STATE+LOCAL TAX
INSIGHTS

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WHERE'S WALDEN? FINDING PROTECTION UNDER THE DUE PROCESS CLAUSE

By R. Gregory Roberts and Rebecca M. Ulich

In the aftermath of *Quill*, and the seemingly low threshold to satisfy the Due Process Clause articulated by the U.S. Supreme Court, many practitioners and taxpayers essentially abandoned the Due Process Clause as a tool to challenge assertions of nexus, preferring instead to focus on the Commerce Clause. However, several recent Supreme Court decisions should cause practitioners and taxpayers to rethink that strategy.

The Court's decisions in *Goodyear*, *J. McIntyre Machinery*, *Daimler* and *Walden* not only show the Court's renewed emphasis on the Due Process Clause as a limitation on assertions of jurisdiction under state long-arm statutes, but also provide taxpayers with a framework to challenge the ever-increasing assertions of nexus for tax purposes by state legislatures and taxing authorities.[1]

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This article begins with an overview of the Due Process Clause, including a discussion of the distinction between "specific" and "general" jurisdiction that was central to the Court's recent due process decisions. This article then discusses the Court's due process analyses in *Goodyear*, *J. McIntyre Machinery*, *Daimler* and *Walden* and concludes with insights into the potential impact of these cases in the state tax arena.

The Due Process Clause: Specific and General Jurisdiction

The Due Process Clause sets the outer boundaries of a state's jurisdiction over an out-of-state entity.[2] In determining whether the exercise of jurisdiction is permissible under the Due Process Clause, the Supreme Court has explained that "[i]t is evident that the criteria by which we mark the boundary line between those activities which justify the subjection of a corporation to suit and those which do not cannot be simply mechanical or quantitative."[3] The Court stated that "[t]he test is not merely, as has sometimes been suggested, whether the activity, which the corporation has seen fit to procure through its agents in another state, is a little more or a little less."[4] Rather, the Court explained that "[w]hether due process is satisfied must depend . . . upon the quality and nature of the activity in relation to the fair and orderly administration of the laws which it was the purpose of the due process clause to insure."[5] To satisfy due process, a state may only exercise jurisdiction over an out-of-state defendant that has certain "minimum contacts" with the state, such that the maintenance of the suit does not offend "traditional notions of fair play and substantial justice."[6]

The distinction between "specific" and "general" jurisdiction evolved from the Supreme Court's decision in *International Shoe Co. v. Washington*, in which the Court elaborated on the concept of "fair play and substantial justice."

The distinction between "specific" and "general" jurisdiction evolved from the Supreme Court's decision in *International Shoe Co. v. Washington*, in which the Court elaborated on the concept of "fair play and substantial justice" by recognizing that jurisdiction may be found over an out-of-state corporation where (i) the suit arises out of or relates to the corporation's contacts with the forum state ("specific" jurisdiction), or (ii) the corporation's continuous corporate operations within the forum state are so substantial and of such a nature as to justify suit against it on unrelated causes of action ("general" jurisdiction).[7]

After its decision in *International Shoe* in 1945, the Court's opinions focused primarily on circumstances involving specific jurisdiction. Prior to *Goodyear* and *Daimler*, the Court had issued only two decisions since *International Shoe* that considered whether an out-of-state corporate defendant's in-state contacts were sufficiently "continuous and systematic" to justify the exercise of general jurisdiction, which the Court has acknowledged requires a "higher threshold" showing than specific jurisdiction.[8]

The Court's recent decisions involving specific jurisdiction are particularly relevant in the state tax context, as indicated by the Court's decision in *Quill*, which followed a specific jurisdiction analysis.[9]

General Jurisdiction: *Goodyear* and *Daimler*

Goodyear involved a wrongful death suit filed in North Carolina state court by North Carolina residents whose sons had died in a bus accident in France, allegedly due to tires manufactured by the foreign subsidiaries of Goodyear.

The North Carolina Court of Appeals held that it could exercise general jurisdiction over the foreign corporations because their products had reached the State through "the stream of commerce," despite the fact that they had no presence in North Carolina and did not take any affirmative action to cause their tires to be shipped to the State.[10] In rejecting this "sprawling view of general jurisdiction," the Court found that "a connection so limited between the forum and the foreign corporation" was an "inadequate basis for the exercise of general jurisdiction" and would result in "any substantial manufacturer or seller of goods . . . be[ing] amenable to suit, on any claim for relief, wherever its products are distributed."[11] In reaching its decision, the Court concluded that "mere purchases made in the forum State, even if occurring at regular intervals, are not enough to warrant a State's assertion of general jurisdiction over a nonresident corporation in a cause of action not related to those purchase transactions."[12]

Elaborating on the distinction between specific and general jurisdiction, the Court in *Daimler* reversed the Ninth Circuit and held that California could not exercise general jurisdiction over a foreign corporation based solely on the presence in the State of a subsidiary.

Elaborating on the distinction between specific and general jurisdiction, the Court in *Daimler* reversed the Ninth Circuit and held that California could not exercise general jurisdiction over a foreign corporation based solely on the presence in the State of a subsidiary.[13] *Daimler* involved Argentinian residents who filed a complaint against DaimlerChrysler Aktiengesellschaft ("Daimler"), a German company, based

Upcoming Speaking Engagements

April 29

COST 2014 Income Tax Conference/Spring Audit Session
Colorado Springs, Colorado

- "Unitary Combined Returns: Who's In and Who's Not"
  Craig B. Fields

NYSBA New York State and New York City Tax Institute
New York, New York

- "New York State Corporate Tax
  Reform Legislation"
  Irwin M. Slomka

May 9

ABA Section of Taxation's 2014 May Meeting
Washington, DC

- "Handling an Equitable Apportionment Case"
  Craig B. Fields

May 14 - 16

TeleStrategies' Communication Taxation 2014
Lake Buena Vista, Florida

- "Sales and Excise Tax: Defense of Digital and 'Cloud' Products and Services from State Taxation"
  R. Gregory Roberts and Rebecca M. Ulich

May 19

Energy Tax Association's 24th Annual Meeting
San Antonio, Texas

- "Significant Developments In State And Local Taxation"
  Craig B. Fields and Nicole L. Johnson

May 22

Annual State + Local Tax West Coast Update
Morrison & Foerster, San Francisco, California

- See ad on pg. 20

May 29

Annual State + Local Tax East Coast Update
Morrison & Foerster, New York, New York

- See ad on pg. 20

June 5 - 6

2014 Oregon Tax Institute
Portland, Oregon

- "Recent Developments in State & Local Taxation"
  Thomas Steele

June 12

University of Wisconsin-Milwaukee's 18th Annual Multistate Tax Institute
Milwaukee, Wisconsin

- "The Multistate Income Tax Update"
  Craig B. Fields

June 21

NYSBA Tax Section Summer Meeting
Providence, Rhode Island

- "New York State Corporate Tax Reform Legislation"
  Irwin M. Slomka

June 26

TEI Region VII Annual Conference
Hilton Head Island, South Carolina

- "State Tax Controversy Updates"
  Craig B. Fields and Philip M. Tatarowicz

June 30 - July 1

IPT 2014 Annual Conference
Phoenix, Arizona

- "State Implications of International Transactions/ Operations"
  Craig B. Fields
- "Pitching the Perfect Game: Best Practices for Administrative Procedures"
  Hollis L. Hyans

July 24

NYU Summer Institute in Taxation
New York, New York

- "New York's Budget Bill/ Recently Enacted Legislation"
  Irwin M. Slomka

on allegations that Daimler's Argentinian subsidiary, Mercedes-Benz Argentina ("MB Argentina") collaborated with state security forces to commit human rights violations.[14] Jurisdiction for the suit was predicated on the California contacts of Mercedes-Benz USA, LLC ("MBUSA"), a U.S. subsidiary of Daimler that distributed Daimler-manufactured vehicles to independent dealerships throughout the United States, including California.[15]

The Ninth Circuit held that it could exercise general jurisdiction over Daimler based on an agency theory.[16] The Court noted that the Ninth Circuit's finding of an agency relationship "rested primarily on its observation that MBUSA's services were 'important' to Daimler" and, therefore, that "[t]he Ninth Circuit's agency theory thus appears to subject foreign corporations to general jurisdiction whenever they have an in-state subsidiary or affiliate, an outcome that would sweep beyond even the 'sprawling view of general jurisdiction' we rejected in *Goodyear*."[17]

Specific Jurisdiction: *McIntyre* and *Walden*

The Court's plurality opinion in *McIntyre* was released on the same day as *Goodyear*, and held that the New Jersey courts could not exercise specific jurisdiction over a foreign manufacturer that "at no time had [] advertised in, sent goods to, or in any relevant sense targeted the State."[18] In *McIntyre*, Robert Nicastro filed a products liability suit against J. McIntyre Machinery, Ltd. ("J. McIntyre") in New Jersey state court after injuring his hand while using a metal-shearing machine.[19] The machine was manufactured by J. McIntyre in England, where the company was incorporated and operated.[20] The assertion of jurisdiction rested on three facts: (i) "[t]he distributor agreed to sell J. McIntyre's machines in the United States;" (ii) "J. McIntyre officials attended trade shows in several States but not in New Jersey;" and (iii) "up to four machines ended up in New Jersey."[21] The New Jersey Supreme Court concluded that the exercise of "[j]urisdiction was proper . . . because the injury occurred in New Jersey," because J. McIntyre "knew or reasonably should have known that its products are

distributed through a nationwide distribution system that might lead to those products being sold in any of the fifty states" and "failed to take some reasonable step to prevent the distribution of its products in th[e] State."[22]

The New Jersey courts could not exercise specific jurisdiction over a foreign manufacturer that "at no time had [ ] advertised in, sent goods to, or in any relevant sense targeted the State."

In reversing the New Jersey Supreme Court's decision and finding that the State could not exercise jurisdiction over J. McIntyre, the U.S. Supreme Court explained that "[a] person may submit to a State's authority in a number of ways:" (i) "explicit consent;" (ii) "general submission to a State's powers [(general jurisdiction)];" and (iii) "a more limited form of submission to a State's authority for disputes that arise out of or are connected with the activities within the state [(specific jurisdiction)]."[23] The Court further explained that:

> Where a defendant purposefully avails itself of the privilege of conducting activities within the forum State, thus invoking the benefits and protections of its laws, it submits to the judicial power of an otherwise foreign sovereign to the extent that power is exercised in connection with the defendant's activities touching on the State. In other words, submission through contact with and activity directed at a sovereign may justify specific jurisdiction in a suit arising out of or related to the defendant's contacts with the forum.[24]

The Court then clarified its jurisprudence regarding the relationship between jurisdiction and the "stream of commerce" by noting that, although "[t]his Court has stated that a defendant's placing goods into the stream of commerce with the expectation that they will be purchased by consumers within the forum State may indicate purposeful availment," this "does not amend the general rule of personal jurisdiction."[25] Rather, the Court's prior statement "merely observe[d] that a defendant may in an appropriate case be subject to jurisdiction without entering the forum."[26] The Court elaborated that the principal inquiry is whether the defendant's activities manifested an intention to submit to the power of a sovereign, "[i]n other words, the defendant must purposefully avail itself of the privilege of conducting activities within the forum State, thus invoking the benefits and protections of its laws."[27] The plurality acknowledged that "[s]ometimes a defendant does so by sending its goods rather than its agents" into the forum state, further noting that "[t]he defendant's transmission of goods permits the exercise of jurisdiction only where the defendant can be said to have targeted the forum; as a general rule, it is not enough that the defendant might have predicted that its goods will reach the forum State."[28]

MOFO ATTORNEY NEWS

WELCOME: Morrison & Foerster's State + Local Tax Group would like to welcome **Eugene J. Gibilaro** and **Michael J. Hilkin**. Mr. Gibilaro and Mr. Hilkin join us as associates in the New York office.

"The defendant's transmission of goods permits the exercise of jurisdiction only where the defendant can be said to have targeted the forum; as a general rule, it is not enough that the defendant might have predicted that its goods will reach the forum State."

Justice Breyer and Justice Alito's concurrence similarly rejected the New Jersey Supreme Court's analysis because adopting the State court's view would "abandon the heretofore accepted inquiry of whether, focusing upon the relationship between the defendant, the *forum*, and the litigation, it is fair, in light of the defendant's contacts *with that forum*, to subject the defendant to suit there."[29] Instead, the Justices stated that they would rest jurisdiction "upon no more than the occurrence of a product-based accident in the forum State," but that "this Court has rejected the notion that a defendant's amenability to suit travels with the chattel."[30]

In *Walden v. Fiore*, the Supreme Court again engaged in an analysis involving specific jurisdiction and reversed the Ninth Circuit after finding that a Georgia police officer who was sued in Nevada by Nevada residents for an allegedly improper search and seizure in a Georgia airport lacked the "minimal contacts" necessary to be subject to specific jurisdiction in Nevada.[31]

Anthony Walden was a police officer working at an airport in Atlanta, Georgia as part of a Drug Enforcement Agency task force. Mr. Walden seized cash from Gina Fiore and Keith Gipson while they were attempting to board a connecting flight to Nevada.[32] Ultimately, no forfeiture complaint was filed against Ms. Fiore and Mr. Gipson and the funds were returned.[33] However, at some point after Mr. Walden seized the cash, he helped draft an affidavit to show probable cause

for the forfeiture of the funds and forwarded that affidavit to a U.S. Attorney's Office in Georgia.[34] Ms. Fiore and Mr. Gipson alleged that the affidavit was false and misleading and filed suit against Mr. Walden in the federal district court for Nevada, claiming that their Fourth Amendment rights against unreasonable searches and seizures had been violated.[35]

The district court granted Mr. Walden's motion to dismiss for lack of personal jurisdiction because it found that the search and seizure in Georgia were not sufficient to establish jurisdiction in Nevada and further, that even if Mr. Walden caused Ms. Fiore and Mr. Gipson harm while knowing that they lived in Nevada, that fact alone did not confer jurisdiction to Nevada.[36]

On appeal to the Ninth Circuit, a divided panel reversed the district court's decision.[37] Although the Ninth Circuit assumed that the search and seizure in Georgia could not support an exercise of personal jurisdiction in Nevada, the court held that jurisdiction could be exercised based on Mr. Walden's affidavit.[38] The court found that, because Mr. Walden knew that the affidavit would affect persons with a "significant connection" to Nevada, Mr. Walden's submission of the affidavit was "expressly aimed" at Nevada.[39] Further, the court found that personal jurisdiction was proper because the delay in returning the funds caused "foreseeable harm" in Nevada and the exercise of personal jurisdiction was otherwise reasonable.[40]

The Supreme Court reversed. In reaching its decision, the Court explained that "[t]he inquiry whether a forum State may assert specific jurisdiction over a nonresident defendant focuses on the relationship among the defendant, the forum, and the litigation."[41] The Court also stated that, "[f]or a State to exercise jurisdiction consistent with due process, the defendant's suit-related conduct must create a substantial connection with the forum State."[42]

The Court emphasized that for specific jurisdiction, the necessary relationship with the state "must arise out of contacts that the defendant *himself* creates with the forum State" and noted that the Court has "consistently rejected attempts to satisfy the defendant-focused 'minimum contacts' inquiry by demonstrating contacts between the plaintiff (or third parties) and the forum State."[43] Thus, the "'minimum contacts' analysis looks to the defendant's contacts with the forum State itself, not [to] the defendant's contacts with persons who reside there." Although the Court acknowledged that "a defendant's contacts with the forum State may be intertwined with his transactions or interactions with the plaintiff or other parties," the Court reiterated that "a defendant's relationship with a plaintiff or third party, standing alone, is an insufficient basis for jurisdiction."[44]

As Mr. Walden's activities related to the search and seizure, including the drafting and submission of the affidavit, occurred in Georgia, and as Mr. Walden had no connections with Nevada, the Court found that Mr. Walden had "formed no jurisdictionally relevant contacts with Nevada."[45]

The "'minimum contacts' analysis looks to the defendant's contacts with the forum State itself, not [to] the defendant's contacts with persons who reside there."

In reaching its decision, the Court noted that the Ninth Circuit's opinion had erroneously "shift[ed] the analytical focus from [Mr. Walden's] contacts with the forum to his contacts with [Ms. Fiore and Mr. Gipson]."[46] The Court explained that the Ninth Circuit's reasoning "improperly attributes a plaintiff's forum connections to the defendant and makes those connections 'decisive' in the jurisdictional analysis" and "also obscures the reality that none of petitioner's challenged conduct had anything to do with Nevada itself."[47] Further, the Court noted that, even if the deprivation of access to their funds constituted a distinct injury to Ms. Fiore and Mr. Gipson, such an injury "is not the sort of effect that is tethered to Nevada in any meaningful way" because they "would have experienced this same lack of access in California, Mississippi, or wherever else they might have traveled and found themselves wanting more money than they had."[48] Thus, the Court found that the effects of Mr. Walden's conduct on Ms. Fiore and Mr. Gipson were not connected to Nevada "in a way that makes those effects a proper basis for jurisdiction."[49] Similarly, the Court found that contact by Ms. Fiore and Mr. Gipson's attorney was "precisely the sort of 'unilateral activity' of a third party that cannot satisfy the requirement of contact with the forum State" and the fact that some of the seized cash originated in Nevada was also an "attenuated connection [that] was not created by petitioner."[50]

Insights

The Supreme Court's recent attention to the Due Process Clause, as well as recent state supreme court decisions in *Scioto* and *ConAgra*, have injected new life into the previously moribund Due Process Clause as a mechanism to challenge the ever-increasing assertions of nexus by states.[51] The Court's decisions in *Goodyear*, *McIntyre*, *Daimler* and *Walden* provide important insight into the types of connections with the forum state that are necessary to establish jurisdiction under the Due Process Clause. In particular, the plurality's emphasis on "purposeful availment" in *McIntyre*, together with the Court's emphasis on the *defendant's* contact with the forum state in *Walden*, provide a useful framework for challenging assertions of nexus in the state tax arena.

At a minimum, the Court's analyses call into question state assertions of nexus based solely on the activities of in-state subsidiaries or affiliates, as well as bright-line nexus provisions that impute nexus on entities based solely on the amount of sales into the state. These types of provisions also seemingly contravene the Court's warning against "simply mechanical or quantitative" tests to determine whether the exercise of

jurisdiction is proper under the Due Process Clause.[52]

Further, in light of the Court's statement in *Walden* that an out-of-state entity's activities must be "tethered" to the state in a "meaningful way," together with its "purposeful availment" analysis in *McIntyre*, it is at least questionable whether the Court would view merely selling items over the Internet or through an online intermediary, for example, without any additional contact with the forum state, to be sufficient to establish nexus under the Due Process Clause.[53]

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1 *Goodyear Dunlop Tires Operations, S.A. v. Brown*, 131 S. Ct. 2846 (2011); *J. McIntyre Mach., Ltd. v. Nicastro*, 131 S. Ct. 2780 (2011); *Daimler AG v. Bauman*, 134 S. Ct. 746 (2014); *Walden v. Fiore*, No. 12-574 (Feb. 25, 2014).

2 *Goodyear*, 131 S. Ct. at 2853; *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286, 291 (1980).

3 *International Shoe Co. v. Washington*, 326 U.S. 310, 319 (1945).

4 *Id.*

5 *Id.*

6 *Goodyear*, 131 S. Ct. at 2853 (quoting and citing *International Shoe*) (internal quotations omitted).

7 326 U.S. 310 (1945); *see also Daimler*, 134 S. Ct. at 754 (discussing the development of specific and general jurisdiction); *Goodyear*, 131 S. Ct. at 2853-54 (same).

8 *Goodyear*, 131 S. Ct. at 2854 (citing to *Perkins v. Benguet Consol. Mining Co.*, 342 U.S. 437 (1952) and *Helicopteros Nacionales de Colombia, S.A. v. Hall*, 466 U.S. 408 (1984) as the two post-*International Shoe* cases involving an analysis of general jurisdiction).

9 *Quill Corp. v. North Dakota*, 504 U.S. 298, 308 (1992) (concluding that "there is no question that Quill has purposefully directed its activities at North Dakota residents, that the magnitude of those contacts are more than sufficient for due process purposes, and that the use tax is related to the benefits Quill receives from access to the State").

10 *Goodyear*, 131 S. Ct. at 2846.

11 *Id.* at 2851, 2856.

12 *Id.* at 2856 (quoting and citing *Helicopteros*, 466 U.S. at 418) (internal quotations omitted).

13 *Daimler*, 134 S. Ct. at 746.

14 *Id.*

15 *Id.*

16 *Id.*

17 *Id.* at 759-60. The Court noted that it "need not pass judgment on invocation of an agency theory in the context of general jurisdiction, for in no event can the appeals court's analysis be sustained." *Id.* at 759. Therefore, the question of whether an agency relationship is sufficient to establish general jurisdiction remains open. The Court, however, recognized that "[a]gency relationships . . . may be relevant to the existence of *specific* jurisdiction" but that "[i]t does not inevitably follow . . . that similar reasoning applies to *general* jurisdiction. *Id.* at n.13 (emphasis in original).

18 *J. McIntyre Mach.*, 131 S. Ct. at 2780.

19 *Id.*

20 *Id.*

21 *Id.* at 2790.

22 *Id.* at 2786.

23 *Id.* at 2787.

24 *Id.* at 2787-88.

25 *Id.* at 2788 (quoting and citing *World-Wide Volkswagen*, 444 U.S. at 298) (internal quotations omitted).

26 *Id.* at 2788.

27 *Id.*

28 *Id.*

29 *Id.* at 2793 (quoting and citing *Shaffer v. Heitner*, 433 U.S. 186, 204 (1977)) (internal quotations omitted) (emphasis in original).

30 *Id.* at 2793 (quoting and citing *World-Wide Volkswagen*, 444 U.S. at 296) (internal quotations omitted). In questioning the Court's seemingly strict interpretation of "purposeful availment," however, the concurrence asked:

> What do those standards mean when a company targets the world by selling products from its Web site? And does it matter if, instead of shipping the products directly, a company consigns the products through an intermediary (say, Amazon.com) who then receives and fulfills the orders? And what if the company markets its products through popup advertisements that it knows will be viewed in a forum?

J. McIntyre Mach., 131 S. Ct. at 2793 (Breyer, J., concurring).

31 No. 12-574 (Feb. 25, 2014).

32 *Id.*

33 *Id.*

34 *Id.*

35 *See Bivens v. Six Unknown Fed. Narcotics Agents*, 403 U.S. 388 (1971) (finding an implied cause of action for individuals whose Fourth Amendment rights have been violated).

36 *Walden*, No. 12-574.

37 *Id.*

38 *Id.*

39 *Id.*

40 *Id.*

41 *Id.* (quoting and citing *Keeton v. Hustler Magazine, Inc.*, 465 U.S. 770, 775 (1984) (quoting *Shaffer*, 433 U.S. at 204)) (internal quotations omitted).

42 *Id.*

43 *Id.* (citing *Helicopteros*, 466 U.S. at 417 and discussing *Hanson v. Denckla*, 357 U.S. 235, 253-54 (1958), *World-Wide Volkswagen*, 444 U.S. at 298 and *Rush v. Savchuk*, 444 U.S. 320, 332 (1980)).

44 *Id.*

45 *Id.*

46 *Id.*

47 *Id.*

48 *Id.*

49 *Id.*

50 *Id.*

51 *Scioto Ins. Co. v. Okla. Tax Comm'n*, 279 P.3d 782, 784 (Okla. 2012) (finding that "[d]ue process is offended by Oklahoma's attempt to tax an out of state corporation that has no contact with Oklahoma other than receiving payments from an Oklahoma taxpayer . . . under a contract not made in Oklahoma"); *Griffith v. ConAgra Brands, Inc.*, 728 S.E.2d 74, 84 (W. Va. 2012) (holding that "royalties earned from the nation-wide licensing of food industry trademarks and trade names [did not] satisfy . . . 'purposeful direction' under the Due Process Clause").

52 *International Shoe*, 326 U.S. at 310.

53 In light of efforts to pass federal legislation, it should be noted that, "while Congress has plenary power to regulate commerce among the States and thus may authorize state actions that burden interstate commerce, it does not similarly have the power to authorize violations of the Due Process Clause." *Quill*, 504 U.S. at 305 (finding that due process was satisfied where the out-of-state company sold its products into the State *and* "solicit[ed] business through catalogs and flyers, advertisements in national periodicals, and telephone calls").

CFCs AND SUBPART F INCOME IN A CALIFORNIA WATER'S-EDGE ELECTION AND WHAT'S WRONG WITH THE *APPLE* DECISION

By Eric J. Coffill

By default, California employs the worldwide unitary method to tax the income of corporations engaged in a unitary business on an international basis. That method has passed federal constitutional muster in cases where there is either a domestic[1] or a foreign[2] parent corporation. However, in 1986, and primarily for political reasons, the California Legislature enacted a water's-edge election ("Election") beginning in income year 1988, under which certain foreign operations of a taxpayer's worldwide unitary business were excluded from the tax base.[3]

Terms of the Election

Subsequent to its legislative creation over 25 years ago, the Election has gone through many legislative amendments. Currently, the most basic of the terms of the Election are: (1) it must be made on a timely filed original return for the year of the Election by all unitary taxpayers included in the combined report; (2) the taxpayer elects for an initial 84 month period and the Election generally remains in place thereafter until terminated; (3) the taxpayer agrees to the business income treatment of certain dividends; and (4) the taxpayer agrees to the taking of depositions from key employees or officers and the acceptance of subpoena *duces tecum* for reasonable document production.[4] Six classifications of entities are included in the water's-edge group, four of which are wholly-included and two of which are partially-included.[5] This article will examine the partial inclusion of the income and factors of unitary controlled foreign corporations ("CFCs").

Specifically, the CFCs subject to partial inclusion in the water's-edge combined report are unitary CFCs, as defined in Internal Revenue Code ("IRC") Section 957, that have Subpart F income.[6] A CFC, generally, is a corporation organized in a foreign country that is more than 50% owned by U.S. shareholders.[7] "Subpart F" income takes its name from Subpart F of the IRC and includes certain forms of passive income earned by CFCs, for example, dividends, income from bank accounts and stock investments.[8] For federal tax purposes, Subpart F income is treated as a deemed dividend to the U.S. shareholder. However, in the Election, Subpart F income becomes part of the formula used to determine the portion of the CFC's income and factors that are included in the combined report.

In general, the income and apportionment factors of a unitary CFC that are included in the water's-edge group are determined by multiplying the income and apportionment factors of the CFC by a fraction, the numerator of which is the CFC's Subpart F income (as defined in IRC Section 952) for that taxable year and the denominator of which is the CFC's earnings and profits for that year (as defined in IRC Section 964).[9] Thus, in the simplest of examples, if a CFC has Subpart F income of $100 for the year and its earnings and profits for the year are $200, then the so called "inclusion ratio" (*i.e.*, 100/200) is 50%. That ratio does not change depending on the ownership interest held in the CFC.[10] Likewise, 50% of the CFC's apportionment factors – currently sales only[11] – are included in the combined report.[12] If there is either no Subpart F income or no current earnings and profits, then none of either the income or the apportionment factors of the CFC will be included in the combined report.[13]

Other than any adjustments for dividends exclusions/deductions discussed below, rarely should material issues arise regarding the computation of the current year earnings and profits figure to be used in the inclusion ratio because, in most cases, that figure can be taken directly from Federal Form 5471.[14] Likewise, regarding the income of the CFC against which the inclusion ratio is applied, other than adjustments for dividend exclusions/deductions discussed below, rarely should material issues arise regarding the computation of the CFC's net income because that figure can be taken from the CFC's books and records, adjusted to conform to California tax law.[15]

Dividend Elimination Under the Election

A significant problem involving CFCs under the Election arises in connection with how dividends are included in the Subpart F income used to compute the inclusion ratio where a CFC owns another CFC and a dividend is paid by a lower-tier CFC to a higher-tier CFC. There are typically two sections of the California Revenue and Taxation Code under which a corporation may eliminate or deduct such dividends.[16] First, Section 25106 generally provides that a corporation may eliminate dividends received from unitary subsidiaries to the extent that the dividends are paid from unitary earnings and profits accumulated while both the payee and payor were members of the combined report.[17] Second, Section 24411 generally provides a 75% deduction for qualifying dividends paid to a member of the water's-edge combined report.[18]

A significant problem involving CFCs under the Election arises in connection with how dividends are included in the Subpart F income used to compute the inclusion ratio where a CFC owns another CFC and a dividend is paid by a lower-tier CFC to a higher-tier CFC.

Whether dividends are eliminated under Section 25106 or deducted under Section 24411 is generally important in two contexts. First, the obvious difference is that Section 25106 provides a full exclusion while Section 24411 permits taxation of 25% of the dividends. Second, other provisions may provide a related disallowance or offset of expenses where dividends are deducted under Section 24411.

For example, Section 24425 disallows deductions for expenses that are "allocable"[19] to items of income that are not included in the measure of tax, but Section 24425 does not apply to expenses that are allocable to dividends eliminated under Section 25106.[20] In addition, Section 24344(c) provides that interest expenses incurred for purposes of foreign investment (as defined in the statute) may be offset against the foreign dividend deduction allowed under Section 24411.[21] Thus, taxpayers may deduct expenses related to dividends eliminated under Section 25106, but expenses and interest expenses related to dividends deducted under Section 24411 may be curtailed under Sections 24425 and 24344(c).[22]

Taxpayers may deduct expenses related to dividends eliminated under Section 25106, but expenses and interest expenses related to dividends deducted under Section 24411 may be curtailed under Sections 24425 and 24344(c).

Fujitsu IT Holdings, Inc. v. Franchise Tax Board[23]

In *Fujitsu IT Holdings, Inc. v. Franchise Tax Board*, the Court of Appeal held that where a CFC receives a dividend that was paid by a lower-tier CFC out of current year earnings consisting of a mix of income previously included in a combined report[24] and excluded from a combined report, the dividends are (1) *first* treated as paid out of earnings eligible for full (100%) elimination under Section 25106; and (2) the *excess* is treated as paid out of earnings eligible for the partial (75%) deduction under Section 24411.

For example, if the lower-tier CFC has current year income of $100, $60 of which was included a combined report[25] and $40 of which was not included in a combined report, and pays a dividend of $100 to a higher-tier CFC in the combined report, then $60 will be eliminated under Section 25106[26] and $40 should be deductible under Section 24411.[27]

Fujitsu also held that the dividends at issue were excluded not only because of the Section 25106 exclusion, but also because of California's incorporation of IRC Section 959(b), which excludes from gross income such dividends to the extent they "are, or have been" included in the gross income of a U.S. shareholder under Subpart F.[28]

Fujitsu stated that in addition to the dividend elimination/deduction from the income of the CFC, "dividends paid out of unitary income of lower-tier subsidiaries should be excluded from all the factors" used in the computation of the inclusion ratio of the recipient CFC.[29] That is, such dividends should be excluded from the numerator (Subpart F income) and the denominator (earnings and profits).[30] Thus, the $60 in the above example should be excluded under *Fujitsu* from both the numerator (Subpart F) and the denominator (earnings & profits) of the inclusion ratio.

The Franchise Tax Board's ("FTB's") immediate reaction to its loss in *Fujitsu* was less than enthusiastic. In a 2005 Technical Advice Memorandum ("TAM"), the FTB directed audit and legal staff to implement *Fujitsu* as follows: (1) dividends described in IRC Section 959(b) will be excluded from the numerator of the inclusion ratio; (2) dividends described in Section 25106 will be eliminated from the numerator of the inclusion ratio; (3) the FTB will not eliminate dividends described in IRC Section 959(b) or Section 25106 from the denominator (earnings and profits) of the inclusion ratio;[31] and (4) dividends will be eliminated from the apportionable income base pursuant to Section 25106, but no reduction in the apportionable income base will be made with respect to dividends described in IRC Section 959(b).[32] The FTB stated these positions were taken "pending consideration" of proposed amendments to the FTB's regulations.[33]

Most surprising in the 2005 TAM was the FTB's bold statement that notwithstanding *Fujitsu*, it would "continue" to treat dividends as being paid *proportionately* from the current year earnings and profits and then from the next succeeding prior year. To its credit, the TAM stated that taxpayers "should be advised this position is contrary" to *Fujitsu*, but that the FTB had prepared proposed regulatory amendments "to provide clarity with respect to this issue."[34] However, apparently upon further reflection and in light of the fact that the FTB never amended its regulations,[35] the FTB later changed course and announced in a 2011 TAM that under *Fujitsu*, dividends paid from current year earnings and profits consisting of a "mix" of included and excluded income should be treated as paid first out of earnings eligible for elimination under Section 25106, with any excess paid out of earnings eligible for partial deduction under Section 24411 until that year's earnings are depleted.[36] This ordering rule (as opposed to a *pro rata* approach) remains the FTB's current position with respect to *Fujitsu* under the 2011 TAM.

Apple, Inc. v. Franchise Tax Board[37]

Seven years after *Fujitsu*, the Court of Appeal decided *Apple, Inc. v. Franchise Tax Board*.[38] As in *Fujitsu*, CFCs partially included under the Election repatriated earnings as dividends to the parent. Apple argued that the dividends were being paid from the CFC's undistributed earnings and profits accrued over the current *and prior* tax years and that California already had taxed all the earnings out of which the dividends were being

paid. Accordingly, Apple asserted that all of the dividends were excluded under Section 25106. In sum, Apple's position was that Section 25106 was applied by first looking to the current year's included income and next to the most recent year's included income, and so forth, until *all* of the previously included (*i.e.*, previously taxed) income was exhausted, and only *then* does one look to excluded income.

So, returning to the earlier example, Apple would argue that if the lower-tier CFC has current year earnings of $100, $60 of which were included in the current year a combined report and $40 of which in the current year were not included in a combined report, but the CFC has $40 of income from the immediate *previous* year that was included in the combined report, and pays a current year dividend of $100 to the higher-tier unitary CFC, then the entire $100 will be eliminated under Section 25106.[39]

The FTB in *Apple* had a different view. The FTB argued that dividends were deemed paid first from current year's earnings, regardless of whether or not all the current year's earnings were previously included in a combined report. The FTB argued that, in applying Section 25106, only after the current year's earnings are *fully* exhausted does one look at the earnings in prior years.

So, in the above example, the FTB would argue that the $100 dividend is first deemed to be paid from the current year's earnings of $100 and, because only $60 of those current year earnings was previously included in a combined report, the taxpayer is entitled to a deduction under Section 25106 of only $60 (not $100).

The FTB prevailed in *Apple*. Accordingly, the FTB's current position with respect to *Apple* and *Fujitsu* is as follows:

- **Ordering of Distributions Within a Year.** Under *Fujitsu,* dividend distributions within a year are treated as first paid from that year's earnings and profits, which are eligible for elimination under Section 25106, until those earnings are depleted, then from earnings eligible for other deductions, such as Section 24411, until that year's earnings are depleted.[40]
- **Last-In-First-Out Ordering Among Years.** Under *Apple*, the Last-In-First-Out ("LIFO") ordering rule applies to determine the order of the years from which dividend distributions are made, starting with the current year, and, only after that year's earnings are depleted, moving to the most recent prior year.[41]

CFC Considerations

To recap, where the Election is made involving CFCs, one should make the following basic inquiries: First, determine whether the dividend payor is a member of the taxpayer's water's-edge combined reporting group. Remember that a water's-edge election is simply the methodology for determining how members of the unitary group are included in the combined report. If an entity (even a CFC) is not unitary, it is excluded from the water's-edge combined report just as it would be excluded from a worldwide combined report.[42] Also, consider the possibility that a taxpayer may have multiple unitary businesses.[43] Second, determine if the income from the member is business income under California's so-called transactional and functional tests.[44] Third, determine the correct amount of income of the CFC for California purposes. Fourth, determine the numerator of the inclusion ratio based upon Subpart F income and ensure that certain dividends have been properly removed. Fifth, determine the denominator of the inclusion ratio. Sixth, determine the includable apportionment factors (*i.e.*, sales) of the CFC. Seventh, determine the proper amount of dividend deductions and eliminations under *Fujitsu* and *Apple*. Eighth, determine the impact of any dividend exclusions and eliminations upon claimed expenses under Sections 24425 and 24344(c).

Application of the *Fujitsu* and *Apple* Decisions

Finally, to consider a more abstract and interesting issue, was *Apple* correctly decided? Unfortunately, the California Supreme Court declined review in both *Fujitsu* and *Apple*, and both published Court of Appeal decisions were allowed to stand. In the author's opinion, certainly *Fujitsu* and *Apple* do not fit seamlessly together, and *Apple*'s distinguishing characterization of *Fujitsu* as addressing the application of Section 25106 and the inclusion ratio "in a different context" is a bit of an exaggeration.[45] The *Apple* decision takes the position that because the facts in *Fujitsu* involved the ordering of dividends *within* a tax year, *Fujitsu* has nothing to say on the issue of the ordering of dividends involving *prior* tax years.[46]

The *Apple* decision takes the position that because the facts in *Fujitsu* involved the ordering of dividends *within* a tax year, *Fujitsu* has nothing to say on the issue of the ordering of dividends involving *prior* tax years.

Several questionable points appear to drive the *Apple* decision. First, the court there gave short shrift to the issue of double taxation, perhaps because both the court and the FTB pointed out that "Apple cannot demonstrate any actual double taxation here" because, under the facts in that case, *all* of the dividends not eliminated under Section 25106 were fully deducted under Section 24402.[47] The FTB's briefing to the appellate court also stressed this point that *none* of the dividends were subject to tax in the year in issue because they all had been eliminated or deducted and, thus, Apple's claim that the FTB's ordering

rule led to double taxation lacked merit.[48] However, as noted above, if the case had instead involved facts where dividends were deducted under Section 24411, then only 75% of those dividends (instead of 100%) would have been deducted and double taxation most certainly would be an issue.

In addition, if the dividends are deducted under Section 24411, there is still the issue of expenses being disallowed under Sections 24425 and 24344(c), which are related to those dividends. In short, the *Apple* court's discussion of the double taxation issue is situational rather than comprehensive.

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Second, the *Apple* court's adoption of the FTB's argument that, "unlike the circumstances in *Fujitsu*," there is "specific statutory and regulatory authority" involving ordering and prior tax years is unsound.[49] *Apple* found that IRC Section 316, incorporated by reference into the California Revenue and Taxation Code,[50] and the FTB's regulations[51] both contain a LIFO, by year, dividend ordering rule.[52] The problem with the *Apple* court's reliance upon the regulatory authority is that an administrative agency may not promulgate a regulation that is inconsistent with the governing statute or that alters, amends, enlarges or impairs the scope of the statute, which brings us back to the question of the meaning, authority and scope of the underlying statute.[53]

The problem with the *Apple* court's reliance upon the regulatory authority is that an administrative agency may not promulgate a regulation that is inconsistent with the governing statute or that alters, amends, enlarges or impairs the scope of the statute.

The problem with the *Apple* court's reliance upon that statutory authority is that, as argued by Apple, IRC Section 959(c) contains "except as otherwise provided" language, which Apple argued to mean that IRC Section 959(c) "trumps" IRC Section 316. The court rejected Apple's argument here by stating that: (1) IRC Section 959(c), "unlike IRC section 316," is not "expressly incorporated" into the California Revenue and Taxation Code; (2) *Fujitsu* did not consider the "clear language" of IRC Section 316; and (3) *Fujitsu* "did not purport to invalidate Regulation 24411."[54]

The problem with the first point is that whether or not "expressly incorporated," *Fujitsu* did, in fact, hold that California has "adopted" IRC Section 959(b) and the *Fujitsu* court then proceeded to apply that subsection.[55] The problem with the second point is that the *Fujitsu* court certainly was aware of IRC Section 316 because they cited to it in defining dividend income.[56] IRC Section 316, "Dividend Defined," simply *defines* what a "dividend" is, but that section says nothing about how to "order" dividends, much less how to order dividends for purposes of applying a California-only dividend exclusion, *i.e.*, Section 25106. The problem with the third point is that the validity of regulation 24411 was not even an issue in *Fujitsu*, and cases are not authority for propositions not considered.[57] The regulation may indeed be invalid *if* one were to challenge it. In short, *Apple* improperly end-runs *Fujitsu* by proceeding on the premise that the *Fujitsu* court would have written a different opinion and would have not have made the "assumption" that California had adopted IRC Section 959(b) had the *Fujitsu* court considered the "clear language" of IRC Section 316 and FTB regulation 24411.[58]

Additionally, *Apple* essentially ignores the discussion and conclusion in *Fujitsu* regarding the purpose and function of Section 25106:

> The Legislature could hardly have chosen words with a clearer meaning. Simply put, section 25106 ensures that amounts included in the combined income of a unitary group can be moved (in the form of dividends) among members of the unitary group without tax consequence. The reason for this is also clear. In a combined unitary group, the subsidiaries' apportioned earnings are taxed as income of the unitary business. Because the state has already taxed the earnings out of which the dividends are paid, the dividends themselves are not subject to taxation. This prevents dividends from subsidiaries from being taxed twice – once as earnings of the issuing subsidiary, and once as separate income to the unitary business from receipt of the dividend.[59]

The *Apple* court responded simply that Section 25106 says nothing about the ordering of dividends or the tax year in which they should be recognized.[60] The court's approach ignores the language above, that Section 25106 ensures that amounts included in the combined income of a unitary group can be moved (in the form of dividends) among members of the unitary group "without tax consequence."[61]

Although the *Apple* court concedes that Section 25106 "expresses a clear legislative policy against imposition of double taxation on income," the court goes on to state that it was not convinced that the double taxation "specter" Apple invoked necessarily arose simply by virtue of LIFO ordering of

the dividend distributions.[62] Most telling is the *Apple* court's next statement that "[c]ertainly it does not appear that it did so *with respect to the tax year at issue here*."[63] Again, the author reads much of the *Apple* decision as being driven by the fact that both parties and the court *agreed* that *none* of the dividends for the year in issue were being taxed by the FTB because they were *all* either being eliminated or deducted in any event. That will not be the case for a taxpayer where only a partial (*i.e.*, 75%) deduction is taken under Section 24411, but Section 24411 was not an issue in *Apple*.

Fourth, there is perhaps a subtle undercurrent in *Apple* of a need to rule to prevent tax avoidance. For example, the *Apple* court comments that to allow preferential ordering of dividends between tax years, as sought by Apple, "would allow potentially indefinite tax avoidance . . . ."[64] The FTB added fuel to the fire by arguing in its briefing to the court that Apple's proposed ordering rule was a "manipulation of the tax laws . . . ."[65] Not so. Tax "avoidance" to use the *Apple* court's term, or more correctly, the avoidance of *double* taxation, would continue only until all previously taxed income was exhausted as a source for dividend elimination under Section 25106.

Finally, although referencing it, the *Apple* decision appears to give little weight to the California Supreme Court's longstanding rule that ambiguities in tax statutes are resolved in favor of the taxpayer.[66] Still further, while both the *Apple* and *Fujitsu* decisions cite to a standard body of case law that such decisions are not legally binding, the court in *Apple* seems to have given excessive and unwarranted deference to the lower administrative decision in the matter by the California State Board of Equalization.[67]

Conclusion

In conclusion, the inclusion ratio for CFCs under California's water's-edge election presents a variety of continuing issues involving the application of *Fujitsu* and *Apple*. And, in the author's opinion, *Apple* is ripe to be re-litigated.

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1 *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

2 *Barclays Bank PLC v. Franchise Tax Bd*., 512 U.S. 298 (1994).

3 1986 Cal. Stat., Ch. 660. For a more complete discussion of the history of the original election, see Eric. J. Coffill, "A Kinder, Gentler 'Water's Edge' Election: California Wards Off Threats of U.K. Retaliation as Part of Comprehensive Business Incentive Tax Package," *State Tax Notes*, Oct. 25, 1993, p. 965, and Eric J. Coffill, "California's New Water's Edge Election Provisions," *State Tax Notes*, Dec. 8, 2003, p. 845.

4 *See* Cal. Rev. & Tax. Code §§ 25110 *et seq.*; California FTB 100W Forms and Instructions, 2013 Corporation Tax Booklet Water's-Edge Filers.

5 Cal. Rev. & Tax. Code § 25110(a).

6 Cal. Rev. & Tax. Code § 25110(a)(2)(A)(ii).

7 *Fujitsu IT Holdings, Inc. v. Franchise Tax Bd.*, 120 Cal. App. 4th 459, 469, n. 4 (2004); *see also* IRC § 957.

8 *Fujitsu*, 120 Cal. App. 4th at 469. *Fujitsu* explains that the Subpart F provisions were enacted by Congress to deter U.S. taxpayers from using foreign subsidiary corporations to accumulate earnings in countries that impose no taxes on such earnings.

9 Cal. Rev. & Tax. Code § 25110(a)(2)(A)(ii). The inclusion ratio cannot exceed one. For example, if current year Subpart F income exceeds earnings and profits, the ratio is deemed to be one, *i.e.*, 100% of the CFC's income and apportionment factors would be included in the combined report.

10 The Subpart F income deemed dividend that is reported by the U.S. shareholder for federal purposes is based on the U.S. shareholder's pro-rata distribution under IRC Section 951(a). However, for California CFC inclusion ratio purposes, 100% of the Subpart F income is included in the numerator under Section 25110(a)(2)(A)(ii). Accordingly, if the U.S. shareholder owns less than 100% of the CFC, then the reportable Subpart F income for federal and California purposes would be different. *See* FTB Water's-Edge Manual, Rev: September 2006, Chapter 2, section 2.3(d). However, remember that a CFC that is owned less than 50% by the water's-edge group is excluded from the group because unity of ownership does not exist.

11 Under Proposition 39, for income years beginning on or after January 1, 2013, most corporate taxpayers apportion using single-factor sales. The three exceptions are for taxpayers that derive more than 50% of their gross business receipts from (1) agriculture, (2) extractive business or (3) bank/financial/savings & loan activities, which use an equally weighted three-factor formula consisting of payroll, property and sales. Cal. Rev. & Tax. Code § 25128.

12 Thus, using a single-sales factor formula, the total sales of the CFC will be included in total sales everywhere (*i.e.*, denominator) in the combined report. It is hard to imagine a situation where a CFC would have sales that are includible in the *numerator* of the California sales factor of the combined report because sales of tangible personal property are assigned on a destination basis and "other" sales are assigned on a market basis. *See* Cal. Rev. & Tax. Code §§ 25135-25136.

13 2013 Instructions for Form FTB 2416, Schedule of Included Controlled Foreign Corporations (CFC).

14 2013 Instructions for Form FTB 2416, Schedule of Included Controlled Foreign Corporations (CFC) (stating that "[earnings and profits ("E&P")], as defined in IRC section 964, includes both business and nonbusiness income for the current taxable year. In most cases, the E&P can be taken from federal Form 5471, page 4, Schedule H, line 5d"). California computes earnings and profits on a separate entity basis. *See Appeal of Young's Market Co.,* No. 84A-432-MCA (Cal. Bd. of Equalization Nov. 19, 1986).

15 2013 Instructions for Form FTB 2416, Schedule of Included Controlled Foreign Corporations (CFC) ("Report the total net income as reflected on the CFC's books and records, adjusted to conform to California tax law."). Typically the current year net income per books of the CFC is taken from IRS Form 5471, which states that the information is to be reported there in accordance with generally accepted accounting principles ("GAAP"). However, because Form 5471 is an "information return," accurate or complete GAAP adjustments may not have been made. Accordingly, bear in mind there are a number of foreign country accounting practices that do not "conform to California tax law" and, therefore, may require adjustment.

16 All statutory references herein are to the California Revenue and Taxation Code, except where otherwise indicated.

17 *See Willamette Industries, Inc. v. Franchise Tax Bd.*, 33 Cal. App. 4th 1242 (1995) (where dividends were paid from pre-acquisition earnings, *i.e.*, not paid from the income of the unitary business).

18 The deduction is 100% for dividends derived from certain foreign construction projects. Cal. Rev. & Tax. Code § 24411(c).

19 Determining precisely what expenses are "allocable" to what income under Section 24425 is not an easy task. In *Appeal of Zenith National Insurance Corp.*, No. 98-SBE-001 (Cal. Bd. of Equalization Jan. 8, 1998), the California State Board of Equalization adopted the approach found in Revenue Procedure 72-18, which focuses upon the taxpayer's dominant purpose for incurring and continuing the subject indebtedness, but also considers the actual use of the debt funds as strong evidence of that purpose. *See also Apple, Inc. v. Franchise Tax Bd.*, 199 Cal. App. 4th 1, 22-26 (2011).

20 *Great W. Fin. Corp. v. Franchise Tax Bd.*, 4 Cal. 3d 1 (1971); *see also Apple,* 199 Cal. App. 4th at 23, n. 26.

21 Cal. Rev. & Tax. Code § 24344(c); *see also* 2013 Instructions for FTB Form 2424, Water's-Edge Foreign Investment Interest Offset.

22 As a practical matter, Section 24425 may not be a meaningful limitation of expenses related to dividends deducted under Section 24411. That is because Section 24344(c) sets forth a specific limitation with respect to interest expense related to those dividends. Once interest expense is limited as it relates to dividends deducted under Section 24411, then query whether there are really any *other* material expenses related to those dividends that could be limited under the general scope of Section 24425.

23 120 Cal. App. 4th 459 (2004).

24 Income could be previously included in a combined report either because the income was included in a worldwide combined report for years prior to when the Election was made or because the income was previously included in a water's-edge combined report as Subpart F income.

25 How much income has been previously included in the combined report under the Election is a function of the inclusion ratio. For example, if a CFC has current income of $100 and an inclusion ratio of 45%, then $45 of income will be included in the combined report. That $45 would be subject to any dividend elimination or deduction.

26 The dividend income deduction under Section 25106 for water's-edge filers is reported on Part I on Schedule H (100W) and on line 10 of Form 100W.

27 The dividend income deduction under Section 24411 for water's-edge filers is reported on Part II on Schedule H (100W) and on line 11 of Form 100W.

28 *Fujitsu*, 20 Cal. App. 4th at 476-77.

29 *Id.* at 478.

30 *Id.*

31 The FTB states this position "is contrary to dicta in *Fujitsu* but should generally benefit taxpayers." FTB Technical Advice Memorandum 2005-0001, p. 2 (Mar. 7, 2005).

32 *Id.* at 1.

33 *Id.* at 1-2.

34 *Id.*

35 The FTB held a public symposium in April 2005 and issued a staff report in September 2005 on *Fujitsu*, and proposed amendments to its regulations. However, the three-member FTB never authorized its staff to proceed on the proposed regulation project and it was abandoned in late 2005.

36 FTB Technical Advice Memorandum 2011-02, p. 3 (Mar. 15, 2011).

37 199 Cal. App. 4th 1 (2011).

38 Both *Fujitsu* and *Apple* were decided by the Court of Appeal for the First Appellate District, but by different divisions of that District (*Fujitsu* by Division Two and *Apple* by Division Five).

39 The parties stipulated that Apple had sufficient included income from the 1989 current tax year in issue *and* prior years to fully eliminate under Section 25106 almost all of the CFC dividends paid in the 1989 tax year. *Apple*, 199 Cal. App. 4th at 18. The tax year 1989 was Apple's first year filing under the election. However, it had included income from prior tax years from when it had previously filed on the basis of a worldwide combined report.

40 FTB Technical Advice Memorandum 2011-2, p. 3 (Mar. 15, 2011).

41 *Id.* Note this TAM was issued in March 2011, which is before *Apple* was decided by the Court of Appeal in September 2011. The FTB wrote the TAM after *Fujitsu* and at the time *Apple* was pending in the Court of Appeal based upon the San Francisco Superior Court (*i.e.*, lower court) judgment in the FTB's favor in *Apple*, which was later affirmed by the Court of Appeal.

42 California courts generally use two tests to determine whether related business entities are engaged in a unitary business. The first is the "Three Unities Test." *Butler Bros. v. McColgan*, 17 Cal. 2d 664 (1941). The second is the "Contribution or Dependency Test." *Edison Cal. Stores v. McColgan*, 30 Cal. 2d 472 (1947). These two tests are alternative methods for determining unity. *A.M. Castle & Co. v. Franchise Tax Bd.*, 36 Cal. App. 4th 1794, 1805 (1995). Of course, there are also numerous federal constitutional limitations on California's ability to define and tax a unitary business. *See, e.g.*, *Container Corp.*, 463 U.S. 159.

43 *See* Cal. Code Regs. tit. 18, § 25120(b).

44 Cal. Rev. & Tax. Code § 25120. California has two alternative tests of business income—"functional" and "transactional"—with the "functional" test raising the most issues in its application. In applying the functional test, the "critical inquiry" is the relationship between the property giving rise to the income and the taxpayer's business operations. *Hoechst Celanese Corp. v. Franchise Tax Bd.*, 25 Cal. 4th 508, 520-27 (2001); *see also Jim Beam Brands Co. v. Franchise Tax Bd.*, 133 Cal. App. 4th 514 (2005). For a discussion of the business/nonbusiness characterization by the FTB of dividends paid by a CFC to its U.S. parent under the American Jobs Creation Act of 2004 (temporary incentive to repatriate the U.S. earnings held by foreign subsidiaries), see FTB Legal Ruling 2005-02 (July 8, 2005).

45 *Apple*, 199 Cal. App. 4th at 16.

46 The FTB argued in its briefing to the appellate court that "*Fujitsu* did not resolve the ordering issue in this case . . . ." The FTB then went further and also argued that "the FTB believes that *Fujitsu* was decided in contravention of the California Supreme Court decision in *Safeway Stores, Inc. v. Franchise Tax Board* . . . ." *Apple v. Franchise Tax Bd.*, 2010 CA App. Ct. Brief 28091, pp. 47-48, 53, n. 14.

47 *Apple*, 199 Cal. App. 4th at 19. The FTB initially characterized the dividends not subject to elimination under Section 25106 as being (partially) deductible under Section 24411. However, while *Apple* was pending, the Court of Appeal decided *Farmer Brothers Co. v. Franchise Tax Board*, 108 Cal. App. 4th 976 (2003), which declared Section 24402 unconstitutional because it facially discriminated against corporations that were not doing business in California. As a consequence of the FTB's backward looking remedy under *Farmer Brothers*, the FTB allowed taxpayers the Section 24402 deduction for dividends received in earlier years regardless of whether the dividend paying corporation was doing business in California. Applying that remedy, the FTB determined that the remaining dividends received by Apple were fully deductible under Section 24402. "Therefore none of the $50 million dividend was included in Apple's corporate tax base subject to California tax." *Apple*, 199 Cal. App. 4th at 19, n. 21.

48 "In this case, however, none of the CFC dividend distributions received by APPLE in 1989 Tax year were subject to California tax because the dividends distributed from included income were eliminated pursuant to RTC section 25106, and the dividends distributions made from excluded income were deducted entirely pursuant to RTC section 24402. (See footnote 1, *supra*.) Thus, APPLES's claim that the FTB's Last In, First Out (LIFO) ordering rule leads to double taxation lacks merit." *Apple v. Franchise Tax Bd.*, 2010 CA App. Ct. Brief 28091, pp. 3-4.

49 *Apple*, 199 Cal. App. 4th at 19.

50 *See* Cal. Rev. & Tax. Code § 24451. Remember that one must be careful when speaking of California "incorporating" provisions of the IRC because federal conformity is not automatic and requires an act of the California Legislature. Currently, references in the California Revenue and Taxation Code to the "Internal Revenue Code" mean the Internal Revenue Code *as enacted on January 1, 2009*. Cal. Rev. & Tax. Code § 17024.5(a).

51 *See* Cal. Code Regs. tit. 18, § 24411.

52 *Apple,* 199 Cal. App. 4th at 19-20.

53 *Woods v. Super. Ct.*, 28 Cal. 3d 668, 679 (1981); *Nortel Networks Inc. v. Bd. of Equalization*, 191 Cal. App. 4th 1259, 1276-77 (2011). The *Apple* court cited to title 18, section 24411 of the California Code of Regulations, which contains an ordering rule, but no such ordering rule is found in Section 24411.

54 *Apple*, 199 Cal. App. 4th at 20-21.

55 *Fujitsu*, 120 Cal. App. 4th at 477.

56 *Id.* at 474.

57 *See Santilli v. Otis Elevator Co.*, 215 Cal. App. 3d 210, 214 (1989).

58 *See Apple*, 199 Cal. App. 4th at 21.

59 *Fujitsu*, 120 Cal. App. 4th at 477.

60 *Apple*, 199 Cal. App. 4th at 21.

61 *Fujitsu*, 120 Cal. App. 4th at 477.

62 *Apple*, 199 Cal. App. 4th at 21.

63 *Id.* at 21 (emphasis added).

64 *Id.* at 22.

65 *Apple v. Franchise Tax Bd.*, 2010 CA App. Ct. Brief 28091, p. 4.

66 *Apple*, 199 Cal. App. 4th at 16; *see Agnew v. State Bd. of Equalization*, 21 Cal. 4th 310, 326 (1999).

67 *Apple*, 199 Cal. App. 4th at 22; *see also Fujitsu*, 20 Cal. App. 4th at 471; *Yamaha Corp. of America v. State Bd. of Equalization*, 19 Cal. 4th 1, 14 (1998). The FTB encouraged this approach: Its very *first* argument on the merits in its opening brief to the appellate court was "The State Board of Equalization's Formal Opinion Affirming the FTB's Position on the LIFO Issue is Entitled to Great Weight." *See Apple v. Franchise Tax Bd.*, 2010 CA App. Ct. Brief 28091, p. 29.

INCOME TAX WITHHOLDING: FRAMEWORK OF THE ISSUES

By Mitchell A. Newmark and Richard C. Call

Withholding audits have domino effects. In addition to resulting in assertions that tax, interest and penalties are due as a result of withholding adjustments, withholding audits often result in subsequent personal income tax audits of highly compensated individuals that are identified during the audit and can result in assertions of personal liability against corporate employees and officers who are in control of withholding and reporting compliance.

Withholding audits often result in subsequent personal income tax audits of highly compensated individuals that are identified during the audit and can result in assertions of personal liability against corporate employees and officers.

Our focus in this article is identifying issues to reduce the likelihood of sustainable assessments and personal liability arising from withholding obligations. We examine the following withholding tax topics:

- Withholding Tax Liability;
- Safe Harbors;
- Deferred and Special Compensation;
- Penalties;
- Responsible Person Liability; and
- Documentation Issues.

We provide the framework for each of these topics and identify additional points to consider.

Withholding Tax Liability

It is intuitive to distinguish between withholding for residents and withholding for non-residents. However, a state statute requiring withholding may not explicitly make such a distinction. For example, New York law provides that "every employer maintaining an office or transacting business within [New York] and making payment of any wages taxable under this article shall deduct and withhold from such wages for each payroll period a tax . . . ."[1] The phrase "wages taxable under this article" in the statute captures both residents and non-residents inasmuch as New York residents are taxable on all of their income and non-residents are taxable on their New York source income.[2]

Residents

It makes sense that a state would require employers to withhold tax for all employees who are residents of that state because all of the income of a resident is typically subject to the taxing jurisdiction of the state. However, the rules vary from state-to-state as to when an employer must withhold for non-resident employees.

Non-residents

Unlike withholding for residents, states may not require withholding tax for all employees who are not residents of the taxing state. For example, New York statutes require withholding tax for non-residents that have New York source income (with some exceptions described below). By contrast, some states exempt an employer from withholding tax for a non-resident employee who works in that state (*e.g.*, State A) if the employee's home state (*e.g.*, State B) has a reciprocal agreement with the state in which the employee works (*e.g.*, State A) that exempts a similarly situated employer from a withholding requirement.[3]

Safe Harbors

When determining an employer's withholding responsibilities for non-residents, some states provide safe harbor provisions. Not all states provide safe harbors, however, and the thresholds for exemption vary in those that do. For example, Arizona has a safe harbor for non-resident employees who are physically present in Arizona for less than 60 days during the taxable year.[4] Connecticut and New York have safe harbors for non-resident employees who are not present in the state for more than 14 days during the taxable year.[5] Although requiring an employer to withhold tax with respect to a non-resident's *de minimis* physical presence may raise constitutional concerns, there is no guarantee that a safe harbor will be provided by the state.

Just as safe harbor thresholds can vary, so do the sources of authority that implement those safe harbors. The Arizona safe harbor referenced above is in a statute and the Connecticut safe harbor referenced above is contained in administrative guidance.[6] These distinctions can be important because the weight of authority may affect whether: (1) the safe harbor would be respected by a court; (2) a legislative or administrative process would be required to change the safe harbor (legislative provisions are more difficult to change than administrative provisions); (3) a change in the safe harbor could have retroactive effect; and (4) a taxpayer can rely on the implementing authority to defend against penalties.

Withholding Tax Safe Harbors Versus Personal Income Tax Nexus

Importantly, although safe harbor provisions may exist in certain states for purposes of withholding tax, those same safe harbor provisions do not necessarily protect an individual from a personal income tax obligation in that state. Many states impose a personal income tax filing and payment obligation on: (1) "residents;"[7] and (2) persons who derive income from sources within the state.[8] Because an individual may derive income from a state without exceeding a statutory withholding threshold (*e.g.*, a days threshold), the individual may have a personal income tax liability, yet her employer may not have a withholding obligation.

Although safe harbor provisions may exist in certain states for purposes of withholding tax, those same safe harbor provisions do not necessarily protect an individual from a personal income tax obligation in that state.

For example, assume that State X subjects a non-resident who derives taxable income from sources within State X to tax and that State X has a withholding safe harbor of 30 days (but not a personal income tax safe harbor). Now assume that during the year an individual works only 25 days in State X. On these hypothetical facts, the non-resident individual's employer may not be required to withhold tax, but the non-resident employee may have a personal income tax reporting obligation as a result of deriving income from the 25 days of work in the state. This dichotomy of withholding liability versus individual subjectivity to tax is often overlooked and can spawn spin-off audits of individual employees.

Federal Legislation

The aforementioned dichotomy has received Congressional attention. The two major issues being debated are: (1) the number of days of presence by a non-resident that will result in a withholding requirement; and (2) whether such a number of days threshold is the appropriate measure to determine whether an individual has a personal income tax reporting requirement.

The proposed Mobile Workforce State Income Tax Simplification Act of 2013 was introduced in the House of Representatives on March 13, 2013.[9] It is intended to provide uniformity of personal income tax nexus standards and the standards for an employer to withhold. Thus, except for certain persons (*e.g.*, entertainers and athletes who can earn significant sums of money in very short periods of time in a state), non-resident personal income tax nexus and withholding requirements would only apply if a non-resident employee worked in a state for more than *30 days*. It is unclear whether the bill will pass, but it certainly has the appeal of administrability as a result of the uniform number of days and a threshold that allows for the mobility of employees between states.[10]

What Is a Day?

Establishing a uniform number-of-days threshold is not the end of the story. Another wrinkle in filing thresholds is how state laws compute a day of presence in the state. Days of presence are important for withholding safe harbors. They are also important for personal income tax definitions of a "resident," which are often tied to the number of days a person spends in a jurisdiction.[11]

Regarding what constitutes a day for residency purposes, the New York regulations provide:

> In counting the number of days spent within and without New York State, presence within New York State for any part of a calendar day constitutes a day spent within New York State, except that such presence within New York State may be disregarded if such presence is solely for the purpose of boarding a plane, ship, train or bus for travel to a destination outside New York State, or while traveling through New York State to a destination outside New York State.[12]

Employers should understand the relevant states' day counting rules and establish systems to help document their employees' locations. State audits and challenges regarding a person's days of presence in a state typically involve various aspects of daily activity including a review of passports, calendars, personal journals, credit card statements, bank statements (such as ATM withdrawal information), phone records, flight information (such as frequent flyer reports and airline tickets), hospital and medical office visit forms and utility bills.[13] Furthermore, the time of arrival or departure of an airplane may be relevant in determining the day count, as was the case in a New York City administrative law judge determination that examined whether a taxpayer's flight landed before or after midnight.[14]

Deferred and Special Compensation

Another issue involves the base from which to withhold taxes. States may require withholding on wages and may define "wages" by reference to the Internal Revenue Code ("IRC"). For example, Maryland defines wages as "salary, wages, or compensation for personal services of any kind as defined in [IRC] §§ 3401 and 3402(o)(2)(A)" and "includes remuneration paid for services described in § 3401(a)(5) and (6) of the [IRC]."[15] North Carolina requires withholding on "wages," but

the North Carolina statutes provide that "'[w]ages . . . has the same meaning as in section 3401 of the [IRC] *except it does not include* [certain specifically enumerated types of income]."[16]

The amount of wages withheld against may vary depending on whether the employee is a resident or a non-resident. For New York residents, employers must withhold on *all* wages paid to resident employees.[17] For non-residents, New York requires withholding on only state source income, which leads to the question of what constitutes state source income.[18] The answer may vary widely among states, especially for income such as deferred and special compensation.

How does a state determine the "source" of income with respect to deferred compensation and stock options? Some states compute the source of deferred compensation and non-statutory stock options by applying an allocation formula that attempts to represent the amount of work performed in the state over a specified period.[19]

For example, Minnesota administrative guidance provides that for deferred compensation, the applicable time period may be the period over which the employee gained the right to that deferred income:

> Other non-statutory [not federally protected] deferred compensation is assigned to Minnesota in the ratio of days worked in Minnesota during the "allocation period" to the total number of days worked for the employer during the "allocation period." The allocation period is the period of time during which the employee accrued the right to the deferred compensation.[20]

Examples in Minnesota's administrative guidance illustrate the mechanics of the allocation period.[21] Consider the following Minnesota example:

> Employer maintains a supplemental retirement plan (SERP) that provides income that does not meet the criteria necessary to be preempted under federal law from state taxation when paid to a nonresident . . . .
>
> Employee is a resident of California and works for the employer for two years in California. Employee then changes her residency to Minnesota where she works for 11 years. Upon terminating employment, Employee changes her residency to another state. Employee is entitled under the SERP to a monthly payment of $4,000 for five years.
>
> Because Employee accrued the right to the deferred compensation throughout Employee's 13 years of service, the allocation period is 13 years. Because the time worked in Minnesota during the allocation period is 11 out of 13 years, 85 percent or $3,385 of each monthly payment (11/13 x $4,000) is assigned to Minnesota.[22]

The above is just one example. State rules and types of compensation vary and, therefore, each state and type of income must be separately considered. Furthermore, inasmuch as formulas such as the foregoing may result in states attempting to tax too great a portion of such income, each such employee's facts should be examined critically.

Penalties

States may impose penalties on employers for failing to timely and properly withhold and remit taxes. New York imposes penalties on employers that non-willfully fail to withhold and pay taxes at the rate of 25% (for late filing) and 25% (for late payment) of the amount of tax that was required to have been withheld.[23]

It is possible that the employee's direct payment of all personal income tax will not be a recognized defense to the assertion of penalties for failing to withhold and remit taxes.

It is possible that the employee's direct payment of all personal income tax will not be a recognized defense to the assertion of penalties for failing to withhold and remit taxes. For example, the Indiana Department of Revenue took the position that a 20% penalty for failing to withhold tax when the tax had been *fully paid* by the individual was correct, asserting that "the issue is not whether the tax was paid, but rather whether the [withholding] taxpayer complied with Indiana laws governing withholding—a statutory mechanism designed to ensure compliance and ease of enforcement of Indiana tax laws."[24]

Responsible Person Liability

Personal liability for unpaid withholding taxes may attach to responsible persons within a corporation.[25] The individuals that qualify as "responsible persons" vary by state.

For example, Ohio imposes personal liability for unpaid withholding taxes on employees of corporations having "control or supervision" over withholding tax compliance and upon corporate officers who are responsible for the "execution of the corporation's . . . fiscal responsibilities . . . ."[26] Wisconsin imposes personal liability on responsible persons when "(1) the individual had the

authority to pay or direct payment of the taxes; (2) the individual had the duty to pay or direct payment of the taxes; and (3) the individual intentionally breached the duty."[27]

Documentation Issues

To support a challenge against an assertion of improper withholding, documentation is important. Further, sufficient documentation is typically *required*. For instance, New York has issued several forms, which, if completed by an employee and relied on by a corporation, constitute sufficient documentation for demonstrating that the corporation acted properly for withholding audit purposes.[28] However, New York places restrictions on such reliance. For example, the New York Withholding Tax Field Audit Guidelines state:

> Employers may rely on information provided by employees regarding residence provided the information is accepted by the employer in good faith, and the employer did not have *actual knowledge* or *reason to know* the statement is inaccurate or unreliable.[29]

What constitutes "actual knowledge" and "reason to know"? The New York State Department of Taxation and Finance asserts that "[a]n employer cannot claim it does not have actual knowledge or reason to know if the business does not have a system in place to verify that the [withholding forms] received from employees are accurate."[30]

Finally, New York State has instructed its auditors to apply *additional* penalties (see above) when an employer has actual knowledge or reason to know that the withholding forms submitted by employees were inaccurate.[31]

State tax agencies view withholding tax audits as low hanging fruit that can generate additional tax revenue, interest and penalties and identify candidates for personal income tax audits.

Conclusion

State tax agencies view withholding tax audits as low hanging fruit that can generate additional tax revenue, interest and penalties and identify candidates for personal income tax audits. Further, under certain circumstances, personal liability may attach to individuals in a company's tax department. For these reasons, a state withholding tax audit can have unforeseen consequences, many of which can be avoided by careful preparation.

1 N.Y. Tax Law § 671(a)(1). Notably, New York tax law uses different statutory language for subjectivity to the corporation franchise tax. *See* N.Y. Tax Law § 209(1) (stating that the tax is imposed "[f]or the privilege of exercising its corporate franchise, or of doing business, or of employing capital, or of owning or leasing property in this state in a corporate or organized capacity, or of maintaining an office in this state . . .").

2 N.Y. Tax Law § 671(a)(1); *see* N.Y. Tax Law § 601(a), (e).

3 Md. Code Ann., Tax-Gen. § 10-907(a)(1); Va. Code Ann. § 58.1-482.

4 Ariz. Rev. Stat. Ann. § 43-403(a)(5).

5 Announcement AN-2010(3) (Conn. Dep't of Revenue Servs. Jan. 11, 2010); Technical Memorandum TSB-M-12(5)I (N.Y. Dep't of Taxation and Fin., Jul. 5, 2012).

6 Ariz. Rev. Stat. Ann. § 43-403(a)(5); Announcement AN-2010(3).

7 "Resident" is a statutory term and the definition varies from state to state. *Compare* Ariz. Rev. Stat. Ann. § 43-104(19), *with* N.Y. Tax Law § 605(b).

8 Ariz. Rev. Stat. Ann. § 43-1011; N.Y. Tax Law § 601.

9 H.R. 1129.

10 The Multistate Tax Commission has issued a model uniform law that would align the two thresholds at 20 days (with various exceptions). Model Mobile Workforce Withholding and Individual Income Tax Statute (Multistate Tax Commission Uniformity Project) project document library (July 27, 2011), *available at* http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Mobile%20Workforce%20resolution%202011.pdf.

11 *See* Ariz. Rev. Stat. Ann. § 43-104(19); N.Y. Tax Law § 605(b).

12 N.Y. Comp. Codes R. & Regs. tit. 20, § 105.20(c).

13 For example, the New York Division of Taxation and Finance issued a subpoena to an airline to find out what time a flight landed. *In re Robertson*, DTA No. 822004 (N.Y. Div. Tax App. Oct. 15, 2009).

14 *Id.*

15 Md. Code Ann., Tax-Gen. § 10-905(f). *See also* N.Y. Comp. Codes R. & Regs. tit. 20, § 171.3 ("Payments which are considered wages for Federal income tax withholding purposes are also wages for purposes of withholding New York State personal income tax.").

16 N.C. Gen. Stat. § 105-163.1(13) (wages defined) (emphasis added); N.C. Gen. Stat. § 105-163.2.

17 *See* N.Y. Comp. Codes R. & Regs. tit. 20, § 171.5. It should be noted that many states only require withholding if an employee makes above a minimum dollar threshold. Although this is an important principle, because these thresholds are typically very low (under a few thousand dollars) those thresholds are not addressed in this article.

18 *See, e.g.*, N.Y. Tax Law §§ 601(e), 671(a)(1).

19 *See* N.Y. Tax Law § 601(e)(3); N.Y. Tax Law §§ 631 *et seq.* (regarding income that is treated as New York source income); Withholding Tax Fact Sheet No. 19 (Minn. Dep't of Revenue Oct. 1, 2008, *revised* Nov. 2013).

20 Withholding Tax Fact Sheet No. 19.

21 *Id.*

22 *Id.*

23 N.Y. Tax Law § 685(f). New York prohibits employers from charging, collecting or passing on the 25% late filing and 25% late payment penalties to employees. *Id.*

24 Letter of Findings No. 08-0318P (Ind. Dep't of State Revenue Oct. 1, 2008).

25 Md. Code Ann., Tax-Gen. § 10-906(d).

26 Ohio Rev. Code Ann. § 5747.07(G).

27 *Lori Ann Little Soldier v. Wis. Dep't of Revenue*, No. 09-W-17 (Wis. Tax App. Comm'n Feb. 22, 2010); *see also* Wis. Stat. § 71.83(1)(b)(2). For a more detailed explanation of responsible person liability, see Mitchell A. Newmark and Richard C. Call, *Individual Liability for Company Taxes*, Morrison & Foerster LLP's State + Local Tax Insights, Winter 2012.

28 *See, e.g.*, New York Forms IT-2104, IT-2104-E and IT-2104.1.

29 N.Y. Withholding Tax Field Audit Guidelines (Mar. 27, 2009), p. 21.

30 *Id.* at 40.

31 *Id.*

CALIFORNIA FRANCHISE TAX BOARD PROVIDES NEW REGULATORY GUIDANCE ON DEFERRED INTERCOMPANY STOCK ACCOUNTS

By Eric J. Coffill

The California Franchise Tax Board ("FTB") has amended its Section 25106.5-1 "Intercompany Transactions" regulation[1] ("Regulation") to provide additional guidance regarding its treatment of Deferred Intercompany Stock Accounts ("DISAs"). Four notable changes were made by the amendments to the Regulation ("Amendments") discussed below. All California taxpayers with a *federal* Excess Loss Account should be aware of these Amendments and consider their implications.

The Amendments were intended to address situations raised by FTB staff, taxpayers and taxpayer representatives involving DISAs, which were not previously addressed in the Regulation. The Amendments were filed with the Office of Administrative Law on January 8, 2014, with an effective date of April 1, 2014.[2] They are applicable to transactions occurring on or after January 1, 2001, but a taxpayer may elect to have the amendments apply prospectively only (*i.e.*, effective April 1, 2014).[3]

The Amendments were intended to address situations raised by FTB staff, taxpayers and taxpayer representatives involving DISAs, which were not previously addressed in the Regulation.

As a matter of background, California Revenue and Taxation Code Sections 24451 *et seq.* generally conform California law to Internal Revenue Code Sections 301 and 311 (distributions) and Section 312 (earnings and profits), which may give rise to non-dividend distributions that present DISA issues.[4] Once current and accumulated earnings and profits have been depleted, additional (non-dividend) distributions will reduce the shareholder's basis in the stock. Distributions in excess of both earnings and profits and the shareholder's basis in the stock are treated as a capital gain.[5] However, under the federal consolidated return group rules, a shareholder may have a negative basis in the stock as a result of such intercompany distributions. Specifically, Treasury Regulations provide for the concept of an Excess Loss Account ("ELA"), the purpose of which is to recapture in consolidated taxable income the shareholder's negative adjustments with respect to the stock.[6] However, California does *not* follow the federal ELA concept. Instead, the FTB's Regulation provides that the portion of an intercompany distribution that exceeds California earnings and profits and the parent's basis in the stock "will create a DISA."[7]

The DISA is treated as deferred income. That deferral continues indefinitely until either the distributor or the recipient is no longer included in the combined report (*e.g.*, excluded from the unitary group by a water's-edge election) or until the occurrence of some other triggering event (*e.g.*, the "sale, liquidation, redemption or any other disposition of shares of the stock").[8] Income restored from a DISA transaction is taken into account ratably over 60 months, unless the taxpayer elects to take the income into account in full in the year of liquidation.[9]

The Regulation provides that the balance of each DISA account must be disclosed annually on the taxpayer's return.[10] If a taxpayer fails to disclose its DISA balance on its annual tax return, the FTB may, in its discretion, require that the amounts in the undisclosed DISA accounts be taken into account in whole or in part in any year of such failure.[11] Penalties also may apply for failure to make the annual DISA disclosure.[12]

As noted above, the Amendments were intended to address situations that were not previously addressed in the Regulation. Accordingly, the regulation process leading to the Amendments was not a contentious one. The Amendments are as follows:

First, issues arose when a (brother/sister) merger occurred between members of a combined reporting group that were owned by the same members of the combined reporting group. There, the stock of the non-surviving member was essentially eliminated, although the assets of the non-surviving member continued to be held within the combined reporting group. Prior to amendment, any DISA attributable to the non-surviving member's stock would be recognized under the Regulation. Moreover, because the DISA is a deferred income item, financial accounting rules require its tax impact to be reflected, which reduced financial statement net income. A capital contribution to the DISA would prevent the financial rules from applying. However, prior to amendment, the Regulation did not provide for a mechanism that allowed subsequent capital contributions.[13]

In response, the Amendments provide that a disposition of stock that triggers a DISA will not occur when members of a combined reporting group merge into one another, if the majority of the voting shares of the stock of each are owned by other members of the combined reporting group.[14] The Amendments also provide that the amount of DISA attributable to the non-surviving member's stock will be included (proportionately) with any DISA attributable to

the surviving member's stock and will be taken into income when the surviving member's stock is disposed of.[15] The Amendments also add an example illustrating a (brother/sister) merger of members.[16]

In addition, because previously there was no mechanism, the Amendments now allow for subsequent capital contributions to reduce existing DISAs.[17] The Amendments also add an example involving a subsequent capital contribution.[18] The Amendments further provide that taxpayers must now annually report any reductions to DISAs brought about by such capital contributions.[19]

Issues also arose regarding when one member of the combined reporting group transferred stock in another member of the combined reporting group that had no attributable DISA to a third member of the combined reporting group that already possessed stock in the member whose stock was transferred and there was a DISA attributable to that stock. Prior to amendment, the transferee would be forced to retain two separate classes of stock, one class of stock with a DISA attributable to it and another class of stock without a DISA attributable to it.[20]

In response, the Amendments provide that if a parent transfers stock with a DISA attributable to it to another member of the combined reporting group and the transferee already possesses shares of that stock that do not have a DISA attributable to them, the DISA will continue to be deferred and the transferee's basis in its existing stock can reduce the DISA attributable to the shares of the stock transferred.[21] The Amendments also provide an example illustrating the transfer of stock with a DISA balance.[22]

Finally, issues arose where the same amount of money or the same property was being distributed through various tiers of members of a combined reporting group. Prior to amendment, it was possible that multiple DISAs might result from essentially the same distribution. If an excess distribution that ordinarily would result in a DISA was allowed to create earnings and profits, the second distributee would not have a DISA when that distributee distributed the same amount of money or the same property to another member of the combined reporting group. However, prior to amendment, the Regulation did not allow intercompany transactions to create earnings and profits.[23]

In response, the Amendments eliminate multiple DISAs from arising in this situation. The Amendments provide that where the same property or the same amount of money is being distributed through various tiers of members of a combined reporting group, the DISA that results at the initial level from the initial distribution is treated as creating earnings and profits.[24] The Amendments add an example illustrating a situation where the same amount of money is distributed and also provide an example illustrating the effect of an additional amount of money subsequently being distributed.[25]

In conclusion, taxpayers should consider this new opportunity to reduce or eliminate existing DISAs by making capital contributions, the option to elect to apply the Amendments retroactively or prospectively, the potential financial impact of the Amendments and any applicable new annual reporting requirements.

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1 Cal. Code Regs. tit. 18, § 25106.5-1.

2 Register 2014, No. 3-Z Cal. Regulatory Notice Reg., p. 78 (Jan. 17, 2014).

3 Cal. Code Regs. tit. 18, § 25106.5-1(k).

4 One must be careful when speaking of California "conforming" to provisions of the Internal Revenue Code because federal conformity is not automatic "real time" and requires an act of the California Legislature. Currently, references in the California Revenue and Taxation Code to the "Internal Revenue Code" mean the Internal Revenue Code *as enacted on January 1, 2009*. Cal. Rev. & Tax. Code § 17024.5(a).

5 IRC § 301(c)(3).

6 Treas. Reg. § 1.1502-19(a)(1).

7 Cal. Code Regs. tit. 18, § 25106.5-1(f)(1)(B).

8 *Id.* "Redemption" was added by the Amendments.

9 Cal. Code Regs. tit. 18, § 25106.5-1(f)(1)(B)(3).

10 Cal. Code Regs. tit. 18, § 25106.5-1(b)(8). Because at one time no FTB form was available for such disclosure, the FTB found taxpayers were failing to annually disclose DISAs. In February 2009, the FTB released Notice 2009-01 (Feb. 20, 2009) to "remind" taxpayers of their annual disclosure requirement and to announce the release of new FTB Form 3726, "Deferred Intercompany Stock Account (DISA) and Capital Gains Information."

11 Cal. Code Regs. tit. 18, § 25106.5-1(j)(7).

12 FTB Notice 2009-01 (Feb. 20, 2009) warned that failure to annually disclose the DISAs could result in not only additional tax liability, but also the imposition of various penalties, including the accuracy-related penalty under Section 19164 and the large corporate understatement penalty under Section 19138.

13 *See* Initial Statement of Reasons for the Amendment of California Code of Regulations, Title 18, Section 25106.5-1 (Apr. 26, 2013), pp. 2-3.

14 Cal. Code Regs. tit. 18, § 25106.5-1(f)(1)(B)(2).

15 *Id.*

16 Cal. Code Regs. tit. 18, § 25106.5-1(f)(2), Ex. 8.

17 Cal. Code Regs. tit. 18, § 25106.5-1(f)(1)(B)(2).

18 Cal. Code Regs. tit. 18, § 25106.5-1(f)(2), Ex. 9.

19 Cal. Code Regs. tit. 18, § 25106.5-1(j)(7).

20 *See* Initial Statement of Reasons for the Amendment of California Code of Regulations, Title 18, Section 25106.5-1 (Apr. 26, 2013), pp. 6-7.

21 Cal. Code Regs. tit. 18, § 25106.5-1(f)(1)(B)(4).

22 Cal. Code Regs. tit. 18, § 25106.5-1(f)(2), Ex. 10.

23 *See* Initial Statement of Reasons for the Amendment of California Code of Regulations, Title 18, Section 25106.5-1 (Apr. 26, 2013), pp. 3-4.

24 Cal. Code Regs. tit. 18, § 25106.5-1(j)(4).

25 Cal. Code Regs. tit. 18, § 25106.5-1(j)(4), Ex. 1 and Ex. 2.

THE ARBITRARY TREND IN FAVOR OF SINGLE-SALES FACTOR APPORTIONMENT

By Andres Vallejo and Daniel L. Eggerman

For some time now, many states have been moving away from the traditional three-factor apportionment formula to an approach that places more or all of the weight on the sales factor. In our view, this trend is not the result of any guiding legal or economic principles or of a broader effort to achieve a fair and uniform system. Instead, this new trend appears to be the result of politically-motivated, state-level decision-making. The emerging system of widely varied, largely unjustified apportionment formulas is regrettable and not only inconsistent with sound tax policy, but also contrary to the original goals and concerns of the Uniform Division of Income for Tax Purposes Act ("UDITPA"). Moreover, this dysfunctional system leads to serious concerns regarding the constitutionality of its inconsistent and arbitrary apportionment formulas.

Brief History of Apportionment Formulas

The U.S. Supreme Court has long recognized that states may impose an income tax on an apportioned share of a multistate business' income.[1] One way to apportion income is to use an apportionment formula that reflects (at least roughly) the in-state activities required to generate the income ultimately subject to state taxation. Traditionally, the states have used a three-factor (*i.e.*, property, payroll and sales) formula to determine the share of income taxable within the state. The Supreme Court has long recognized the constitutional viability of such a formula.[2]

In the 1950s, UDITPA was drafted as a model for the division of multistate business income. The UDITPA drafters were primarily interested in achieving the uniform use of fair rules (hopefully tethered to sound economic principles), including apportionment, concerning the division of income. To that end, they advocated the use of a three-factor formula. And, at that time, almost all states with corporate income taxes adopted UDITPA's formula or one similar to it.[3] That uniformity began to splinter in the wake of the decision in *Moorman Manufacturing Co. v. Bair*.[4]

Today, apportionment formulas vary widely among the states and include the traditional equally-weighted three-factor apportionment formula, three-factor formulas that double weight the sales factor, single-sales factor formulas and elective or variable systems that defy easy classification in any one category.[5] This considerable inconsistency is made worse by the staggering array of special rules applicable to certain taxpayers, diverse definitions, differing sourcing rules and often inconsistent regulatory and judicial interpretations of applicable law.[6]

Moorman and the Advent of Single-Sales Factor Apportionment

The taxpayer in *Moorman* was an animal feed manufacturing company, based in Illinois, with sales to customers in Iowa.[7] The company was subject to a three-factor apportionment formula in Illinois, but a single-sales factor apportionment formula in Iowa. The taxpayer argued that Iowa's single-sales apportionment formula violated the Due Process Clause of the U.S. Constitution, in part, because it taxed income earned in Illinois. The taxpayer also argued that Iowa's formula violated the Commerce Clause, in part, because the interaction between Iowa's single-sales factor apportionment approach and Illinois' three-factor formula resulted in double taxation.[8]

While the Supreme Court upheld Iowa's single-sales factor formula in the specific circumstances of the case, this legal holding does not mean that single-sales factor apportionment is economically sound or constitutes wise tax policy.[9] In fact, the Court has long expressed significant concerns regarding the wisdom of such a formula.[10] However, the Court also has recognized the flaws inherent in three-factor apportionment formulas and has acknowledged that, in any specific instance of apportionment, double taxation may result from either formula.[11] Accordingly, the Court has refused to force the states to use any particular formula to apportion income. As such, the Supreme Court determined in *Moorman* that Iowa's single-sales factor apportionment was constitutional.[12] But finding on specific facts and arguments that a particular apportionment formula does not violate the Constitution is not the same as an endorsement of the wisdom or effectiveness of such a formula.

Economic Theory of Apportionment

At its simplest, apportionment is a process (or a step in a process) intended to estimate how much of a multistate business' income is fairly attributable to sources within a particular state.[13] Apportionment formulas are mathematical processes. The inputs of these processes are geographically traceable factors representing sources of income.[14] The outputs of these processes are numbers between zero and one that, when multiplied by multistate business income, are intended to approximate the amount of that income taxable in the apportioning state.

At its simplest, apportionment is a process (or a step in a process) intended to estimate how much of a multistate business' income is fairly attributable to sources within a particular state. Apportionment formulas are mathematical processes.

Property and labor have long been recognized as significant contributors to the generation of income.[15] In addition, a business' investments in both property and labor (*e.g.*, payroll) can be traced to geographic locations.[16] Thus, including property and payroll factors in UDITPA's three-factor formula was a sensible decision based on an economic guiding principle and sound tax policy.

Inclusion of a sales factor is harder to justify and may depend as much on political reality as economic theory or tax policy. In fact, as UDITPA was being debated, many economists believed that the sales factor should serve no role in apportionment formulas.[17] As originally envisioned, the sales factor was intended to represent the contributions that a taxpayer's market for goods and services in a particular state made to that taxpayer's income.[18] In today's environment, we seriously question whether this initial purpose for the sales factor still holds true in the very different economic landscape and in light of the new and ever-changing rules governing the calculation of the sales factor.

The sales factor is also problematic because the contributions to income that it reflects are difficult to geographically trace.[19] Sales factor sourcing rules have long been one of the most controversial aspects of apportionment.[20] The sales factor has been variously sourced to the customer's location, the delivery location, the seller's location or a split between multiple locations.[21]

Despite these problems, the framers of UDITPA concluded that the sales factor was useful in promoting UDITPA's goal of uniformity because its inclusion protected the interests of states in which products and services were sold.[22] As one commentator noted:

> Ordinarily, in apportionment formulae, the property and payroll factors tend to favor the state of origin or production in the assignment of income. The basic theory justifying the inclusion of the sales factor in such formulae is that it offsets the effects of the property and payroll factors and protects the interest of the state of destination. This seems appropriate since the state of delivery contributes to the income arising from the sale; it has provided the market.[23]

By their very nature, all apportionment formulas yield imperfect results and provide only rough approximations of the sources of income. Accordingly, commentators have long recognized that all apportionment formulas are, at some level, arbitrary.[24] This arbitrariness is (at least in part) due to the fact that, even assuming all factors of income could be identified, the relationship between those factors is so complex that a single formula is unlikely to ever provide accurate results for all businesses. States have tried to combat this problem by adopting industry-specific formulas, but such formulas are also

inadequate to the task of precisely and accurately dividing the income of each unique business, even within a similar industry.[25] That said, the inherent shortcomings of formulary apportionment in general should not be used to justify the inadequately narrow and even more arbitrary system of single-sales factor apportionment.

Political Motivations, Not Any Economic Guiding Principle or Sound Tax Policy, Have So Far Driven the Trend Toward Single-Sales Factor Apportionment

One is hard pressed to think of an economic guiding principle or a sound tax policy argument that justifies abandoning the three-factor apportionment formula in favor of a single-sales factor formula. Indeed, single-sales factor apportionment is virtually unjustifiable economically.[26] Among other things, such a formula ignores completely the contribution to income of labor and property, which, as discussed above, are two critically important contributors to income.

The truth is that, for the most part, states have adopted single-sales factor apportionment formulas because lawmakers and policymakers perceive that doing so potentially provides economic advantages to the state (*e.g.*, in the form of increased in-state economic activity or increased tax revenue) with little political cost.[27] Increasing the relative weight of the sales factor rewards businesses whose relative in-state presence (reflected by the average of their property and payroll factors) exceeds their in-state sales factor.[28] Businesses whose relative in-state presence (reflected by the average of their property and payroll factors) is less than their in-state sales factor bear an increased tax burden relative to their income.[29]

Moving to single-sales factor apportionment generally shifts tax burdens from companies that concentrate substantial property and labor in the state to companies that do not.

In other words, moving to single-sales factor apportionment generally shifts tax burdens from companies that concentrate substantial property and labor in the state to companies that do not. It seems clear, at least in large part, that the purpose underlying single-sales factor apportionment is to provide tax breaks for companies with substantial in-state property and payroll, while potentially offsetting the decrease in tax revenue by increasing the tax burden on taxpayers that have the majority of their property and payroll outside the state. Indeed, for example, when California moved to single-sales factor apportionment, it projected a revenue increase resulting from the change to a single-sales factor formula from a three-factor formula (even with the double weight given to the sales factor in the apportionment formula that California had been using since the mid-1990s).[30] In essence, California managed to pass tax legislation that increased revenue, while at the same time reducing the tax liability of numerous taxpayers with a large in-state presence (in terms of property and payroll). All things being equal, it follows that companies with the majority of their property and payroll outside California will bear the tax burden that supports the increase in state revenue.

As we alluded to above, we cannot resist wondering whether a court may find that a situation like the one in California fits squarely within the Supreme Court's pronouncement that discrimination against interstate commerce simply means "differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter."[31]

States do not seem to apply any principled framework when adopting single-sales factor formulas. Rather, they seem to enact these formulas based on political motivations without regard for uniformity, tax policy or sound economic theory.

Conclusion

States do not seem to apply any principled framework when adopting single-sales factor formulas. Rather, they seem to enact these formulas based on political motivations without regard for uniformity, tax policy or sound economic theory. This trend seems to have been sparked by the *Moorman* decision because, at least on its surface, the decision painted single-sales factor apportionment with a veneer of constitutionality. But even assuming that constitutional challenges to single-sales factor apportionment are unsuccessful, is the *ad hoc*, politically motivated process by which these formulas are adopted a sensible approach to important tax policy? Even if every state adopts a uniform single-sales factor formula, thereby eliminating the risk of double taxation, is there any reason to believe those rules provide anything more than a largely arbitrary division of income? It seems a reasonable proposition that laws governing the complex system of state taxation in the United States should be the result of deliberate and thoughtful processes, not *ad hoc*, state-specific decisions based mostly on economic and political motivations. Raising policy concerns and challenging the constitutionality of single-sales factor formulas may at least shed light on, and possibly succeed in curbing, the arbitrary nature of the trend in favor of single-sales factor apportionment.

1 *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920).

2 *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 171 (1983); *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 282 (1978) (Blackmun, J., dissenting).

3 *See Moorman*, 437 U.S. 267.

4 *Id.*

5 Only Eleven states still use a traditional, equally weighted, three factor formula. *See e.g.,* Alaska Stat. § 43.19.010; Haw. Rev. Stat. § 235-29; R.I. Gen. Laws § 44-11-14. Twelve states use three factors but double weight the sales factor. *See e.g.,* Ark. Code Ann. § 26-51-709; N.C. Gen. Stat. § 105-130.4; Tenn. Code Ann. § 67-4-2012(a). Seventeen states have adopted a single-sales factor formula. *See e.g.,* Cal. Rev. & Tax. Cd. § 25128; Ind. Code § 6-3-2-2; N.J. Rev. Stat. § 54:10A-6.

6 This complexity is further magnified by the dizzying variety of local taxes. Due to the staggering complexity of the American system of state and local taxation, only the largest and most sophisticated multistate businesses have any hope of understanding even a majority, let alone all, of their tax obligations.

In *The Wealth of Nations*, Adam Smith posited four maxims applicable to all taxes. *See* Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations,* Part II, Of Taxes (1776). His second maxim is that "[t]he tax which each individual is bound to pay, ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid ought all to be clear to the contributor, and to every other person." *Id.*

Although not the focus of this article, we believe it is fair to say that the nearly infinite complexity facing even the smallest of multistate businesses violates this maxim because such taxpayers often have no idea to whom, and when, they owe what amount of tax.

7 *Moorman*, 437 U.S. 267.

8 *Id.*

9 *Id.* The question remains whether *Moorman* forecloses the possibility of successful constitutional arguments to a single-sales factor formula beyond as-applied challenges such as constitutional distortion.

10 *General Motors Corp. v. District of Columbia*, 380 U.S. 553, 561 (1965) (stating that "[t]he standard three-factor formula can be justified as a rough, practical approximation of either a corporation's sources of income or the social costs which it generates. By contrast, the geographic distribution of a corporation's sales is, by itself, of dubious significance in indicating the locus of either factor.").

11 *Moorman*, 437 U.S. 267.

12 *Id.*

13 S*ee Container Corp.*, 463 U.S. at 170 (holding that apportionment must be fair). Some early commentators suggested that income should be divided by determining which states bore the cost of that business' activities. *See* Charles E. McLure, Jr. & Walter Hellerstein, *Does Sales Only Apportionment of Corporate Income Violate the GATT?*, NBER Working Paper Series, Working Paper 9060, 38, fn.10 (July 2002).

14 *Moorman*, 437 U.S. at 274; *Norfolk & Western R. Co. v. State Tax Comm'n*, 390 U.S. 317, 325 (1968).

15 The origins of the idea that property and labor contribute to income can be traced to Adam Smith, who said that the private revenue of individuals arose from rent (from land), profit (from stock) and wages. *See* Adam Smith, *supra*.

16 Admittedly, sourcing these factors to a geographic location can be conceptually difficult in some instances, such as determining the geographic site of intangible property.

17 Richard Pomp, *Report of the Hearing Officer Multistate Tax Compact Article IV (UDIPTA) Proposed Amendments*, Multistate Tax Commission, 12 (Oct. 25, 2013).

18 Arthur D. Lynn, Jr., *Formulary Apportionment of Corporate Income for State Tax Purposes: Natura Non Facit Saltum*, 18 Ohio St. L.J. 84, 98 (1957).

19 Some of this difficulty is likely due to the fact that apportionment formulas largely attempt to assign to one state the value derived from what are often interstate market transactions.

20 Lynn, *supra*, at 98.

21 *Id.* at 90.

22 *Id.* at 99.

23 *Id.* at 98.

24 *Id.* at 87, 88.

25 *See, e.g.*, Cal. Rev. & Tax. Code § 25128(b) (applying an alternate apportionment rule to businesses in California engaged in agricultural, extractive, savings-loan and bank-financial business activities).

26 Pomp, *supra*, at 14.

27 At least one prominent commentator has stated that legislators view the adoption of a single-sales factor apportionment formula as an incentive for in-state investment. *See id.* at 13. A 1998 study by two University of Chicago professors supports the view that single-sales factor formulas create incentives for in-state investment. Austan Goolsbee & Edward L. Maydew, *Coveting Thy Neighbor's Manufacturing: The Dilemma of State Income Apportionment*, NBER Working Paper Series, Working Paper 6614, 4 (June 1998). That study stated that "employment does increase in states that cut their payroll weights but every job comes directly from another state." *Id.* Some legislators have even relied (at least in part) on this study in enacting single-sales factor formulas. *See, e.g.*, Jamie Bernthal et al., *Single Sales Factor Corporate Income Tax Apportionment: Evaluating the Impact on Wisconsin*, xi (May 2012) (stating that the 1998 Goolsbee/Maydew study "played an important role in the decision to enact single-sales factor apportionment") *available at* https://www.lafollette.wisc.edu/publications/workshops/2012/DOR.pdf.

The potential in-state economic benefits appear to be the primary consideration driving adoption of single-sales factor apportionment formulas. For example, one budget summary noted that "[r]eplacing the current three-factor formula with a single-sales factor apportionment factor would reduce taxes on corporations that have a substantial amount of their production activities in the state . . . converting to a single-sales factor is viewed as a means of generating economic growth." Wisconsin Joint Committee on Finance, Corporate Income and Franchise Tax – Single Sales Factor Apportionment Formula, LFB 2001-03 Budget Summary, p. 23, No. 9 (June 5, 2001) *available at* http://legis.wisconsin.gov/lfb/publications/budget/2001-03-Budget/Documents/Budget%20Papers/103.pdf. Similar considerations were important in Illinois; Illinois General Assembly Commission on Governmental Forecasting and Accountability, *Illinois Tax Incentives*, 25 (July 2009) (stating that "[t]he intent of P.A. 90-0613 [single-sales factor apportionment] was to encourage the growth of manufacturing industries in the State. The single-sales factor reduces the income tax burden on firms that have a relatively large share of their property and payroll in Illinois, while making most of their sales out of the state"), *available at* http://cgfa.ilga.gov/Upload/2009JULYILLINOISTAXINCENTIVES.pdf.

We note that a single-sales factor apportionment law, which is enacted for the specific purpose of reducing the tax liability of taxpayers with more labor located in-state and more in-state capital investment, may be discriminatory under the Commerce Clause to the extent it also increases the burden on taxpayers with the majority of their employees and property outside the state. *See Bacchus Imports, LTD v. Dias*, 468 U.S. 263, 272 (1984) (providing that "[a] finding that state legislation constitutes 'economic protectionism' may be made on the basis of either discriminatory purpose . . . or discriminatory effect . . .") (internal citations omitted).

28 Pomp, *supra*, at 12-13.

29 *Id.*

30 *See* Proposition 39 Tax Treatment for Multistate Businesses Clean Energy and Energy Efficiency Funding Initiative Statute, Official Title and Summary, *available at* http://vig.cdn.sos.ca.gov/2012/general/pdf/39-title-summ-analysis.pdf (last visited Apr. 2, 2014).

31 *Oregon Waste Sys., Inc. v. Department of Envtl. Quality of Or.*, 511 U. S. 93, 99 (1994).

ABB v. Missouri
Albany International Corp. v. Wisconsin
Allied-Signal, Inc. v. New Jersey
AE Outfitters Retail v. Indiana
American Power Conversion Corp. v. Rhode Island
Citicorp v. California
Citicorp v. Maryland
Clorox v. New Jersey
Colgate Palmolive Co. v. California
Consolidated Freightways v. California
Container Corp. v. California
Crestron v. New Jersey
Current, Inc. v. California
Deluxe Corp. v. California
DIRECTV, Inc. v. Indiana
DIRECTV, Inc. v. New Jersey
Dow Chemical Company v. Illinois
DuPont v. Michigan
EchoStar v. New York
Express, Inc. v. New York
Farmer Bros. v. California
General Motors v. Denver
GMRI, Inc. (Red Lobster, Olive Garden) v. California
GTE v. Kentucky
Hair Club of America v. New York
Hallmark v. New York
Hercules Inc. v. Illinois
Hercules Inc. v. Kansas
Hercules Inc. v. Maryland
Hercules Inc. v. Minnesota
Hoechst Celanese v. California
Home Depot v. California
Hunt-Wesson Inc. v. California
IGT v. New Jersey
Intel Corp. v. New Mexico
Kohl's v. Indiana
Kroger v. Colorado
Lorillard Licensing Company v. New Jersey
McGraw-Hill, Inc. v. New York
MCI Airsignal, Inc. v. California
McLane v. Colorado
Mead v. Illinois
Meredith v. New York
Nabisco v. Oregon
National Med, Inc. v. Modesto
Nerac, Inc. v. New York
NewChannels Corp. v. New York
OfficeMax v. New York
Osram v. Pennsylvania
Panhandle Eastern Pipeline Co. v. Kansas
Pier 39 v. San Francisco
Powerex Corp. v. Oregon
Reynolds Metals Company v. Michigan
Reynolds Metals Company v. New York
R.J. Reynolds Tobacco Co. v. New York
San Francisco Giants v. San Francisco
Science Applications International Corporation v. Maryland
Scioto Insurance Company v. Oklahoma
Sears, Roebuck and Co. v. New York
Shell Oil Company v. California
Sherwin-Williams v. Massachusetts
Sparks Nuggett v. Nevada
Sprint/Boost v. Los Angeles
Tate & Lyle v. Alabama
Toys "R" Us-NYTEX, Inc. v. New York City
Union Carbide Corp. v. North Carolina
United States Tobacco v. California
UPS v. New Jersey
USV Pharmaceutical Corp. v. New York
USX Corp. v. Kentucky
Verizon Yellow Pages v. New York
Wendy's International, v. Illinois
Wendy's International v. Virginia
Whirlpool Properties v. New Jersey
W.R. Grace & Co.—Conn. v. Massachusetts
W.R. Grace & Co. v. Michigan
W.R. Grace & Co. v. New York
W.R. Grace & Co. v. Wisconsin

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