



# State Tax Alternative Apportionment

A “New” Tax Consideration for Multistate Businesses

By Wayne D. Roberts and Jay Long

**A**lternative apportionment is a remedial measure used to provide for fair taxation of multistate businesses that has been available to both state taxing authorities<sup>1</sup> and taxpayers for many years. And although this alternative apportionment concept is not entirely new, recent developments in the law and the business environment offer the potential for new and unprecedented applications of alternative apportionment. This article will examine alternative apportionment generally, review both historical and current developments, and discuss the relevance of these issues for multistate taxpayers in navigating the current economic climate.

### Tax base apportionment and alternative apportionment

A review of traditional statutory apportionment methods applicable to multistate business activities helps us understand alternative apportionment. In general, each state in which a multistate taxpayer conducts a unitary business activity<sup>2</sup> is legally entitled to tax its fair share of the business's activity using a reasonable apportionment methodology.<sup>3</sup> A state can impose its business tax on an apportioned basis and collect taxes from out-of-state companies that conduct business within its borders.<sup>4</sup> State apportionment statutes typically involve a mechanical calculation determined by multiplying an apportionment factor based on some combination of property, payroll, and sales by a particular multistate business's tax base. The tax base is typically the business's total income, gross receipts, net worth, or a tax base based on

some other measure. Application of a statutory apportionment formula results in an arithmetic division of a multistate taxpayer's aggregate tax base (e.g., income) among the states in which the taxpayer conducts business.<sup>5</sup> That type of formula apportionment is distinguished from an allocation, which specifically allocates readily identifiable quantities of different types of income (e.g., investment interest income) to be taxed in full in a particular state.<sup>6</sup>

Under alternative apportionment, a taxpayer can calculate its apportioned state tax base by deviating from a state's statutorily mandated apportionment formula. Alternative apportionment is available in cases in which the statutory formula fails to fairly represent a taxpayer's business activity in a particular state.<sup>7</sup> Alternative apportionment is not merely a matter of administrative or legislative grace, but is mandated by constitutional due process and commerce clause considerations, which require that state taxes on interstate business activity must be fairly apportioned.<sup>8</sup>

Many states, including Michigan, have adopted a statutory framework authorizing use of alternative apportionment;<sup>9</sup> however, neither state taxing authorities nor taxpayers have regularly used this method except in extreme cases. Recent caselaw developments and the current business climate indicate that businesses may be well served to review potential alternative apportionment implications to assess potential audit exposure and potential tax-planning opportunities.

### Historical alternative apportionment foundations

Because alternative apportionment exists as a statutorily provided method of calculating state tax liabilities and as a constitutionally derived right, the history of alternative apportionment involves both statutory and caselaw considerations.

#### Statutory foundations of alternative apportionment

The statutory concept of modern apportionment is largely based on the Multistate Tax Compact, a model law adopted by the Multistate Tax Commission (MTC) in an effort to promote uniformity in tax administration procedures among states relative to multistate businesses.<sup>10</sup> A key provision of the compact is Article IV, which consists of the Uniform Division of Income for Tax Purposes Act (UDITPA). UDITPA was originally approved by the National Commission on Uniform Laws as a model act in 1957 and addresses the equitable allocation and apportionment of income of multistate businesses, using as its recommended standard a three-factor apportionment formula comprised of property, payroll, and receipts.<sup>11</sup> Importantly, UDITPA Section 18 provides for statutory apportionment relief in cases in which the standard three-factor formula does not fairly represent the extent of

### At a Glance

If a company does business in multiple states, each state expects to collect a tax on the business activity conducted within its borders. They often adopt policies to maximize the amount of taxes they collect. Suppose a company builds a machine in Ohio, has a sales force in Indiana, and sells the machine in Michigan. How is the income from this activity apportioned? Apportionment is a tax issue that is frequently litigated based on differing state laws and the overriding governance of the U.S. Constitution. This article addresses the use of an alternative apportionment methodology, which addresses deficiencies that arise from the use of formulas by states to tax multistate companies. Alternate apportionment methods offer a potential tax savings opportunity and a way to minimize potential audit exposure.

**Any taxpayer considering a Michigan alternative apportionment strategy should adopt a plan that minimizes exposure to challenges. A careful review of Department of Treasury guidance is a first step toward developing a successful strategy.**



the taxpayer's business activities in a particular state. UDITPA Section 18 provides, in relevant part, as follows:

If the [standard] allocation and apportionment provisions . . . do not fairly represent the extent of the taxpayer's business activity in this State, the taxpayer may petition for or the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (a) separate accounting;
- (b) the exclusion of any one or more of the factors;
- (c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this State; or
- (d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.<sup>12</sup>

#### Caselaw foundations for alternative apportionment

*Hans Rees' Sons v North Carolina*, the seminal case in which alternative apportionment relief was granted, was decided in 1931. In *Hans Rees*, a New York company with multi-state and international business activities illustrated that although 17 percent of its business income on average was attributed to activities performed in North Carolina, between 66–85 percent of its business income was taxed by North Carolina based on that state's single-factor apportionment formula.<sup>13</sup> The Supreme Court held that the apportionment formula was invalid as applied to *Hans Rees* because income attributed to North Carolina was "out of all appropriate proportion to the business transacted . . . in that state."<sup>14</sup>

The *Hans Rees* decision reaffirms the constitutional requirement that alternative apportionment should be available to correct unconstitutional reporting of income in a particular state. But courts have also held that alternative apportionment relief may not be "confined to correcting constitutional distortions."<sup>15</sup> Even if a distortion does not rise to the level of a constitutional violation, that distortion could nevertheless provide a basis for alternative apportionment premised on a fact-specific analysis.

#### Overview of apportionment and alternative apportionment in Michigan

Consistent with constitutional precedent, Michigan law provides for formulary apportionment in cases in which a taxpayer has business activity in multiple states.<sup>16</sup> If a Michigan taxpayer conducts multistate business and apportionment applies, the state's standard statutory apportionment formula utilizes a single sales factor to apportion the taxpayer's income to Michigan. The relevant statute provides:

- (2) [t]he tax base of a taxpayer whose business activities are confined solely to this state shall be allocated to this state. The tax base of a taxpayer whose business activities are subject to tax both within and outside of this state shall be apportioned to this state by multiplying the tax base by the sales factor . . .<sup>17</sup>

Although it is a sovereignty member of the MTC, Michigan has enacted a separate alternative apportionment statute that

varies slightly from the MTC model statute. The Michigan Corporate Income Tax (CIT) Act states:

- (1) If the apportionment provisions of this part do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the state treasurer may require the following, with respect to all or a portion of the taxpayer's business activity, if reasonable:
  - (a) Separate accounting.
  - (b) The inclusion of 1 or more additional or alternative factors that will fairly represent the taxpayer's business activity in this state.
  - (c) The use of any other method to effectuate an equitable allocation and apportionment of the taxpayer's tax base.
- (2) An alternate method may be used only if it is approved by the department.
- (3) The apportionment provisions of this part shall be reputedly presumed to fairly represent the business activity attributed to the taxpayer in this state, taken as a whole and without a separate examination of the specific elements of the tax base unless it can be demonstrated that the business activity attributed to the taxpayer in this state is out of all appropriate proportion to the actual business activity transacted in this state and leads to a grossly distorted result or would operate unconstitutionally to tax the extraterritorial activity of the taxpayer.
- (4) The filing of a return or an amended return is not considered a petition for the purposes of subsection (1).<sup>18</sup>

### Michigan administrative guidance

In 2018, the Michigan Department of Treasury issued Revenue Administrative Bulletin 2018-28 to explain its view of how alternative apportionment operates under the CIT Act.<sup>19</sup> In the bulletin, the department provides specific guidance on alternative apportionment including the standards and procedures for requesting relief, and discusses its view that taxpayers seeking alternative apportionment relief must "prove by clear and convincing evidence that the statutory method grossly distorts the taxpayer's business activity in Michigan or operates to unconstitutionally tax extraterritorial activity and that the proposed alternative is a reasonable method of apportioning the taxpayer's income."<sup>20</sup>

For a taxpayer to seek alternative apportionment, the department requires that the taxpayer submit a request at least 90 days before the due date of the initial or amended return.<sup>21</sup> The request must be in writing, be clearly labeled "Request for Alternative Apportionment," identify the tax type and tax period, include a statement showing why the standard method does not fairly represent the taxpayer's business activity, include a proposed alternative apportionment method, and

disclose whether the proposed apportionment method is being used by other states.<sup>22</sup>

Any taxpayer considering a Michigan alternative apportionment strategy should adopt a plan that minimizes exposure to challenges. A careful review of Department of Treasury guidance is a first step toward developing a successful strategy.

### State caselaw

The Michigan Court of Appeals earlier this year considered an apportionment challenge and granted alternative relief to a Minnesota corporation that conducted business activities in multiple states, including Michigan. In *Vectren Infrastructure Services Corporation v Department of Treasury*,<sup>23</sup> the court reversed a lower court decision that upheld the standard formula apportionment method, finding that Michigan's formula resulted in a constitutional distortion. The *Vectren* court analyzed whether the application of Michigan's statutory apportionment formula operated to "unreasonably and arbitrarily attribute to the taxing state a percentage of the total income out of all appropriate proportion to the business transactions by the taxpayer in that state."<sup>24</sup> The Department of Treasury filed an application for leave to appeal with the Michigan Supreme Court, which is pending.

Shortly after the *Vectren* case was decided, the Mississippi Supreme Court granted alternative apportionment relief to a taxpayer that challenged its franchise tax liability. In *Mississippi Department of Revenue v Comcast Cable Communications*, Comcast had multiple unitary and non-unitary subsidiaries that operated multistate business activities.<sup>25</sup> The unitary businesses provided limited services in Mississippi; the non-unitary subsidiaries had no connection with Mississippi. Comcast argued that the franchise tax assessment based on the standard apportionment system did not fairly represent the true value of business activity in Mississippi because the formula included capital related to investments in its non-unitary subsidiaries.<sup>26</sup> Comcast also offered an alternative apportionment formula to correct the alleged distortion.<sup>27</sup> The court accepted Comcast's argument based on a finding that the standard apportionment formula and related tax assessment did not fairly represent the true value of its business activity and capital in Mississippi.<sup>28</sup>

### Potential alternative apportionment issues specific to the COVID-19 environment

In the current business climate, many businesses have employees working remotely from different locations, including multiple states. In these cases, having a single employee in a state could create nexus and a tax filing responsibility in the state in which the employee is working.<sup>29</sup> Accordingly, with employees working from home and other locations,



both nexus and apportionment issues can be of increasing importance. And though certain states have enacted nexus exceptions and will not deem nexus to exist if employees are working at home within the state due solely to the COVID-19 pandemic, many states have remained silent on the issue.

## Conclusion

Although alternative apportionment has been a component of state tax law for many years, recent caselaw and the current environment render now as a good time for taxpayers to review whether there are opportunities—or audit exposures—related to alternative apportionment. In many situations, businesses may find that they have material tax liability in a state due to corporate and unitary business structures,<sup>30</sup> non-unitary affiliates, one-time business transactions, economic nexus,<sup>31</sup> or nexus created by employees working at home or factors beyond its control. If businesses have such liabilities that do not fairly represent activity in the relevant state, alternative apportionment could be an option. Taxpayers should also bear in mind that while some states have enacted laws or issued guidance to protect corporations from tax nexus if a company has employees working at home in a taxing state due solely to COVID-19,<sup>32</sup> many states do not provide such explicit relief. Therefore, most taxpayers with multistate activities or with employees working from home in different taxing jurisdictions will benefit from a review of applicable state laws to determine whether alternative apportionment might apply to them and learn the administrative requirements for requesting such relief. ■



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## ENDNOTES

1. *Vodafone Americas Holdings, Inc & Subsidiaries v Roberts*, 486 SW3d 496, 533 (2016) (upheld the Department of Revenue's use of alternative apportionment for a wireless business based on a finding that the statutorily-provided costs of performance formula failed to fairly represent the taxpayer's business activity in the state).
2. *Mobil Oil Corp v Comm'r of Taxes*, 445 US 425, 439; 100 S Ct 1223; 63 L Ed 2d 510 (1980).
3. *Underwood Typewriter Co v Chamberlain*, 254 US 113, 118; 41 S Ct 45; 65 L Ed 165 (1920).
4. *Id.* and *Complete Auto Transit, Inc v Brady*, 430 US 274; 97 S Ct 1076; 51 L Ed 2d 326 (1977).
5. E.g., MCL 206.661.
6. E.g., MCL 206.110(4) (rents, royalties, capital gains, interest, dividends or patent or copyright royalties, to the extent they constitute nonbusiness income, are specifically allocated).
7. *Hans Rees' Sons v North Carolina*, 283 US 123, 130, 134; 51 S Ct 385; 75 L Ed 879 (1931). See also, Revenue Admin Bull 2018-28; this and other bulletins are available at <[https://www.michigan.gov/taxes/0,4676,7-238-43551\\_84522-456662-,00.html](https://www.michigan.gov/taxes/0,4676,7-238-43551_84522-456662-,00.html)> [<https://perma.cc/CMC8-VWB43>]. All websites cited in this article were accessed October 3, 2020.
8. *Complete Auto Transit, Inc v Brady*, 430 US 274, 279; 97 S Ct 1076; 51 L Ed 2d 326 (1977) and *Container Corp v Franchise Tax Bd*, 463 US 159, 165-166; 103 S Ct 2933; 77 L Ed 2d 545 (1983).
9. E.g., MCL 206.667.
10. Multistate Tax Comm, *About The Multistate Tax Compact, With Suggested Enabling Act* (January 2015), available at <[www.mtc.gov/getattachment/The-Commission/Multistate-Tax-Compact/About-the-Compact-and-Suggested-Enabling-Act.pdf.aspx](http://www.mtc.gov/getattachment/The-Commission/Multistate-Tax-Compact/About-the-Compact-and-Suggested-Enabling-Act.pdf.aspx)> [<https://perma.cc/P4A2-C726>].
11. *Id.* and Multistate Tax Compact, Art IV(9) (1967), as amended. This and other articles of the Multistate Tax Compact are available at <<http://www.mtc.gov/The-Commission/Multistate-Tax-Compact>> [<https://perma.cc/9YBY-N3X5>].
12. Multistate Tax Compact, Art IV(18)(a) (1967), as amended.
13. *Hans Rees*, 283 US at 128.
14. *Id.* at 135.
15. E.g., *Microsoft Corp v Franchise Tax Bd*, 39 Cal.4th 750, 765 n 16; 139 P3d 1169 (2006) and *Twentieth Century Fox Film Corp v Dep't of Revenue*, 299 Or 220; 700 P2d 1035 (1985).
16. MCL 206.661.
17. *Id.*
18. MCL 206.667.
19. Revenue Admin Bull 2018-28.
20. *Id.* at p 2.
21. *Id.* at p 5.
22. *Id.* at pp 5-6.
23. *Vectren Infrastructure Services Corp v Dep't of Treasury*, unpublished per curiam opinion of the Court of Appeals, issued March 12, 2020 (Docket No. 345462).
24. *Id.* at 4.
25. *Mississippi Dep't of Revenue v Comcast of Georgia/Virginia, Inc*, opinion of the Supreme Court of Mississippi, issued August 13, 2020 (No. 2019-CA-01134-CT).
26. *Id.* at \*2-\*3.
27. *Id.* at \*2.
28. *Id.* at \*8.
29. E.g., *Telebright Corp v Director, New Jersey Div of Taxation*, 424 NJ Super 384; 38 A3d 604 (2012).
30. E.g., MCL 206.611(5)-(6), MCL 206.691 and Revenue Admin Bull 2018-12.
31. *South Dakota v Wayfair, Inc*, 585 US \_\_\_, 138 S Ct 2080, 2099; 201 L Ed 2d 403 (2018).
32. E.g., *Telecommuter COVID-19 Employer and Employee FAQ*, New Jersey Div of Taxation (May 27, 2020) <<https://www.state.nj.us/treasury/taxation/covid19-payroll.shtml>> [<https://perma.cc/Q8Y9-2ZRJ>].