.

[60] The Multistate Tax Commission was created in 1967 by the Multistate Tax Compact. *About Us*, MULTISTATE TAX COMM'N, https://www.mtc.gov/the-commission/about-us/ [https://perma.cc/W2G8-P3AC]. It is an intergovernmental state tax agency working on behalf of states and taxpayers to facilitate the equitable and efficient administration of state tax laws that apply to multistate and multinational enterprises.

[61] *See* MULTISTATE TAX COMPACT art. 4 (MULTISTATE TAX COMM'N, amended 2015).

[62] *See* MODEL GEN. ALLOCATION & APPORTIONMENT REGULS. (MULTISTATE TAX COMM'N, amended 2018). It should be noted that each state must individually adopt the MTC model regulations and any amendments to those regulations.

[63] In 2022, the MTC Uniformity Committee authorized the review of MTC model sales/receipts sourcing and special industry regulations. The project is ongoing. *See Model Receipts Sourcing Regulation Review Work Group*, MULTISTATE TAX COMM'N, https://www.mtc.gov/uniformity/model-receipts-sourcing-regulation-review-project/ [https://perma.cc/SBR7-4KCU].

The model Act IV regulations and the Section 18 regulations addressing specific industries have been modified and amended over the years.[64] In 2012 the MTC, in an effort to modernize the Compact in response to evolving business practices and economic realities, undertook a project to update Article IV of the Compact.[65] As part of this project, the MTC made updates to Section 18 of Article IV. In 2015, the MTC adopted Compact amendments to Article IV Section 18 to: [66]

Clarify when and how alternative apportionment can be applied, including who bears the burden of proof. The party seeking to use an alternative method (either the taxpayer or the state) must demonstrate that the standard formula does not fairly represent business activity.[67]

Define the scope of permissible alternative methods, such as separate accounting, exclusion of one or more factors, or inclusion of additional factors. The updated section includes guidance on what evidence is needed to justify alternative apportionment.

Establish procedural safeguards to ensure consistent application and prevent abuse by either taxpayers or tax authorities.

The MTC has also updated the model regulations to implement the revisions to Article IV's Section 18 provisions.[68] The revised model

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[64] The MTC's model Regulation IV.18(a) has evolved over the years. The original version in effect from 1973-2010 stated "only in specific cases where unusual fact situations (which ordinarily will be unique and non-recurring) produce incongruous results." ALLOCATION & APPORTIONMENT REGULS. (MULTISTATE TAX COMM'N, amended 2007). The regulation was amended in 2010 to state "only in limited and specific cases where the apportionment and allocation provisions contained in Article IV produce incongruous results." ALLOCATION & APPORTIONMENT REGULS. (MULTISTATE TAX COMM'N, amended 2010). The current regulation removed the contingency language requiring a specific or limited case.

[65] The Multistate Tax Commission's Executive Committee in December 2012 approved public hearings for proposed model amendments to Article IV of the Compact. *Article IV–UDITPA*, MULTISTATE TAX COMM'N, https://www.mtc.gov/Uniformity/Article-IV/ [https://perma.cc/5NAD-RVNG].

[66] The amendments (1) provided tax administrators with the authority to establish appropriate rules and regulations for determining alternative apportionment methods in Section 18(b); (2) Section 18(c) addressed the standard of proof that the standard apportionment provisions do not fairly represent the extent of the taxpayer's activity and that the alternative apportionment method is reasonable; (3) Section 18(d) addressed the imposition of civil penalties; and Section 18(e) addressed the revocation of permission to use an alternative apportionment formula. *See* MULTISTATE TAX COMPACT art. 4 (MULTISTATE TAX COMM'N, amended 2015).

[67] *See* Appeal of Fluor Corp., No. 93A-0719, 1995 WL 799363, at *2 (Cal. St. Bd. Eq. 1995) (holding that whichever party is attempting to deviate from the plain reading of the statute must "prove[] that application of the general provisions of UDITPA would lead to an unfair representation of the extent of the taxpayer's activities in this state").

[68] MODEL GEN. ALLOCATION & APPORTIONMENT REGULS. (MULTISTATE TAX COMM'N, amended 2018). For a detailed analysis of the changes and the rationale for the changes to the

regulations address the equitable apportionment authority and provide certain procedural safeguards.

IV. Key Triggers for Alternative Apportionment

A. *The Principles Guiding the Application of UDITPA Section 18*

Initially it was argued that the draftsmen of Section 18 believed the use of the provisions of UDITPA section 18 "should be interpreted narrowly and were designed to permit [deviation from the prescribed method] only in unusual cases and in cases where the application of the specifically prescribed methods might be held unconstitutional."[69] The thought was that giving Section 18 a broad construction would defeat the goal of obtaining uniformity. Early California decisions reflect the narrow construction of Section 18.[70] The focus of the analysis in these cases was not on the degree of distortion but rather on whether the formula reflected how the business was carried out in California. The analysis has evolved into a review of the relationship of the interstate business activities to the income attributed to the state.

The fundamental question is when Section 18, alternative apportionment, should be invoked. In determining whether alternative apportionment should be invoked, one must first assess the constitutionality of the formula. Is the formula internally and externally consistent? If the statutory formula fails either the internal or external consistency test, it is unconstitutional on its face. However, the use of Section 18 is not limited to facially unconstitutional statutory formulas. Rather, an alternative formula may be utilized if the statutory formula as a whole does not fairly represent the extent of the taxpayer's business activity in the state.[71] The proposed alternative formula must be reasonable. In other words, the proposed formula must represent the taxpayer's business activity in the state, and if applied uniformly, it would not result in no more or no less than the taxation of 100 percent of the taxpayer's income, *i.e.*, internal consistency, and reflects the

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MTC's model regulations, see Richard Pomp, *Report of the Hearing Officer: Multistate Tax Compact Article IV [UDITPA] Proposed Amendments*, MULTISTATE TAX COMM'N (Oct. 25, 2013), https://www.mtc.gov/wp-content/uploads/2023/02/Pomp-final-final3-2.pdf [https://perma.cc/W9UC-APZM].

[69] Frank M. Keesling & John S. Warren, *California's Uniform Division of Income For Tax Purposes Act*, 15 UCLA L. REV. 156, 171 (1967).

[70] California has adopted UDITPA, and Revenue and Taxation Code section 25137 is the codification of Section 18. It is now accepted in California and generally in the UDITPA states that the relief provisions of UDITPA Section 18 may be invoked by the taxing state when the standard formula results in the under representation of the business of the taxpayer in the state. Appeals of Pacific Tel. & Tel. Co., 1978 WL 3941 (Cal. St. Bd. Eq. 1978); see also *Donald M. Drake Co.*, 500 P.2d 1041; *Kennecott Copper Corp.*, 493 P.2d 632; *Amoco Prod. Co.*, 518 P.2d 453.

[71] Twentieth Century-Fox Film Corp. v. Dep't of Rev., 700 P.2d 1035, 1039 (1985).

economic reality of the income generated by in-state business activity, *i.e.*, external consistency.

B. *Alternative Apportionment – Standard of Proof*

The MTC regulations and existing case law make it clear that the party seeking to deviate from the standard apportionment formula bears the burden of proof.[72] The question arises as to what must be shown to meet that burden. The states' response to the question has not been uniform. California addressed the issue concluding that the taxpayer is required to prove by clear and cogent evidence that the standard apportionment formula does not fairly represent the taxpayer's business activities in the state.[73] The party invoking the alternative formula must prove by clear and convincing evidence that the statutory formula is not a fair representation of the taxpayer's business activities.[74] The court, in *Microsoft*, developed a qualitative and quantitative analysis to determine the need for alternative apportionment.[75]

Unlike California, the Oregon Supreme Court has determined that the standard of proof is by the preponderance of the evidence.[76] The Oregon Supreme Court addressed whether the intangible value of the taxpayer's film negatives should be included in its property factor.[77] The department argued it had the authority to impose an alternative apportionment method on the motion picture industry.[78] The Tax Court concluded that the department was not permitted to include the intangible value of film negatives in the property factor because the UDITPA provisions, except in limited instances, did not permit a deviation from the standard formula.[79] The Oregon Supreme Court reversed, disagreeing with the burden of proof imposed by the Tax Court.[80] Rather, the court applying a preponderance of the evidence standard held excluding the value of the intangibles from the property factor "substantially underrepresent[ed] the business activity of [the] taxpayer in

[72] *Fluor Corp.*, 1995 WL 799363, at *2. The burden of proof applies equally to taxpayers and taxing authorities. *See* CarMax Auto Superstores West Coast, Inc. v. S.C. Dep't of Rev., 725 S.E.2d 711, 714 (S.C. 2012); Media Gen. Commc'ns, Inc. v. S.C. Dep't of Rev., 694 S.E.2d 525 (S.C. 2010).

[73] Microsoft Corp. v. Franchise Tax Bd., 139 P.3d 1169, 1178 (Cal. 2006).

[74] *Id.*; *see also Moorman Mfg. Co.*, 437 U.S. 267; British Land (Maryland), Inc. v. N.Y. Tax Appeals Tribunal, 647 N.E.2d 1280 (N.Y. 1995).

[75] *Microsoft*, 139 P.3d at 1180-81.

[76] *Twentieth Century-Fox*, 700 P.2d at 1044.

[77] *Id.* at 1043.

[78] *Id.* at 1040. The department had previously adopted OAR 150-314.670-(A), which granted it the authority to use alternative apportionment for the motion picture industry and other industries.

[79] *Id.* at 1038.

[80] *Id.* at 1045.

[Oregon]" and that the inclusion of the value in the apportionment formula was reasonable.[81]

In *Montana Department of Revenue v. United Parcel Service*, the Montana Supreme Court recognized there were two different standards for requesting apportionment relief.[82] The court ruled that if the challenge was to the apportionment formula, *i.e.*, the use of the state's three-factor formula as the basis for calculating the taxpayer's income tax liability, the taxpayer must prove distortion.[83] However, the taxpayer needs only prove that application of the apportionment method results in an unfair representation of the extent of its in-state business activity in the state to invoke the statutory relief provisions. Thus, in Montana, it appears there is a lower evidentiary standard for a taxpayer seeking statutory relief. In contrast, in a case involving the same taxpayer, the Wisconsin Court of Appeals concluded that the United Parcel Service's failure to show that a 1.5 percent apportionment differential, based upon comparison of the standard formula and the proposed alternative formula, demonstrated that the standard formula's tax calculation was out of all appropriate proportion to business transacted in-state, or grossly distortive (i.e., the constitutional burden of proof was applied).[84]

Other state courts have used even lesser standards than Oregon or Montana to allow alternative apportionment. The South Carolina Supreme Court has held that if the method is appropriate, it will be upheld.[85] The Utah Supreme Court did not rely on any standard but merely concluded the statute allowed the use of an alternative formula.[86]

It is clear from these court decisions that the party seeking to deviate from the standard formula must prove that the application of that formula will lead to an unfair representation of the taxpayer's business activities in the state. However, there is no consistent standard establishing what must be shown to establish that the statutory formula does not fairly represent the business activities contributing to the income or the value of the business activities within the taxing jurisdiction. The lack of consistent standards of proof contributes to the erosion of the original drafter's goal of uniformity.

C. *The Role of Symmetry in Tax Base and Apportionment Factor Alignment*

A central tenet of sound corporate income tax policy is maintaining symmetry between the composition of the tax base and the apportionment factors used to divide that base among taxing jurisdictions. The corporate income tax base typically reflects a combination of returns to capital, labor, and market engagement—that is, profits derived from the deployment of

[81] *Id.* at 1044.
[82] Mont. Dep't of Revenue v. United Parcel Serv., 830 P.2d 1259, 1264 (Mont. 1992).
[83] *Id.* at 1262.
[84] United Parcel Serv. v. Wis. Dep't of Revenue, 553 N.W.2d 861, 866 (Wis. Ct. App. 1996).
[85] *Media Gen. Commc'ns, Inc.*, 694 S.E.2d at 532.
[86] *Kennecott Copper Corp.*, 493 P.2d at 635.

property, the efforts of employees, and the realization of sales. The apportionment formula, in general, should mirror this underlying structure by incorporating factors that correspond to each of these income-generating inputs to ensure an economically grounded allocation of taxable income. The Court has long recognized that apportionment formulas must fairly reflect a corporation's in-state and out-of-state activities and should bear a rational relationship to the income attributed to the taxing state.[87] State courts have likewise emphasized the need for apportionment formulas to reflect economic reality and to avoid unjustified distortions in the allocation of income.[88] For example, if the tax base includes income attributable to the productive use of capital assets, then the property factor should feature prominently in the apportionment formula; similarly, if labor contributes significantly to the production of income, the payroll factor should be included. Likewise, to the extent that profits are driven by sales or customer location, the sales factor provides a critical proxy for market-based income. When the apportionment factors are misaligned with the components of the tax base, the asymmetry may lead to distortion in the income assigned to a taxing jurisdiction. The courts have cautioned that apportionment methods must not result in a grossly distorted reflection of a corporation's income attributable to the taxing state.[89] Asymmetry between the tax base and the apportionment formula may raise constitutional concerns as income may be taxed in jurisdictions with only tenuous connections to the economic activity that produced it, potentially violating the Due Process and Commerce Clauses.[90]

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[87] *Moorman Mfg. Co.*, 437 U.S. at 273-74 ((upholding Iowa's use of a single-factor sales formula while acknowledging that apportionment must be "fair" under the Commerce Clause); *Container Corp.*, 463 U.S. at 169-70 (noting that apportionment formulas must reflect a "reasonable sense of how income is generated" and be internally consistent).

[88] *See* Sherwin-Williams Co. v. Dep't of Revenue, 996 P.2d 500, 500-01 (Or. 2000) (rejecting the use of a single sales factor when it grossly overrepresented in-state activity relative to the taxpayer's economic footprint).

[89] *Hans Rees'*, 283 U.S. at 133 (invalidating North Carolina's apportionment method where it attributed 85% of income to the state despite only 17% of business occurring there); *see also* Microsoft Corp. v. Franchise Tax Bd., 150 Cal. Rptr. 3d 770, 782 (Cal. Ct. App. 2012) (upholding a distortion adjustment where the standard formula did not fairly reflect in-state business activity); Gillette Co. v. Franchise Tax Bd., 363 P.3d 94, 104 (Cal. 2015) (noting that distortion must be addressed when the standard apportionment method does not reflect actual in-state business activity).

[90] *Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768, 778-79 (1992) (holding that a state may not tax income lacking a "minimal connection" with in-state activity and that apportionment must fairly reflect the taxpayer's economic presence); *see also American Telephone & Telegraph v. Department of Revenue*, 422 N.W.2d 629 (1988) (holding that an apportionment formula must bear a rational relationship to the in-state activity being taxed under both Due Process and Commerce Clause doctrines).

1. *Taxation of Dividends, Royalties, and Interest*

Fair apportionment requires symmetry between the tax base and the apportionment factors used to assign that tax base. The fair apportionment question then arises when dividend, interest, and royalty income are included in the tax base but excluded from the computation of the apportionment formula. This issue is of increased importance as the states seek to expand the tax base to include additional items of foreign source income, *e.g.*, Global Intangible Low Taxed Income (GILTI), Net Controlled Foreign Corporation Tested Income (NCTI),[91] foreign dividends, and Subpart F income. The Supreme Court in *Mobil Oil* held that under the Due Process Clause, a state could require a non-domiciliary multistate taxpayer to include dividends received from foreign subsidiaries in its apportionable tax base so long as the taxpayer and the foreign subsidiaries had a unitary relationship.[92] Although concluding that the dividend income represented income earned in Mobil's unitary business, the majority of the Court never addressed the issue of whether a state may include unitary income in the tax base without providing representation in the apportionment formula for the factors which generated the income at the level of the dividend-paying subsidiaries. The issue was noted by Justice Stevens in his dissent:

> Unless the sales, payroll, and property values connected with the production of income by the payor corporations are added to the denominator of the apportionment formula, the inclusion of earnings attributable to those corporations in the apportionable tax base will inevitably cause Mobil's Vermont income to be overstated.[93]

The issue discussed by Justice Stevens in his dissent in *Mobil Oil* was specifically identified by the Court in *Container*. In *Container,* the Court held that California's worldwide combined reporting system was constitutional as applied to domestic multinational corporations.[94] In so doing, the Court held that an apportionment formula will not violate constitutional standards so long as, if applied by every jurisdiction, it would result in no more than all the unitary business income being taxed, and so long as the factor or factors used in the apportionment formula reflect a reasonable sense of how the income is generated.[95] In footnote 5, the Court acknowledged that Justice Stevens had raised the apportionment issue in his dissent in *Mobil Oil.*[96]

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[91] Under the One Big Beautiful Bill Act (OBBBA), the Global Intangible Low-Taxed Income (GILTI) regime was renamed and restructured as Net Controlled Foreign Corporation Tested Income (NCTI).

[92] *Mobil Oil Corp.*, 445 U.S. at 438.

[93] *Id.* at 461 (Stevens, J., dissenting).

[94] *Container*, 463 U.S. at 196.

[95] *Id.* at 169.

[96] *Id.* at 168 n.5.

Although the Court acknowledged that the apportionment formula should reflect how the income was generated, it did not set out guidelines for determining when and what values were to be included in the formula's factors.[97]

The application of Justice Stevens' dissent in *Mobil Oil* and footnote 5 in *Container* played out in a series of cases involving the NCR Corporation. The first test of the theory was in Maryland in an appeal from the Tax Court's decision holding that if foreign source dividend and royalty income was subject to apportionment, the apportionment factors should be adjusted to reflect the worldwide factors that generated the income.[98] The appellate court rejected the argument that the Maryland statute required the inclusion of the subsidiary factors.[99] It also rejected as "wishful thinking" the argument that in footnote 5 of the *Container* decision the Court adopted Justice Stevens' dissent in *Mobil Oil* that apportionment of dividends required inclusion of subsidiary factors in the apportionment formula.[100] The court also rejected the inclusion of the factors of the royalty-paying subsidiaries, concluding that it would be no different than including the factors of independent third-party entities to whom the taxpayer licensed its processes or patents.[101] The court did acknowledge that it would be fair to include factor representation for the dividend-paying subsidiaries.[102]

Not to be deterred by the Maryland decision, NCR again argued in Minnesota that if the interest and dividend income was included in its gross income, the payroll, property, and sales of the subsidiaries from which that income was earned should be included in the denominators of the apportionment factors.[103] The Minnesota Supreme Court, in rejecting the argument, looked at the Maryland decision and found its construction of statutory language persuasive.[104] The court first concluded that the payments from licensees and subsidiaries were properly included in the tax base.[105] The court concluded the term "taxpayer" in the statute did not include the foreign

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[97] *Id.* at 169.

[98] NCR Corp. v. Comptroller of Treasury, 544 A.2d 764, 772 (Md. 1988).The state also appealed the determination of the Tax Court that Internal Revenue Code section 78 gross-up income and domestic placement interest income should be excluded from the apportionable tax base. *Id.* at 766.

[99] *Id.* at 781.

[100] *Id.* at 779.

[101] *Id.* at 781.

[102] *Id.* The court, however, was unable to determine whether the resulting disproportionality was of constitutional magnitude and remanded the case to the lower court for a determination on that point, stating that if such disproportionality existed, a modification must be made to the apportionment formula. *Id.*

[103] *NCR Corp. v. Comm'r*, 438 N.W.2d 86, 88 (Minn. 1989).

[104] *Id.* at 90.

[105] *Id.*

subsidiaries, and the statute did not contemplate the inclusion in the apportionment formula the factors of foreign affiliates not subject to taxation in Minnesota.[106] Thus, there was no statutory support for the NCR factor representation argument. The court also rejected NCR's Due Process Clause argument by concluding that NCR failed to meet its burden of proof to sustain either the internal or external consistency test challenge.[107]

Next up was South Carolina, where the matter was heard twice. In the first iteration, the court rejected NCR's argument that the South Carolina statute contemplated the inclusion of the factors of foreign subsidiaries that paid royalties and interest to the parent in the apportionment formula.[108] It also rejected NCR's arguments that the failure to include the factors of the subsidiaries subjected the taxpayer to the risk of double taxation of the type declared unconstitutional in *Japan Lines*.[109] The court did apply an external consistency analysis and concluded that, as applied, the formula did not fairly reflect how the income at issue was generated.[110] However, the court concluded it did not have sufficient information to determine whether the degree of error was outside the "substantial margin of error" permitted in cases involving the use of formula apportionment.[111] The case was remanded to the lower court for a determination on this point.[112] In the second iteration of the case the court sustained the methodology used by the trial judge to determine the magnitude of the error caused by the failure to include the foreign subsidiaries' factors in the apportionment formula and held that the magnitude of the error, 27.9 percent, was within the permissible margin of error and that as result there was no "gross disparity" and no violation of the Due Process Clause.[113]

In the last of the NCR sagas, the New Mexico Appellate Court likewise rejected NCR's argument that the taxation of royalties, interest, and dividends received from foreign subsidiaries violated the Foreign Commerce Clause.[114] With respect to the factor adjustment argument, the appellate

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[106] *Id.*

[107] *Id.* at 92. NCR also argued that the possibility of multiple taxation violated the Foreign Commerce Clause. *Id.* at 93. The court responded to the argument by saying that it was recognized in any income tax apportionment formula that a continual risk of multiple taxation exists, but a constitutional analysis does not require a state to apply a different formula simply because the risk may be lower. *Id.* at 94. With respect to the argument that the formula impaired federal uniformity, the court said that NCR had provided no evidence of any clear federal directive which would preclude Minnesota from applying its apportionment formula as it did. *Id.* at 95.

[108] NCR Corp. v. S.C. Tax Comm'n, 402 S.E.2d 666, 669 (S.C. 1991).

[109] *Id.* at 671.

[110] *Id.* at 672-73.

[111] *Id.* at 673.

[112] *Id.* at 674.

[113] NCR Corp. v. S.C. Tax Comm'n, 439 S.E.2d 254, 257 (S.C. 1993).

[114] NCR Corp. v. Taxation & Revenue Dep't, 856 P.2d 982, 988 (N.M. Ct. App. 1993).

court held that NCR failed to show by clear and cogent evidence that the income attributed to New Mexico was disproportionate to the business transacted in the state.[115] Absent such a showing, there was no basis for apportionment factor relief.[116]

Although the Court has not set definitive guidelines for the values to be included in the apportionment formula, several state courts have attempted to do so. The Maine Supreme Judicial Court, addressing the fact that the State Tax Assessor included dividends received from foreign affiliates in the corporate income tax base without a factor adjustment, held that the Assessor's formula, as applied to the taxpayer, violated the internal consistency standard set forth in *Container*.[117] The court reasoned that the foreign subsidiaries would be subject to foreign tax on their income and that the same income would again be subject to tax when it was paid to the parent in the form of dividends and taxed as income of the parent.[118] The court concluded the exclusion of the factors of the subsidiaries from the apportionment formula meant recognition was not given to the factors that generated the income.[119] As a result, there was an over-apportionment of income to Maine.[120] The court went on to hold that the factors of the foreign dividend-paying subsidiaries must be included in the apportionment formula to ensure that the formula reasonably reflected how the income was generated.[121]

As a result of the decision in *Tambrands*, Maine developed the "Augusta formula," which utilizes a comparison of a worldwide combined reporting and water's-edge calculation to ensure the fairness of the Maine system of taxation.[122] The Maine Supreme Judicial Court applied the "Augusta formula" to Du Pont and concluded it was not entitled to factor representation for its foreign dividend-paying subsidiaries.[123] Du Pont argued that the Maine water's edge combined reporting scheme resulted in unconstitutional discrimination against foreign commerce under *Kraft*.[124] The court, relying on the decision of the Kansas Supreme Court in *Appeal of*

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[115] *Id.* at 991.

[116] *Id.* at 991.

[117] Tambrands, Inc. v. State Tax Assessor, 595 A.2d 1039, 1043-44 (Me. 1991).

[118] *Id.* at 1043.

[119] *Id.* at 1044.

[120] *Id.* at 1045.

[121] *Id.* The factor adjustment fashioned because of this decision is referred to as the "Augusta formula." Additionally, the court found the Maine water's edge reporting system resulted in the taxation of extraterritorial values because the foreign dividends were earned in the operation of a worldwide unitary business but apportioned using only domestic factors. *Id.* at 1044; *see also* Homart Dev. Co. v. Norberg, 529 A.2d 115, 121 (R.I. 1987) (reaching the same conclusion).

[122] See Section V.B for a discussion of the Augusta formula.

[123] E.I. Du Pont de Nemours & Co. v. State Tax Assessor, 675 A.2d 82, 90-91 (Me. 1996).

[124] *Id.* at 86-88.

Morton Thiokol, Inc.,[125] found the statute was not discriminatory because the Maine water's edge system provided a type of tax symmetry that was not present in a single entity system.[126] Additionally, the use of the Augusta formula ensured that when the foreign dividends are included in income, the tax liability will not exceed the amount computed under the worldwide combined reporting method.[127]

New Mexico also addressed the taxation of foreign dividends and the interplay of factor representation in *Conoco, Inc. v. Taxation & Revenue Department*. The New Mexico tax scheme during the years at issue provided multistate and multinational corporations with four alternative methods of reporting: separate accounting, separate corporate entity reporting, a combination of unitary corporations, or federal consolidated group reporting.[128] Both Conoco and Intel elected separate corporate entity reporting.[129] Because, like Iowa, the New Mexico tax calculation started with federal taxable income, the New Mexico tax scheme was similar to that struck down by the Court in *Kraft*.[130] However, unlike Iowa, New Mexico applied the "Detroit formula" when separate entity reporting was elected.[131] The Detroit formula provides for the inclusion of the factors of the dividend-paying corporation in the denominator of the apportionment formula in the ratio of the dividends paid to the book income of the payee corporation.[132] Thus, because of the application of the Detroit formula, partial recognition was given to the factors of the dividend-paying foreign subsidiaries and had the effect of partially eliminating those dividends from the tax base.[133]

The New Mexico Supreme Court rejected the Taxation and Revenue Department's argument that the Supreme Court had implied approval in *Kraft* for excluding foreign subsidiary factors when the income of domestic

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[125] Appeal of Morton Thiokol, Inc., 864 P.2d 1175 (Kan. 1993). Kansas used a unitary combined filing method that included domestic corporations meeting an over 50% ownership test. *Id.* at 1185. Under the Kansas taxing system, dividends between members of the group were eliminated, but dividends from foreign corporations were included in taxable income. *Id.* at 1183-84. The Kansas Supreme Court, relying on a suggestion in footnote 23 of the *Kraft* opinion, upheld the taxation of the foreign dividends, finding that there was no discrimination. *Id.* at 1184-85. Under the Kansas system, both the entire income of the domestic subsidiaries and the dividends from foreign subsidiaries were included in the income subject to apportionment to Kansas. *Id.* at 1183-84. As the income of both domestic and foreign subsidiaries was included in the tax base, the court concluded that there was no discrimination. *Id.* at 1186.

[126] *E.I. Du Pont*, 675 A.2d at 88.

[127] *Id.* at 91. As a result of the application of the Augusta formula, Du Pont's tax liability was computed in a manner identical to that struck down earlier by the same court in *Tambrands*.

[128] Conoco, Inc. v. Taxation & Revenue Dep't, 931 P.2d 730, 739 (N.M. 1996).

[129] *Id.*

[130] *Id.*

[131] *Id.*

[132] *Id.* at 741. See Section V.B for a detailed discussion of the Detroit formula.

[133] *Conoco*, 931 P.2d at 741.

subsidiaries was subject to apportionment.[134] Rather, the court found that, notwithstanding the elections offered to the taxpayer and the use of the Detroit formula, the New Mexico income tax scheme unconstitutionally discriminated against foreign commerce.[135] The court found that the use of the Detroit formula did not eliminate dividends paid by foreign affiliates from the tax base in every case.[136] Thus, because the separate entity reporting system eliminated domestic dividends in every case, the New Mexico separate entity reporting system unconstitutionally discriminated against foreign commerce despite the use of the Detroit formula.[137]

The Wisconsin appellate court decision in *American Telephone & Telegraph Co. v. Department of Revenue*, is another example of a state court decision holding that subsidiary factor representation is required when dividends are included in the tax base, even though there was no finding relative to a specific percentage of distortion or disproportionality.[138] The Department of Revenue included dividends paid by the subsidiaries to AT&T in the company's apportionable tax base without including the apportionment factors of the subsidiaries in the apportionment formula.[139] AT&T argued that the application of the standard three-factor formula did not fairly represent the taxpayer's business activity in Wisconsin and requested that the denominator of its property factor include the book cost of the investment in and advances to the subsidiaries generating the dividend income.[140] The court rejected the Department's argument that the property factor only included tangible and real property, noting the argument ignored the nature of the unitary business.[141] The court concluded that the legislature, in referring to the "taxpayer's" real and tangible personal property, had not affirmatively intended to limit the property factor of the apportionment formula to real and tangible personal property owned or used by the parent corporation of a unitary business and found that neither the statute nor Wisconsin case law excluded from the apportionment formula the value of

[134] *Id.* at 744.

[135] *Id.* at 745.

[136] *Id.* at 741.

[137] *Id.* at 744-45. The court then went on to determine whether the election of methods offered to taxpayers as a threshold matter could save the separate entity method. *Id.* at 744. The court relied on *Campbell v. Wood*, 18 F.3d 662, 680 (9th Cir. 1994), which deals with an election between unconstitutional conditions of probation and constitutionally permissible incarceration for the proposition that the right to elect between an unconstitutional method and a constitutional method will not save the unconstitutional method. *Id.* The problem is that *Campbell v. Wood* is a death penalty case in which, among other things, the Ninth Circuit said that a defendant could waive his constitutional right to be present during jury selection. *Campbell*, 18 F.3d at 671.

[138] Am. Tel. & Tel. Co. v. Dep't of Revenue, 422 N.W.2d 629, 636 (Wis. Ct. App. 1988).

[139] *Id.* at 631.

[140] *Id.*

[141] *Id.* at 632.

AT&T's investment in the real and tangible personal property of its subsidiaries.[142]

The court then turned to the question of whether the formula fairly reflected AT&T's business activity in the state. The court stated that while the formula passed the internal consistency test, it did not reasonably reflect the way income was generated.[143] The court noted that, although dividends received from functionally integrated subsidiaries were included in apportionable income, a state could not tax such income by use of an apportionment formula unless the formula bore a reasonable relationship to the corporate activities in the state. The court found that the required reasonable relationship did not exist.[144]

The Pennsylvania Commonwealth Court has also addressed the issue in the context of its franchise tax.[145] The Pennsylvania franchise tax was imposed on the capital stock value of every out-of-state corporation doing business in Pennsylvania and was designed to tax only the business conducted in the Commonwealth.[146] Unisys owned either directly or indirectly the stock of more than 100 domestic and foreign corporations.[147] Under the statute, the tax base included the value of the investments, and the dividends received from those investments.[148]

Unisys argued that both the Due Process and Commerce Clause require the inclusion of the property, payroll, and sales of its affiliates in the apportionment formula because excluding these items was fundamentally

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[142] *Id.*

[143] *Id.* at 634-36.

[144] *Id.* at 635-36. While the court did not specifically discuss the degree of disproportionality and did not analyze it in terms of the *Hans Rees'-Container* standard, a careful reading of the decision indicates that the court was satisfied that there was substantial disproportionality. In its external consistency analysis, the court recited figures which read together tend to demonstrate the existence of gross disproportionality. *Id.* at 634-35. For example, AT&T reported $500 million in earned income and $3 billion in intangible income; the Wisconsin percentage of AT&T property was 1.5 percent while the Wisconsin percentage of AT&T unitary group property was .1 percent or one fifteenth of the AT&T percentage; AT&T had 235 employees in Wisconsin while AT&T had a total of 34,906 employees and the unitary group had over 735,000 employees. *Id.*

[145] Unisys Corp. v. Commonwealth, 726 A.2d 1096 (Pa. Commw. Ct. 1999).

[146] *Id.* at 1098.

[147] *Id.* at 1099.

[148] Under the formula elected by Unisys, only the tangible property, the payroll, and the sales of Unisys itself were included in the apportionment formula. *Id.* A taxpayer could elect to apportion its net worth using a single factor formula. *Id.* Had Unisys elected the single-factor formula, the value of the intangible property would have been included in the formula. *Id.* at 1099 n.4. The court acknowledged that where a taxpayer has the right to choose an alternative that passes constitutional muster, it cannot later complain if it chooses an alternative that has an unconstitutional result, but concluded that both alternatives would have resulted in actionable distortion.

unfair.[149] In the alternative, Unisys argued that it was entitled to statutory equitable relief under the special apportionment provision of the statute.[150] The court in analyzing whether an apportionment formula complied with due process, recognized the Supreme Court developed a two-part test. The court applied the external consistency test articulated in *Container*, concluding that the difference of 44.5 percent between the results of the standard three-factor formula and the Unisys combined reporting approaches was not sufficient to demonstrate that the result of the three-factor formula was "outside of the constitutional margin of error delineated by the Supreme Court."[151]

Additionally, the court addressed whether the Pennsylvania equitable relief statute, which was modeled on Section 18 of UDITPA, contained a different standard of disproportionality for granting relief, or, put another way, whether what constitutes unfairness under Section 18 differs from what constitutes unfairness under the Constitution.[152] The court answered the question in the affirmative, saying of the nearly 45 percent difference, "we simply cannot say that an allocation so far at variance 'fairly represents the extent of [Unisys'] business activity in this State.' "[153] Thus, the apportionment formula did not fairly reflect Unisys's business activity in the Commonwealth.

An analysis of the cases that have addressed the issue of factor representation for subsidiaries that have made dividend, royalty, or interest payments to U.S. parent corporations gives rise to two basic questions that must be answered. First, does the disparate treatment of domestic and foreign affiliates run afoul of the *Kraft* decision and violate the Foreign Commerce Clause? Second, does the lack of symmetry resulting from the failure to include the factors of the payors result in unfair representation of the business activities carried out in the taxing jurisdiction, thus resulting in a disproportionate amount of income being assigned to the taxing jurisdiction? If the answer to either of these questions is yes, the foreign subsidiaries' factors should be included in the apportionment formula.

2. *The Sales Factor - Fair Representation*

The three-factor formula that was approved by the Supreme Court in *Butler Bros.*, had become the benchmark against which all other formulas are

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149 *Id.* at 1100-01.

150 *Id.* at 1103 (citing 72 PA. CONS. STAT. § 7401(3)2.(a)(18) (1999)).

151 *Id.* at 1102-03.

152 *Id.* at 1104.

153 *Id.* The court pointed out that each case must be decided on its own merits, and Section 18 relief may not be granted in all cases. *Id.* at 1104-05. The court specifically stated that the inclusion of the factors in the apportionment formula was not the only remedy available to the Department. *Id.* at 1105.

measured.[154] Historically, the standard formula was the ratio of a taxpayer's in-state property, payroll, and sales to total payroll, property, and sales.[155] Traditionally, it was thought that these items represented how the business value was generated.[156] A sales measure was included in the formula to represent the contribution the market state made to a business' profitability. The UDITPA definition of the term "sales" coupled with the movement to a single or heavily weighted sales factor apportionment scheme has increased the need to evaluate "fair representation" and develop alternative apportionment methods to fairly reflect the business activities of the taxpayer.[157]

One of the more complex sales factor issues relates to the treatment of receipts derived from the sale of intangible assets. The issue has several facets. First, the issue arises with respect to treatment of receipts from the sale of short-term financial investments used in the business, *e.g.*, commercial paper, U.S. Treasury investments or hedging transactions. The financial activities giving rise to the receipts are conducted in the regular course of business and constitute a necessary and fundamental business function. A plain reading of the UDITPA provisions, *e.g.*, the definition of "sales," would support the conclusion that the gross receipts from these financial transactions should be included in the computation of the denominator of the sales factor.[158] For sales factor numerator purposes the gross receipts would be sourced consistent with the various state provisions for sourcing receipts from other than the sale of tangible property.[159] The inclusion of the gross receipts in the

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[154] *Container*, 463 U.S. at 170.

[155] UDITPA Section 9 incorporates the concept of an evenly weighted three-factor formula. UNIF. DIV. OF INCOME FOR TAX PURPOSES ACT § 9 (Unif. L. Comm'n 1957).

[156] The standard three-factor formula was designed for manufacturing and mercantile companies. The property and payroll factors reflect the contribution of the manufacturing states (origin states) and the sales factor represents the contribution of the market states (destination states). *See* Pomp, *supra* note 68; see also Arthur D. Lynn, Jr., *The Uniform Division of Income for Tax Purposes Act*, 19 OHIO ST. L.J. 41, 51 (1958).

[157] UDITPA Section 1 defines the term "sales" to mean "all gross receipts of the taxpayer not allocated under Sections 4 through 8 of this Act." UNIF. DIV. OF INCOME FOR TAX PURPOSES ACT § 1(g) (Unif. L. Comm'n 1957). The comments clearly state the inclusive definition is intended to make apportionable all income not specifically allocated. *Id.* at § 1(g) cmt. The comments for UDITPA Section 1(a) make it clear income from sales of property used in a trade or business are included in the apportionment factors. *Id.* at § 1(a) cmt.

[158] The term "sales" is defined in UDITPA as all "receipts" or all gross receipts of the taxpayer. *See id.* at § 1(g).

[159] The receipts for purposes of the sales factor under current statutes would be sourced either using a cost of performance method or a market-based sourcing method. UDITPA Section 17 adopts the cost of performance method. *Id.* at § 17. MTC Model Regulation IV.17 adopts the market-based sourcing method of apportioning receipts from other than tangible personal property. MODEL GEN. ALLOCATION & APPORTIONMENT REGUL. § IV.17.(a)(1) (MULTISTATE TAX COMM'N, amended 2018).

denominator, although consistent with the definition of sales, potentially reduces the amount of income assigned to a taxing jurisdiction. This raises the issue of whether the formula fairly reflects the business activities in the state. The fair reflection requirement is magnified when the standard apportionment formula consists of a single or heavily weighted sales factor. As a result, taxing authorities have argued that the inclusion of these types of gross receipts, *e.g.*, receipts from financial transactions, in the computation of the sales factor creates a gross disparity between the factor's contribution to profitability and the taxpayer's actual profitability in the state. The fundamental question is whether the sales factor, particularly in a single sales factor apportionment scheme, is a good indicator of the business activity conducted in the state.

The California courts faced with this issue developed a qualitative and quantitative analysis to determine if treasury function receipts should be included in the sales factor.[160] A key metric for the quantitative analysis is the profit margins among the various business activities.[161] The qualitative analysis focuses on the similarity between business activities.[162] The treasury function transactions generated only 2 percent of Microsoft's business income but approximately 73 percent of its gross receipts.[163] The court in applying the quantitative/qualitative analysis concluded that the inclusion of the treasury function gross receipts created sufficient distortion to justify the use of alternative apportionment methods.[164] The alternative method adopted excluded the treasury function receipts from the computation of the sales factor.[165] Excluding the receipts was determined by the court to be a reasonable means of accurately reflecting the taxpayer's business in the state.[166] The MTC model regulations have been revised to limit the receipts from these types of transaction to net receipts.[167]

The Minnesota Supreme Court, applying a *Microsoft* quantitative and qualitative analysis, held the inclusion of the gross receipts from foreign exchange contracts did not fairly represent Du Pont's business activity in

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160 *Microsoft*, 139 P.3d at 1180-81.

161 *Id.* at 1180.

162 *Id.* at 1181; *see also* General Mills, Inc. v. Franchise Tax Bd., 146 Cal. Rptr. 3d 475, 488 (Cal. Dist. Ct. App. 2012).

163 *Id.* at 1182.

164 *Id.*

165 *Id.*

166 *Id.*

167 MTC Model Regulation IV.2.(a) excludes certain proceeds, *e.g.*, the repayment of principal of a loan, bond, or mutual fund or certificate of deposit or similar marketable instruments and amounts realized on the federally-unrecognized exchanges of inventory, from "gross receipts" even if the income is included in apportionable business income. MODEL GEN. ALLOCATION & APPORTIONMENT REGUL. §§ IV.2.(a)(5), (6) (MULTISTATE TAX COMM'N, amended 2018).

Minnesota. The court concluded that the use of net receipts as an alternative formula did fairly represent those business activities.[168]

Constitutionally, fair apportionment requires symmetry between the tax base and the apportionment factors. The question is how that symmetry is achieved in a single sales factor apportionment scheme when, unlike in the historic three-factor apportionment scheme, there are no additional factors to mitigate the potential for an unreasonable result. This is particularly troublesome when the single sales factor apportionment scheme is coupled with the sale of assets, stock, partnership interests, or an extraordinary transaction such as the sale of an entire enterprise. A single sales factor standard apportionment formula's treatment of receipts derived from these types of transactions may and frequently does give rise to the need for an alternative apportionment method.

A recent Michigan decision is a good example of the issue.[169] Minnesota Limited was headquartered in Minnesota and engaged in pipeline repair activities in Michigan during the first 3 months of 2011.[170] In early 2011, in connection with the sale of its company to Vectren, Minnesota Limited made an election under Internal Revenue Code section 338(h)(10) to treat the sale for tax purposes as a sale of assets.[171] The sales transaction was a terminating event for both federal and Michigan income tax purposes and the company's tax year immediately ended on March 31, 2011.[172] This termination required the filing of a three-month short period income tax returns for both Michigan and federal tax purposes.[173] The short period tax return reported a capital gain of approximately $51 million recognized on the deemed asset sales.[174] The capital gain represented approximately 93 percent of the income reported on the Michigan short period return.[175] The Department of Treasury, however, did not permit the inclusion of the receipts from the deemed sale of the assets in the computation of the apportionment formula.[176] As a result,

[168] E. I. duPont de Nemours & Co. v. Comm'r, 25 N.W.3d 381, 397 (Minn. 2025). It should be noted, the court's conclusion is consistent with MTC Model Regulation IV.18.(c), which provides if gains on the sale of liquid assets are not excluded from the sales factor by other provisions under Regulation IV.18(c), only the overall net gains (rather than the gross proceeds) recognized from certain sales of liquid assets should be included in the sales factor. MODEL GEN. ALLOCATION & APPORTIONMENT REGUL. § IV.18.(c) (MULTISTATE TAX COMM'N, amended 2018).

[169] Vectren Infrastructure Servs. Corp. v. Dep't of Treasury, 999 N.W.2d 748 (Mich. 2023).

[170] *Id.* at 753-54.

[171] *Id.* at 766.

[172] *Id.* at 754.

[173] *Id.*

[174] *Id.* at 788 (Zahra, J., dissenting).

[175] *Id.*

[176] *Id.* at 789.

approximately 70 percent of the company's income was apportioned to Michigan.[177]

While the fact pattern in *Vectren* was unique—with a one-time capital gain intersecting with a short-period return—the inclusion of significant income in the corporate tax base without any factor representation is not unique and is an example of how a single sales factor apportionment scheme operates unfairly. Although 93 percent of Minnesota Limited's tax base included in Michigan's taxable income was attributable to the capital gain from the sale of the business (the gain-represented value that had accrued over the 32 plus years the company had been in business), the apportionment formula excluded all the (sales) factors associated with generating the capital gain, *i.e.*, the value associated with both the business's tangible and intangible assets.[178] The Michigan statutory apportionment formula, without utilizing its "safety valve" allowing for alternative apportionment, was devoid of any factors that contributed to the significant capital gain that Vectren was required to include in its Michigan taxable income.[179] This lack of symmetry between the tax base and the apportionment formula resulted in approximately 70 percent of Vectren's entire enterprise value being apportioned to Michigan, a state that played at best a minimal role in contributing to the company's overall value. The failure of the Michigan courts to address the lack of symmetry is an example of an apportionment scheme that potentially violates the external consistency test set forth in *Container*, as there was no rational relationship between Minnesota Limited's business activity in Michigan and the factors in the apportionment formula. The prescribed apportionment formula did not properly reflect a rational relationship between income attributed to Michigan and Minnesota Limited's business activities within Michigan.[180]

V. Acceptable Alternative Apportionment Methods

UDITPA Section 18 provides for the use of alternative methods of apportionment when the standard formula does not fairly represent the business activities reported to the taxing jurisdiction. Four approaches to resolving this inequity are found in Section 18. Those four approaches include the use of separate accounting; the exclusion of one or more factors; the inclusion of additional factors; and the employment of any other method to effectuate an equitable allocation or apportionment of the taxpayer's income.[181] The alternative method must reasonably reflect the taxpayer's business activity in the taxing jurisdiction.[182]

[177] *Id.*
[178] *Id.* at 804. The key drivers of the gain were the intangible assets associated with goodwill. *Id.*
[179] *Id.* at 804, 809.
[180] *Id.* at 813 (Viviano, J., dissenting).
[181] UNIF. DIV. OF INCOME FOR TAX PURPOSES ACT § 18 (UNIF. L. COMM'N 1957).
[182] *Id.* at § 18 cmt.

A. *Separate Accounting*

Separate (geographic) accounting is a technique which carves out of the taxpayer's overall business the activities taking place, the property employed, and the income derived from sources within a single state. The method analyzes and attributes the profits to that portion of the business conducted within the state.[183] The theory of separate accounting is based on the premise that a multistate taxpayer can be divided into separate segments so that the activities within one taxing jurisdiction may be segregated from the activities in other jurisdictions.[184] Thus, the income is taxed based on the business activities within the geographic confines of the state. Separate accounting requires the identification of all items of income and costs related to the business activities within the taxing jurisdiction and then the computation of a statewide net income using those items.[185] There are two general methods used to compute the separate income of a multistate manufacturing business. The first method ascertains the actual cost of the manufacturing and adds to it a reasonable profit. The profit may be determined by looking at the profit earned by similar corporations in comparable businesses. The second method ascertains the price at which the articles manufactured may be purchased from another manufacturer. That price is then used to establish a selling price from which manufacturing costs are then subtracted to arrive at the income earned.

The Court has addressed use of separate accounting as an alternative apportionment method. In *Exxon Corporation v. Wisconsin Department of Revenue*, the Court rejected the taxpayer's separate accounting argument and approved the use of formula apportionment by Wisconsin saying that "a State may apply an apportionment formula to the taxpayer's total income in order to obtain a 'rough approximation' of the corporate income that is 'reasonably related to the activities conducted within the taxing State.' "[186] Three years later, the Court stated separate accounting had theoretical weaknesses that justify the use of formula apportionment.[187] Thus, the Court once again

[183] Tex. Co. v. Cooper, 107 So. 2d 676, 679 (La. 1958).

[184] *Id.* at 683-84.

[185] *See id.* at 682-83.

[186] Exxon Corp. v. Wis. Dep't of Revenue, 447 U.S. 207, 223 (1980) (quoting *Moorman Mfg.*, 437 U.S. at 273).

[187] *Container*, 463 U.S. at 180-84. While separate accounting cannot by itself impeach the results of formula apportionment, separate counting can. In *Norfolk & Western*, the Court struck down the use of a mileage formula to apportion rolling stock to Missouri for property purposes. 390 U.S. at 329. By actual count of rolling stock in the State on tax day, the railroad showed that 2.71 percent of its rolling stock was in the state. *Id.* at 327. This was good enough to impeach the apportionment formula which assigned 8.28 percent of the rolling stock to the state. *Id.*

confirmed that the apportionment formula need not obtain absolute accuracy.[188]

B. *Addition or Exclusion of Factors*

Section 18 acknowledges that inequity in an apportionment formula may be resolved by adding or excluding a factor from the formula. This approach has been used in a number of scenarios. With respect to the taxation of foreign dividends, royalties, and interest income the state courts have fashioned alternative methods by incorporating additional factors into the formula. The alternative apportionment method known as the "Detroit Formula" provides for the inclusion of the factors of the dividend paying corporation.[189] While initially developed to be used for the taxation of dividends, the methodology applies equally to interest and royalty income.

The Detroit Formula was developed when the prevailing apportionment formula was the standard three-factor formula. However, the fundamental concepts of the Detroit Formula also apply in a single sales factor apportionment scheme. In general, the method includes in the denominator of the property, payroll, and sales factors the property, payroll, and sales of the taxpayer's controlled foreign subsidiaries in the same ratio that the net dividends received from those subsidiaries bear to each subsidiary's entire net profits. The ratio cannot exceed 100 percent of the profits.[190] The rationale is those factors contributed to the subsidiaries' profits that were distributed in the form of dividends. In a single sales factor scheme the same rationale applies: the receipts of the subsidiaries are reflective of the profits that are being distributed in the form of a dividend.

The methodology employed by the Detroit Formula gives rise to a number of unanswered questions. Specifically, (1) Should the income of the foreign subsidiaries be reduced by foreign income tax paid; (2) Is the proportionate

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[188] *See* Exxon Corp. v. S.C. Tax Comm'n, 258 S.E.2d 93 (1979). The taxpayer argued that its exploration and production activities comprised an unrelated business and that the income allocated by it to those activities should be directly assigned to the states where such activities were conducted. *Id.* at 95. The South Carolina Supreme Court ruled that the corporation was a single unitary business comprised of the exploration and production of crude oil and natural gas, the refining of crude oil and the marketing of natural gas, and refined petroleum products. *Id.* at 97. Further, the court held that the corporation possessed the characteristics of unity of ownership, unity of management, and unity of operation. *Id.* The court upheld the tax assessment, concluding that it was not multiple taxation to levy taxes on different incidents, and that the corporation showed no multiple burden. *Id.* at 99-100.

[189] The Detroit Formula was named after an agreement addressing how foreign dividends should be reported for Detroit income tax purposes that was reached between Ford Motor and the City of Detroit. *See* Lynn A. Gandhi, *Rev Your Engines — The Detroit Formula, Time for a Revival?*, 91 STATE TAX NOTES (TA) 467, 469 (Feb. 11, 2019).

[190] *Id.* With respect to a year in which a loss is incurred, the ratio is net dividends received divided by the retained earnings at the beginning of the tax year.

contribution of the foreign affiliates to the property, payroll, and sales computed on a combined basis (*i.e.*, the royalties, interest income, and dividends paid by all foreign subsidiaries are combined and then divided by the combined income of all subsidiaries to determine the ratio); and (3) Should the formula be modified to reflect the single sales factor apportionment scheme? These questions gain significant importance as the states expand the corporate income tax base to include additional foreign source income.[191]

A second method, the Augusta formula, was devised by Maine State Tax Assessor in response to the Maine Supreme Judicial Court decision in *Tambrands*.[192] Under the Augusta formula, when a taxpayer receives dividends from a unitary foreign affiliate, the taxpayer's Maine income tax liability is determined by making and comparing the results of three separate calculations:

a) First, the income of the taxpayer is apportioned using the water's edge method and including the foreign source dividends in the income subject to apportionment.

b) Second, the income of the taxpayer is apportioned using the worldwide combined reporting method in which the income and factors of foreign unitary subsidiaries are included in the computation.

c) Third, the water's edge method is used, but the foreign source dividends are excluded from the income subject to apportionment.[193]

If the tax assessed using the water's edge method, with the dividends included, does not exceed the tax computed using the worldwide combined reporting method, the water's edge method will be used, and the dividends will be included in the income subject to apportionment.[194] If the tax assessed using the worldwide combined method is lower than the amount computed using the water's edge method with dividends included, then the worldwide combined method is used.[195] Thus, the water's edge method, with the exclusion of foreign source dividends, becomes a floor below which the tax is not allowed to fall. If the worldwide combined reporting yields a higher Maine income tax than the statutory water's edge combined reporting method, the statutory computation is used even though foreign source dividends are included, and there is no adjustment to the factors.

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[191] For example, the states of Minnesota and Illinois both amended their statutes to include 50% of GILTI in the tax base. MINN. STAT. § 290.21(10); 35 ILL. COMP. STAT. 5/203(b)(2)(O) (2025).

[192] *E.I. Du Pont*, 675 A.2d at 83.

[193] *Id.* at 84.

[194] *Id.* at 90.

[195] *Id.*

C. *Any Other Method*

The fourth approach allows for the utilization of any other method that will result in an equitable apportionment of a taxpayer's business activities. While the initial intent of the drafters of Section 18 was to utilize it in unusual cases and/or when the standard formula would reach an unconstitutional result, the scope of Section 18 has been broadened over the years. The question is whether the intended "safety valve" is broad enough to encompass adjustments to the tax base. Put another way, may a taxing authority require, or a taxpayer request the use of, combined unitary reporting, an adjustment to the tax base, as an alternative apportionment method?[196] Recent court decisions raise the question of whether Section 18 is a proxy for combined reporting.

South Carolina has been at the forefront of asserting combined unitary reporting as an alternative apportionment method. The rationale is found in South Carolina's Supreme Court's reasoning in *Media General Communications, Inc. v. South Carolina Departmentt of Revenue*. In *Media General*, the taxpayers argued that because of related party transactions related to intangibles and licenses, the standard apportionment formula did not fairly reflect their South Carolina business activities.[197] The taxpayers requested combined unitary reporting as an alternative apportionment method.[198] The court rejected the Department's argument that it did not have the authority to grant the request to use combined unitary reporting and held that combined unitary reporting was an appropriate alternative apportionment method under South Carolina's version of Section 18.[199] The South Carolina Department of Revenue, in response to the *Media General* Decision, issued Revenue Ruling 15-5, setting forth guidance on the use of alternative apportionment in general and the use of combined unitary reporting as an alternative method.[200] South Carolina has continued to assert the use of

[196] A combined return is a method of computing the taxable income of a unitary group. The traditional method of combined-return reporting has the unitary business principle as its foundation. This method dictates that the apportionable tax base include the income of the entire unitary business group, without regard for the business's organizational structure. This method's objective is to treat all members of the unitary business group as a single entity by requiring the taxpayer to include the income and factors of other affiliated entities engaged in the same unitary business in calculating its apportioned share of the unitary business's income. UDITPA § 18(d) & cmt.

[197] *Media Gen.*, 694 S.E.2d at 527.

[198] *Id.*

[199] *Id.* at 532. The Department of Revenue stipulated that combined reporting was an appropriate alternative apportionment method. *Id.* at 529.

[200] S.C. Rev. Rul. #15-5. The guidance is in the form of revenue ruling and not a regulation, giving rise to potential deference issues.

combined unitary reporting to adjust the tax base rather than the allocation of apportionment of the tax base to South Carolina.[201]

In contrast to South Carolina, California rejected the argument that Revenue and Taxation Code section 25137 allowed an adjustment to the tax base. The State Board of Equalization (SBE) in *Appeal of Crisa* set forth the circumstances when alternative apportionment would be appropriate.[202] The case involved a worldwide combined return that included a Mexican subsidiary that had suffered through Mexico's hyperinflation.[203] The taxpayer argued that under section 25137, it was entitled to an adjustment to the standard apportionment formula to account for the distortive effect of the Mexican hyperinflation.[204] The SBE, in rejecting the taxpayer's argument, stated that section 25137 was a part of UDITPA and UDITPA only deals with the allocation and apportionment of income and not the computation of the income itself.[205] Thus, there was no statutory support for adjusting the tax base. The California Franchise Tax Board Legal Ruling No. 2019-01 addresses requests for variances and alternative apportionment and makes clear that Revenue and Taxation section 25137 does not grant statutory authority to grant variances for items unrelated to apportionment and allocation.[206]

The California approach is grounded in the original purpose of UDITPA. William J. Pierce, who was the principal drafter of UDITPA, stated that:

> [UDITPA] assumes that the existing state legislation *has defined the base of the tax* and that the only remaining problem is the amount of the base that

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[201] *Tractor Supply Co.* addressed the South Carolina Department of Revenue's authority to require combined reporting from Tractor Supply Company despite the state's general practice of separate entity reporting. Tractor Supply Co., No. 19-ALJ-17-0416-CC, 2023 WL 5216952, at *34-46 (S.C. Admin. L. Ct. 2023). The court upheld the Department's position, finding that the company's transfer pricing practices resulted in income distortion and that combined reporting was a reasonable method to fairly represent the company's business activity in South Carolina. *Id.* at 41. Tractor Supply has appealed the decision to the South Carolina Court of Appeals. In *CarMax*, the South Carolina Department of Revenue conducted an audit of CarMax for fiscal years 2016–2018 and determined that the company's intercompany transactions significantly distorted its taxable income in the state. CarMax Auto Superstores, Inc., No. 21-ALJ-17-0182-CC, 2024 WL 3469780, at *1 (S.C. Admin. L. Ct. 2024). As a result, the Department imposed an alternative apportionment method, requiring CarMax to file combined income tax returns. *Id.* The Administrative Law Court upheld the Department's position, finding that the intercompany transactions did indeed distort income and that combined reporting was a reasonable method to fairly represent CarMax's business activity in South Carolina. *Id.* at *42-43. CarMax has appealed this decision to the South Carolina Court of Appeals.

[202] *Appeal of Crisa Corp.*, No. 34424, 2002 WL 1400003, at *8-11 (Cal. St. Bd. Equal. 2002).

[203] *Id.* at *1.

[204] *Id.* at *2.

[205] *Id.* at *8; *see also Appeal of CTI Holdings, Inc.*, , (Cal. St. Bd. Equal. 1996).

[206] Cal. Franchise Tax Bd. Legal Rul. 2019-01.

> should be assigned to the particular taxing jurisdiction. Thus, the statute does not deal with the problem of ascertaining the items used in computing income or the allowable items of expense.[207]

Based on the original rationale for UDITPA and Section 18, an argument may be made that South Carolina is an outlier. Section 18 is not a proxy for adjustments to the computation of taxable income or the use of combined unitary reporting. The section does not grant a taxing jurisdiction the authority to adjust the tax base or a taxpayer to request an adjustment to taxable income.

VI. Conclusion

The evolution of state apportionment methodologies, particularly the expansive use and interpretation of UDITPA Section 18, reflects the increasing complexity of multistate and multinational business taxation. Originally intended as a constitutional safety valve to prevent arbitrary or unreasonable applications of the standard apportionment formula, Section 18 has, in practice, become a mechanism invoked not only in cases of constitutional distortion but also in circumstances where the statutory formula fails to reflect economic reality.

The divergence in state-level interpretations and applications of Section 18 has created a patchwork of standards, undermining the uniformity that UDITPA sought to achieve. Some jurisdictions, such as California, have constrained Section 18 within its traditional boundaries, limiting its application to adjustments in allocation and apportionment, and not to changes in the computation of the tax base. Others, notably South Carolina, have interpreted Section 18 more broadly, using it as a vehicle for combined reporting and other structural modifications to address perceived inequities in tax outcomes. This dissonance raises critical questions about the permissible scope of state discretion under the guise of alternative apportionment.

Judicial decisions interpreting the constitutional requirements of fair apportionment, namely, internal consistency, external consistency, and nondiscrimination have set meaningful but flexible guardrails. Yet, the lack of a consistent evidentiary standard for invoking Section 18 across jurisdictions fosters uncertainty for both taxpayers and state tax administrators. As states continue to expand their tax bases to include items such as GILTI, NCTI, Subpart F income, foreign dividends, royalties, and gains from intangible assets, the demand for meaningful symmetry between the tax base and the apportionment factors grows increasingly urgent.

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[207] William J. Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 TAXES 747, 747 (1957) (emphasis in original).

To preserve the integrity of interstate and foreign commerce and ensure the equitable application of state tax laws, greater uniformity and transparency in the application of alternative apportionment provisions are essential. Reforms, whether judicial, legislative, or through model regulations promulgated by the MTC, should aim to clarify the threshold for invoking Section 18 and delineate the appropriate bounds of alternative methodologies. Without such guidance, the original objectives of UDITPA—uniformity, fairness, and constitutional compliance—risk erosion amid the growing complexity of the modern tax landscape.