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The Sales Factor: Top Five Issues Taxpayers Need to Consider

The sales factor is becoming dominate in multistate apportionment; this leads to opportunities for the nimble and traps for the unwary.

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The effect that the sales factor has on state income tax liabilities of multistate taxpayers has grown significantly over the past several years. Currently, ten states impose a "single sales factor" method, [1] and more than 20 others give greater weight to the sales factor. [2] The current emphasis on the sales factor contrasts with the apportionment landscape in earlier years when the sales factor was typically equally weighted with the payroll and property factors. [3] Today, fewer than a dozen jurisdictions still generally employ the "standard" three-factor formula. [4] If this trend continues, one may reasonably assume that those "standard" states will emphasize their sales factors as well.

The extra weighting of the sales factor has some interesting implications. Does a single, sales-factor apportionment regime, with no consideration given to a taxpayer's payroll or property, fairly reflect the taxpayer's activity within a state? [5] The inclusion of payroll and property dimensions of a taxpayer's activity would seem to lend a balance to the measurement of the taxpayer's overall in-state business. If the extra-weighting of sales does not fairly reflect a taxpayer's in-state activity, is such unfairness sufficient to violate constitutional standards? The reliance on a single or heavily weighted sales factor would seem to afford a taxpayer a degree of planning flexibility since the taxpayer need alter only one aspect of its business to significantly alter the apportionment percentage. Moreover, as compared to the payroll and property factors, the sales factor is arguably less precise in terms of its "geography" (i.e., jurisdictional sourcing) and, therefore, more easily rearranged to accomplish various planning agendas, as discussed further below.

Ironically, the sales factor was initially excluded from the recommended standard apportionment formula by a federal congressional panel (the "Willis Committee"), which believed that payroll and property were better measures of in-state activity. [6] The sales factor was included in the original Uniform Division of Income for Tax Purposes Act (UDITPA), however, and became an equally weighted part of the standard three-factor method of income attribution.

If a heavily weighted sales factor facilitates the tax planner's agenda, why have the states moved toward an emphasis on the sales factor? Is the trend based on states' needs for revenue? Is the adoption of the sales factor a competitive economic weapon to attract industry? The sales factor can be said to "export" the tax base to out-of-state taxpayers, and to create an incentive for in-state business. The states' quest for a fair playing field seems to have been tossed aside in the fight for in-state economic investment.

Because apportionment is intended to divide a taxpayer's total taxable business income among the states in which that taxpayer operates, logic would seem to demand that the sales factor include those receipts that generate business income. Similarly, receipts that generate nonbusiness income, which is allocated rather than apportioned, logically should be excluded from the sales factor. With respect to nonbusiness income, logic prevails. [7] Receipts giving rise to nonbusiness income are excluded from the sales factors of all states.

But logic seems to break down with respect to business income, because even if certain sales give rise to *apportionable* income, those sales are not necessarily included in "total" sales, i.e., the sales factor denominator. The authors of UDITPA added a comment in §15 stating: "The sales to be included in the [sales factor] fraction are only the sales which produce business income." [8] In many cases, the states have interpreted this language to mean that while all nonbusiness income must be excluded from the sales factor, all business income is not necessarily included in the sales factor. UDITPA §18 provides for alternative methods when the standard formula does not fairly represent the extent of a taxpayer's business activity in a state, [9] and many states have interpreted this section to allow the exclusion of receipts resulting from the incidental occasional sale of business assets, which receipts normally are considered business income. [10] The statutory intent appears to be to exclude extraordinary items that might skew the apportionment factor within a particular accounting period. The concept seems to be based on the assumption that the vast majority of a typical taxpayer's taxable income in every tax year is from normal business operations. In the year in which a taxpayer sells a substantial portion of its business assets, however, the vast majority of the taxpayer's income may be from the occasional sale of those assets. Thus, the UDITPA §18 exception can and often does lead to less fairness, in direct contrast to its intended purpose.

Another important exception to "total sales" is the exclusion from the sales factor of income from intangible property that is not associated with any particular "income producing activity" of the taxpayer (e.g., interest, dividends, royalties, capital gains, and similar receipts from the "mere holding" of intangibles). [11] The result of this rule: the inclusion of income in the tax base subject to apportionment with no factor representation. This exception can and often does lead to unfair or distorted results—and taxpayers should be vigilant in identifying such circumstances. If the taxpayer identifies a clearly distorted or unfair result prior to the filing of the return, the taxpayer has a better chance to petition the applicable state tax authorities for alternative apportionment.

The general treatment of dividends for state tax purposes often results in a different kind of mismatch. Dividends from subsidiaries are certainly receipts, and therefore normally the taxpayer would include such dividends in the sales factor. States, however, often provide for a statutory exemption or full or partial exclusion for dividends, particularly in instances where specified stock ownership thresholds are met. In unitary states where dividends from subsidiaries are eliminated, their exclusion from the sales factor makes sense. What, however, makes sense in separate-filing states that require the inclusion of all or a part of the dividend in apportionable income?

Most of the controversy regarding sales-factor apportionment seems to fall into two basic scenarios: Generally the states seek to augment the numerator, and taxpayers seek to augment the denominator and/or minimize the numerator. This motivation, of course, will reverse in accounting periods when the taxpayer incurs a net operating loss.

Greater chance of distortion? It would seem that a single-sales factor regime, or a regime that heavily weights the sales factor, may yield distorted or at least unfair results more often than might the traditional, equally weighted three-factor formula. If so, taxpayers should take a new look for opportunities to petition for alternative apportionment. Taxpayers also may experience more instances where states seek to impose alternative apportionment formulas in situations where a heavily weighted sales factor reduces the overall apportionment percentage. (A good example of this phenomenon is illustrated in the receipts "churning" discussion in the text below.)

Another instance where the sales factor can produce distorted or unfair results is with a business consisting of two distinct divisions with markedly different profit margins. The division with a higher margin may have lower sales volume but contribute most of the taxable income. The division with higher sales volume may operate on thin margins, contributing little taxable income. The distortion arises when the taxpayer must combine the sales of both divisions to apportion a single tax base.

Consider a taxpayer that operates two divisions in two states, each with a single sales factor apportionment regime. One division has high margins relative to the other. The taxpayer sells all of its production from the high margin division into state A, and all of its low margin production into state B. In this example, the taxpayer would attribute most sales, and therefore most of the tax base to state B—even though B is the state for the company's low-margin market activity. Taxpayers should carefully analyze profit margins of various businesses operating in jurisdictions with extra-weighted sales factors. In such instances, the taxpayer may have a better chance to justify an alternative apportionment methodology.

Throwback

UDITPA provides a destination test as the general rule for sourcing receipts in computing the sales factor for sales of tangible personal property.[12] Under this rule, gross receipts are in a particular state if the property is delivered or shipped to a purchaser within the state regardless of the f.o.b. point or other conditions of sale.

UDITPA then provides an exception to the general rule, under what is commonly known as the "throwback" rule.[13] Under this rule, gross receipts from sales of tangible personal property are in a state if "the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser."

The Multistate Tax Commission Allocation and Apportionment Regulations, in MTC Reg. IV.16.(a)(6), provide the following example to illustrate the throwback rule:

"The taxpayer has its head office and factory in State A. It maintains a branch office and inventory in this state. Taxpayer's only activity in State B is the solicitation of orders by a resident salesman. All orders by the State B salesman are sent to the branch office in this state for approval and are filled by shipment from the inventory in this state. Since the taxpayer is immune under Public Law 86-272 from tax in State B, all sales of merchandise to purchasers in State B are attributed to this state, the state from which the merchandise was shipped." (P.L. 86-272 is a federal statute that limits a state's ability to assert income tax jurisdiction over a business whose only activity in the state is the solicitation of orders for sales of tangible personal property, provided the orders are sent out of the state for approval and are filled by shipment from outside the state. [14])

Taxable in another state.

The throwback rule theoretically is designed to ensure that all of a taxpayer's sales are attributed to a state in which the taxpayer is taxable, and thus avoid "nowhere" sales. Throwback has been adopted by about half of the states that impose a corporate income tax. [15]

The throwback rule applies when the seller is not taxable in the other, generally destination, state. For example, federal constitutional restrictions might limit the state's ability to impose tax (e.g., the seller does not have a physical presence in the destination state), or P.L. 86-272 may apply to deprive the purchaser's state the power to impose an income or income-based franchise or similar tax. Much of the controversy in this area focuses on whether the seller is "taxable" in the destination state.

Under UDITPA, "a taxpayer is taxable in another state if (1) in that state [the taxpayer] is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or (2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not." [16] Under the first test, a taxpayer is taxable in another state if the taxpayer is actually subjected to the type of taxes listed. The taxpayer may have to prove that a tax return was filed and the requisite tax paid in the other state. The second test uses a notional or hypothetical standard rather than an actual one. According to the UDITPA commentary, the reference in the second test to a "net income tax" is not intended to be more restrictive with respect to the hypothetical tax than the section is with respect to an actual tax. Thus, arguably a taxpayer need prove only that the state has jurisdiction to subject the taxpayer to a franchise tax or privilege tax, not merely a "net income tax."

A sampling of case law. In *Appeal of The Olga Company,* [17] the taxpayer argued unsuccessfully that its activities in other states exceeded the bounds of P.L. 86-272 and therefore should be subject to tax in those states. Olga was a California corporation engaged in the manufacture and wholesaling of high-quality lingerie. Olga employed sales representatives residing in other states who worked out of their homes. The sales personnel helped retailer-customers to inventory and display the taxpayer's products, and used their homes or rented hotel rooms to set up "mini markets" where they presented new product lines to potential and existing customers.

Cal. Rev. & Tax. Code §25122 is modeled after UDITPA's "taxable in another state" provisions. In determining if a taxpayer is "subject to" one of the specified taxes in another state, the taxpayer is required to prove that the requisite tax return has been filed in the other state and any resulting taxes have been paid. A taxpayer that voluntarily files and pays one or more such taxes when not required will not be considered subject to one of the specified taxes. The Franchise Tax Board's (FTB's) administrative rules provides guidance regarding when a state is deemed to have jurisdiction to subject a taxpayer to a net income tax. Under 18 Cal. Code Regs. §25122(c), jurisdiction to tax is not present if the state is prohibited from imposing tax due to P.L. 86-272. In *Olga,* the taxpayer conceded that it did not file any tax returns in the other states. The California State Board of Equalization held that the activities of Olga's salesmen did not rise beyond the protections afforded by P.L. 86-272. Accordingly, Olga's sales from California into the other states where its salesmen worked were thrown back and included as California sales.

In *Dover Corp. v. Department of Revenue,* [18] the Illinois Appellate Court considered that state's administrative rules on when a taxpayer is taxable in another state. Under 86 Ill. Admin. Code §100.3200(a)(2), a taxpayer not only must be subject to tax in another state, but also must pay tax in that other state. In *Dover,* the court agreed with the taxpayer that its activities in the other states exceeded the protections afforded by P.L. 86-272. The taxpayer argued therefore that those other states had jurisdiction to tax its income. Citing the regulation, however, the court held that since Dover did not actually pay tax in the other states, its sales into those states should be thrown back to Illinois. [19]

In contrast, the Indiana Department of State Revenue ruled that, for purposes of Indiana's throwback rule, a company was subject to tax in Kentucky where there was no P.L. 86-272 protection, even though the taxpayer did not actually file income tax returns or pay tax in Kentucky. [20] The Department noted that "whether taxpayer does or does not file a Kentucky income tax return, does or does not pay Kentucky income taxes, is irrelevant and is of no concern to the state of Indiana." Thus, the taxpayer was not required to throw back Kentucky sales to Indiana, and was able to obtain "nowhere" income.

Similarly, in *Colgate-Palmolive Company v. Commissioner of Revenue,* [21] the Massachusetts Appellate Tax Board ruled that a company's sales of medical supplies to customers in 33 other states should not be thrown back to Massachusetts because the taxpayer's activities in the other states exceeded the protections of P.L. 86-272. The case did not discuss whether the taxpayer actually filed tax returns in those other states.

The throw-out rule. New Jersey and West Virginia have adopted an alternative to throwback; they employ a "throw-out" rule, whereby receipts sourced to a state where the taxpayer is not subject to tax are removed from the receipts factor entirely, thereby increasing the overall receipts factor in taxing state. New Jersey regulations provide that if the taxpayer is not subject to a tax on or measured by profits or income or a tax on business presence or activity in the destination state, the sales are excluded from the denominator of the New Jersey sales factor. [22] Thus, if the seller is subject to a gross receipts or net worth tax in the destination state, the throw-out would not apply.

West Virginia, the first state to adopt the throw-out rule by statute, provides that receipts from sales of tangible personal property (other than sales to the federal government) delivered or shipped to a purchaser in a state in which the taxpayer is not taxed are excluded from the denominator of the sales factor. [23] "Taxable in another state" refers to the taxpayer's actually being subject to an income or franchise tax, or the other state's having the jurisdiction to subject the taxpayer to a net income tax.

Double throwback. UDITPA also provides for the sourcing of sales involving "drop shipments," which the MTC regulations describe as sales made by salespersons operating from an office in one state to a purchaser in another state where the taxpayer-vendor is not taxable and that are filled by a third party shipping directly to the purchaser. [24] Under this rule, if the taxpayer is taxable in the state from which the product is shipped, the sale is sourced to that state. If the taxpayer is not taxable in the shipped-from state, the sale is sourced to the state where the salespersons operate. This rule is sometimes known as the "double throwback" rule.

The MTC regulations provide the following example to illustrate this rule: "The taxpayer in this state sold merchandise to a purchaser in State A. Taxpayer is not taxable in State A. Upon direction of the taxpayer, the merchandise was shipped directly to the purchaser by the manufacturer in State B. If the taxpayer is taxable in State B, the sale is in State B. If the taxpayer is not taxable in State B, the sale is in this state." [25]

Large Internet retailers frequently make drop-shipment sales using third-party manufacturers. If the retailer is not taxable in the destination state, the sale should get thrown back to the location where the product is shipped from, or if the retailer is also not taxable in that state, to the state in which the sales agent's office is located.

FIN 48 implications from throwback. In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109* (generally referred to as "FIN 48"), which clarifies rules regarding income tax accounting for financial statement purposes, and provides a recognition threshold and measurement in connection with evaluating and reporting the benefit of an uncertain tax position. [26]

Under FIN 48, a retailer may find that it has to accrue state income tax expense related to states where it has not previously been filing returns. This situation could arise, for example, if an Internet retailer with a related entity that has "brick-and-mortar" stores in the destination state has previously taken the position that there was no nexus for the Internet sales entity. Presumably, the retailer has previously thrown back these sales to its home state. Under FIN 48, there is now double tax expense recorded on the books—once for the throwback sales and once for the potential liability related to the destination sales. In this situation, it may actually be desirable to file in the destination states and avoid throwback to the home state. The retailer may even be able to get refunds for open tax years by filing in the destination states for those years and amending the home state returns to eliminate the throwback.

Joyce vs. *Finnigan:* Risks and Opportunities

A related issue arises in the throwback arena when dealing with a combined unitary reporting state. As noted above, under UDITPA sales are thrown back when the taxpayer is not taxable in the destination state. A question then arises as to whether "taxpayer" means (1) only the selling member of the unitary group, or (2) all the members of the group. A corollary issue arises for sales into a combined reporting state as to whether the destination sales should be included in determining the numerator of the combined reporting group's sales factor when the entity making the sale does not have nexus in the taxing state.

In *Appeal of Joyce, Inc.*, [27] a California corporation and its non-California parent (U.S. Shoe Co., Inc.) manufactured and sold women's shoes. The California State Board of Equalization (SBE) held that the two companies operated as a unitary business in California. The parent company was protected from California tax by P.L. 86-272. As a result, the SBE held that the apportionment of income to California for the unitary group should be made on the basis of Joyce's property, payroll, and sales in California. The parent's sales into California were not considered in the numerator of the unitary group's combined sales factor.

The "*Joyce*" rule was in effect in California for more than 20 years, until the SBE's decision in *Appeal of Finnigan Corp.* [28] While *Joyce* concerned sales into California (inbound sales), *Finnigan* involved the throwback of sales from California (outbound sales). The question in *Finnigan* was whether "taxpayer" meant the particular selling company or all the corporations within the unitary group. Finnigan and its wholly owned subsidiary sold goods that were shipped from California to a customer in another state where the parent was taxable but the subsidiary was not. The FTB, following *Joyce,* determined that since the subsidiary, as a separate legal entity, was not taxable in the destination state, its sales had to be thrown back to California even though the parent was taxable in the destination state. The SBE rejected the FTB's position and held that "taxpayer" as used in the relevant California statute "means all corporations within the combined unitary group." Thus, agreeing with the taxpayer, the SBE held that no throwback was required.

In FTB Notice No. 90-3, 6/8/90, the FTB announced that, as a result of the SBE's decision in *Finnigan,* it would thereafter follow that rule rather than the *Joyce* rule. The *Finnigan* rule thus became the law of California, but only until 1999 when the SBE decided *Appeal of Huffy Corp.* [29] There, the SBE noted that only a minority of states had adopted the *Finnigan* rule, and that the application of that rule gives rise to the following scenarios (which would not arise under the *Joyce* rule):

- "California-based sellers who sell into other states where they are immune from tax as individual corporations will not be subject to tax in any jurisdiction even though their sister entities are taxable."
- "Non-California based sellers who sell into California where they are immune but their sister entities are taxable will run the risk of being subject to double taxation. (Their home states will treat the sale as allocable there because of the throwback rule; California will treat the same sales as California-based.)"

In *Huffy* (which, like *Joyce,* involved inbound sales), the position established in *Finnigan* was abandoned and the rule set forth in *Joyce* was prospectively readopted.

Other states consider the divergent *Joyce*/*Finnigan* rules.

In 1987,in *Airborne Navigation Corp. v. Arizona Department of Revenue,* [30] the Arizona State Board of Tax Appeals applied the *Finnigan* rule with respect to inbound sales, and concluded that the Arizona-destination sales of a nontaxpayer member of a unitary group were includable in the numerator of the group's sales factor if any member of the group were subject to Arizona's taxing jurisdiction. Thus, in *Airborne,* Arizona sales by the group's parent corporation, which was otherwise protected under P.L. 86-272, had to be included in the numerator because the unitary subsidiary was subject to tax in Arizona.

In *Emerson Electric Co. v. Wasson,* [31] the South Carolina Supreme Court held that throwback was required for outbound sales where the taxpayer was not taxable in the destination states, although its parent corporation was. The court effectively applied the *Joyce* rule in a consolidated rather than combined return setting. [32] The court noted that "when two or more corporations join in a consolidated tax return, each remains an identifiable taxpayer," and a corporation "does not lose its status as an identifiable entity by affiliating with another."

In a 1991 ruling, the Kansas Department of Revenue held that for tax years beginning after 1990, the *Finnigan* rule would apply. [33] Thus, if sales are made by one member of a unitary group from an out-of-state location into Kansas and the activities of any one or more members of the group in Kansas exceed the activity protected by P.L. 86-272, the sales will be treated as Kansas sales for purposes of the state's sales factor. Conversely, if sales are made by one member of a unitary group from a Kansas location into a state in which the activities of any one or more members of the group exceed the activity protected by P.L. 86-272, those sales will be treated as sales in the destination state for purposes of the sales factor numerator, and throwback is not required.

In *Dover Corp. v. Department of Revenue,* [34] the Illinois Appellate Court held that an Illinois member of a unitary group that shipped goods from Illinois to a state where the member was not subject to tax could not avoid throwback of sales based on the taxability in the destination state of another member of the group. The court refused to follow the *Finnigan* decision and noted (similar to the South Carolina court in *Emerson*) that individual corporations do not lose their identity as taxpayers merely because they file combined returns with related entities.

Most recently, in *Disney Enterprises, Inc. v. New York Tax Appeals Tribunal,* [35] the Department of Taxation and Finance sought to apply the *Finnigan* rule where it found that a corporate group, viewed in its unitary capacity, was engaged in activities in New York beyond mere solicitation and was not protected by P.L. 86-272. The New York Tax Appeals Tribunal upheld the Department, although it acknowledged that if the subsidiary in question were viewed alone, the entity would be a nontaxpayer in New York protected by P.L. 86-272. In affirming the Tribunal's decision, the Appellate Division, quoting P.L. 86-272, noted that it prohibits taxation "if the *only* business activities within such state by or *on behalf of* such person" are limited to the solicitation of orders for sales. (Emphasis added by the court.) The court found, however, that the New York activities of the other members of the taxpayer's unitary business group greatly benefited the entity in question and fell within the statute's "on behalf of" language. According to the court, no single member's role "should be extracted from the group, analyzed separately, and afforded ... a protection that would distort the group's economic activity in New York." Thus, the New York sales of the subsidiary in question, which may otherwise have been protected by P.L. 86-272, were included in the numerator of the New York sales factor.

Examples.
The following examples illustrate how a company's apportionment factor can be dramatically altered depending on whether the *Joyce* or *Finnigan* rule applies in a particular state. Since *Joyce* effectively allows a taxpayer's legal form to override economic substance, in certain circumstances taxpayers may consider combining their sales and manufacturing operations into one legal entity or separating them depending on the desired result.

Example 1: Inbound sales. Parent "P" is not a taxpayer in the destination state, where it is comes under the protection of P.L. 86-272. Subsidiary "S" is a taxpayer in the destination state, and is engaged in a unitary business there with P. In Part A, the destination state is Kansas, which uses the *Finnigan* rule. In Part B, the destination state is California, which uses *Joyce.*

As indicated in Exhibit 1, with regard to inbound sales, the destination state's apportionment factor is 31.3% under the *Finnigan* rule, but only 14.6% under the *Joyce* rule.

Example 2: Outbound sales and throwback. S is engaged in a unitary business with P, and is a taxpayer in all destination states. It has total sales of $10,000, of which

$8,000 are in the home state and $2,000 are shipped to other states. P has total sales of $20,000, all of which are shipped outside the home state, and $15,000 of which are shipped to states in which P comes under the protection of P.L. 86-272 and thus is not a taxpayer. Therefore, the potential for throwback exists for these $15,000 of sales. In Exhibit 2, the home state of both S and P is Kansas, a *Finnigan* state, and in Exhibit 3, California, a *Joyce* state.

As indicated in Exhibit 2, the home state's apportionment factor is 25.8% under the *Finnigan* rule. In Exhibit 3 however, as a result of throwback for outbound sales under the *Joyce* rule, the home state's apportionment factor is 50.9%.

The Sales Factor in Foreign Commerce

How is the sales factor applied to sales into the U.S.? How is the sales factor applied to U.S. sales into foreign countries? Can states with throwback (or throw-out) rules use them with regard to sales made to customers in foreign countries? How do tax treaties with foreign countries fit in? As one might expect, the states have inconsistent approaches with respect these issues.

Effect of U.S. treaties on state taxation of foreign commerce.

The U.S. has tax treaties with almost every industrialized country. These treaties represent agreements between the governments to impose consistent tax regimes in order to preclude double taxation of entities that reside and carry on business in both treaty countries. Unfortunately, the U.S. has consistently taken the position that its tax treaty network generally does not cover state taxation. As a consequence, state and local taxation of a U.S. business selling into a foreign country is generally not limited by any U.S. tax treaty, and a foreign business in country that is a party to a U.S. tax treaty is generally not thereby protected from U.S. state and local taxation. [36]

Anomalies presented by UDITPA and P.L. 86-272.

Under UDITPA, a "state" includes "any foreign country." [37] This inclusive definition becomes important when U.S.-based companies sell directly into foreign countries from any of the more than 20 states with a throwback rule. [38] Since, as discussed above, the state taxpayer has no treaty protection, those states will, under certain circumstances, throwback foreign sales. [39]

In connection with UDITPA's defining a "state" as including a foreign country, an issue arises as to when, for purposes of throwback, a business is deemed "taxable" in the foreign country. The states have taken various approaches. To be considered "taxable," some states require that taxpayer's activities in the foreign country comprise more than mere "solicitation" under P.L. 86-272. Other states require that the business be taxable under U.S. constitutional standards (i.e., due process) without regard to P.L. 86-272. Still others require that the taxpayer be subject to tax under the applicable foreign jurisdictional standard. And some states require that the taxpayer provide a copy of a foreign tax return or that, in addition to the foreign country's having jurisdiction to tax, the taxpayer actually pay tax to that foreign country.

Since P.L. 86-272 applies to "income derived ... from interstate commerce," [40] one might argue that by requiring that, for "taxability," activities must exceed P.L. 86-272 in the foreign jurisdiction, a state is reaching beyond the scope or intent of that statute. Nevertheless, in *Appeal of Dresser Industries, Inc.,* [41] the California Franchise Tax Board argued that such a standard should apply with regard to a foreign jurisdiction, or California would lack "uniformity" in the taxation of interstate and foreign commerce because P.L. 86-272 would apply to the former but not to the latter. The State Board of Equalization, however, disagreed.

Dresser Industries and its subsidiaries operated a multinational unitary business. The company sold pumps in various foreign countries, (1) some where it filed tax returns and paid tax; (2) others where Dresser did not conduct business but, rather, sold pumps to foreign subsidiaries that, in turn, sold to third parties; and (3) still others where it sold via salesmen who submitted orders to be filled and shipped from California. The parties agreed that sales under item (1) were not to be thrown back. The FTB argued that the sales under (2) and (3), however, were to be thrown back because the taxpayer's activity in those countries would have been protected under P.L. 86-272 had the foreign jurisdiction been a state. Dresser countered that since P.L. 86-272 applied to only "interstate commerce," the sales were not subject to throwback.

The SBE agreed with Dresser, reasoning that the FTB, in a theoretical case involving sales by a foreign company into California, would argue for the inapplicability of P.L. 86-272 and seek to tax such activity. If P.L. 86-272 would be inapplicable in an inbound context, it should be inapplicable also in an outbound context. Thus, in *Dresser,* California adopted a U.S. constitutional standard for taxability, interpreting P.L. 86-272 as applying to interstate sales only, and not to exports from California to foreign countries, which exports therefore are not thrown back to California.

A 2002 Multistate Tax Commission survey indicated that of the 23 states that require throwback of foreign sales, 12 use a P.L. 86-272 standard. [42] California and Idaho use U.S. constitutional standards, and the remaining foreign throwback states use the foreign jurisdictional standard. In states that use the latter standard, determining what foreign tax to use in establishing taxability may be difficult. For example, should a company's being subject to the European "value added tax" be considered the standard?

State of origination for purposes of foreign sales throwback. A risk may exist that a taxpayer's foreign sales could get thrown back to more than one state when, e.g., the goods originate in one state but are exported through a port in another state. In a 1986 Multistate Tax Commission survey (the only readily available information found on this topic), [43] only New Hampshire had "no position" on the subject. Most states would require throwback to the state from which the goods were originally shipped, rather than the port state. If the goods were "processed" in the port state, however, most states would throw back the sales to the port state. Unfortunately, the survey did not define "processed," which some states interpreted as meaning "manufacturing" or "change in value," while others interpreted it as "material alteration." As with other sales-factor issues, this question will become more important as the sales factor continues to "gain weight," since many export sales involve different origination and port states.

Foreign companies that export goods to the U.S. Since P.L. 86-272 protects only interstate commerce, foreign companies selling into the U.S. cannot claim immunity under that law. Moreover, as noted above, even if the foreign company is based in a country that is a party to a U.S. tax treaty, the treaty generally does not preclude state taxation. Thus, a state may be able to impose an income tax on a foreign company that has no "permanent establishment" and is merely soliciting sales in the U.S., even if that company is protected by treaty from U.S. income taxation. Nevertheless, as a practical matter, since most state income tax systems are based on federal taxable income, a foreign company's state income tax exposure would be unlikely without federal income tax exposure.

Still, consider a foreign company that is soliciting sales in the U.S. but has no "permanent establishment" here. The company's home country has a tax treaty with the U.S. that, presumably, would prohibit U.S. federal income taxation of the foreign company absent a U.S. "permanent establishment." Because the treaty does not bind a state, however, and, in foreign commerce, mere solicitation is not protected by P.L. 86-272, the state presumably could impose an income tax on the foreign company. In this example, two results seem possible, depending on the basis by which the state imposes an income tax. If the state income tax is based on "federal taxable income," the foreign company would escape taxation since there it has no federal taxable income. If, however, the state has adopted the Internal Revenue Code and imposes a tax "as if" the company had taxable income under the Code, the foreign company could have state income tax exposure.

Churning

As the states have emphasized the sales factor over the past few years, taxpayers have sought additional ways to increase the sales factor denominator. As noted above, a larger denominator generally benefits the taxpayer, while a larger numerator generally benefits the taxing state.[44] The inclusion in the sales factor denominator of gross receipts arising out of the activities of a corporation's finance or treasury department can often materially affect the taxpayer's apportionment factor. This tactic is sometimes referred to as "churning," i.e., buying and selling short-term securities, giving rise to significant gross proceeds for apportionment purposes.

The benefit of the churning strategy is maximized when "receipts" include the *gross proceeds*—i.e., return of principal, and not just the profits—from the sale of marketable securities. Many corporate treasury departments trade securities on a frequent, even daily, basis, and the impact of the strategy can be significant.[45] If the corporate treasury department is located in a state where such "receipts" are not included in the sales factor numerator or if the treasury activities are in a separate corporation in a state that does not tax this type of income, the net effect of the strategy is to decrease the taxable income apportioned to taxing states. In states where the sales factor is equally weighted, the benefit of churning is reduced by the property and payroll factors. In today's environment, however, where many states are more heavily weighting the sales factor, the inclusion of churning receipts can have a more significant impact on state tax liabilities.

The states are hardly consistent as to whether such receipts are included in the sales factor. Some states specifically exclude securities redemptions but include receipts from securities sales. Other states include "net proceeds" or "net gain," while still others refer only to "gross receipts" without further guidance or authority. In response to the controversy surrounding churning, the MTC has proposed model regulations, which might be termed "anti-churning," that exclude investment returns of capital and include only net investment gains in gross receipts. In many instances, the net gain on the sale or redemption of securities traded on a regular basis is small, if not zero. Therefore, states with a "net gain" rule have taken most of the dilutive power of churning off the table.[46]

The court decisions dealing with churning generally have "good news" and "bad news" components. On the taxpayer side, courts have often held that receipts of principal (not just gains), as well as interest or return on investment, are properly considered "gross receipts" for apportionment purposes under prevailing statutory definitions of "gross receipts" or "sales." Other courts have also often held that the inclusion of churning receipts, while proper from a definitional standpoint, creates an unfair result for the taxing state. Accordingly, in many cases, the states have successfully invoked their alternative-apportionment-methodology powers in order to exclude from the sales factor denominator receipts attributable to return of principal.

The unusual aspect of these "churning" decisions is the frequency of the states' use of their discretionary powers to set aside the standard statutory methodology—a power that a taxing state, at least in theory, should use only in unusual or infrequent circumstances. If the states are on the road to regularly imposing an alternative apportionment methodology because the heavily weighted sales-factor approach fails to fairly apportion income, does this imply that such sales-factor regimes are often unfair?

California courts weigh in on churning.

Three recent California cases addressed either the churning issue or the definition of "receipts" for apportionment purposes. All three cases concerned whether receipts from the respective taxpayer's out-of-state treasury department investment activities, e.g., proceeds from securities sales, redemptions, and repurchase agreements (commonly known as "repos"), are "gross receipts" for apportionment purposes. In two of the cases, *Microsoft Corporation v. Franchise Tax Board* [47] and *Square D Company v. California Franchise Tax Board,* [48] the courts agreed with the respective taxpayers that gross proceeds from treasury department investment activities are included in gross receipts for apportionment purposes. Nevertheless, these courts also agreed with the FTB that this inclusion of treasury's gross receipts in the sales factor denominator resulted in distortion and, therefore, the FTB could employ alternative apportionment under Cal. Rev. & Tax. Code §25137 (California's equivalent of UDITPA §18).

The *Microsoft* case. In *Microsoft,* the California Supreme Court considered whether Microsoft's proceeds from sales and redemptions of short-term marketable securities were included under Cal. Rev. & Tax. Code §25120(e), which defines gross receipts for apportionment purposes. Microsoft sold some of these securities to third parties, while others were held and redeemed at maturity. The entire proceeds of these transactions, $5.7 billion, were included as gross receipts, and all the resulting treasury department income was reported as business income. On audit, the FTB accepted the taxpayer's treasury business-income classification and allowed the inclusion of proceeds from securities *sales* as gross receipts. For securities held to maturity, however, only the difference between the redemption price and the purchase price was treated as gross receipts. Because Microsoft's treasury department activities were carried on in Washington, receipts were included in the taxpayer's California sales factor denominator but not the numerator. Thus, inclusion of the full proceeds as gross receipts would have diluted the sales factor (from roughly 11% percent to 3%) and reduced Microsoft's California income tax by nearly 50%. In contrast, including only the net price differential had the effect of increasing Microsoft's California sales factor and its resulting state tax.

In finding that, from the security holder's perspective, redemptions of securities were not different from sales of securities, the California high court stated: "In the sale of a security one day before maturity, the investor relinquishes the bundle of rights that go with the security in exchange for, let us say, a sale price of 99.98. In a redemption upon maturity, the investor relinquishes the identical bundle of rights on the maturity date for the full par value of 100. From the perspective of the investor's balance sheet, the transactions are identical...."

But the finding that proceeds from both sales and redemptions of securities were included in gross receipts did not end the matter. The court agreed with the FTB regarding its authority to impose an alternative apportionment formula because, in the court's view, the inclusion of the sales and redemption proceeds caused distortion. Since the FTB was the party invoking Cal. Rev. & Tax. Code §25137, the court required the FTB to show that

(1) the approximation provided by the standard formula was unfair, and (2) the proposed alternative apportionment method was reasonable. In examining whether to invoke §25137's corrective role, the court examined four factors:

> (1) The qualitative differences between the company's principal business and its treasury department activities.
> (2) The quantitative difference between the income produced by the treasury department activities and the gross receipts generated by those activities.
> (3) The quantitative difference between the treasury margin and the non-treasury margin.
> (4) The overall quantitative difference between applying the UDITPA formula both with and without the full redemption price included in the sales factor.

The court did not address the regulatory requirement that a departure from UDITPA's standard apportionment methodology should apply only in "limited and specific cases" involving "unusual fact situations (which ordinarily will be unique and nonrecurring)." [49] In view of the other two cases discussed below, it may be difficult to comprehend that the typical trading patterns in a large corporation's treasury department is "limited and specific" or is an "unusual fact situation."

The *GM* case. On the same day it decided *Microsoft,* the California Supreme Court also rendered its decision in *General Motors Corporation v. Franchise Tax Board.* [50] In this case, the court distinguished Microsoft's sales and redemptions of short-term marketable securities and General Motors' income earned from repurchase agreements, or "repos." Following an extensive analysis of the nature of repos, the court ultimately held that they were more akin to loans than to sales or redemptions, and thus the return-of-principal element of repos were excluded from the sales factor (only investment returns, such as interest and net gains, were included). The court reasoned that repos are "in essence nothing more than financing arrangements by which one party provides funds to another for a short period of time." The court remanded to the FTB for further proceedings the issue of alternative apportionment.

The *Square D* case. More recently, a California Superior Court considered a refund claim of Square D Company in connection with a "churning" issue regarding the taxpayer's total receipts from Eurodollar time deposits held to maturity. The court ruled that these transactions were "investments," not loans, and therefore generated gross receipts for sales-factor purposes. Similar to the outcome in *Microsoft,* however, the court held that the FTB had proven that the standard apportionment formula failed to fairly reflect Square D's business activity in California. Here, too, the court did not address the additional regulatory requirements that a departure from UDITPA's standard apportionment methodology should apply only in "limited and specific cases" involving "unusual fact situations (which ordinarily will be unique and nonrecurring)." The mere fact that, in the course of nine months, California courts heard three cases involving similar "churning" fact patterns seems to indicate that these are not "limited and specific cases" and do not involve "unusual fact situations."

Why did the courts fail to address California's additional regulatory requirements for application of an alternative apportionment methodology? If they had, a different conclusion might have resulted. Just how "limited" is the turnover of securities by a treasury department? How "unusual" is it to redeem short-term securities? What is it about these fact patterns that are "unique and nonrecurring"? If such fact patterns are ordinary, should the courts sanction the FTB's repeated imposition of alternative apportionment?

Other states' litigation. Several other cases concern the "churning" issue, and many states have amended their laws to keep "churned" receipts out of the sales factor. In apparently only one case, *Sherwin-Williams Co. v. Department of Revenue,* [51] did the taxpayer enjoy a victory. This taxpayer victory was short-lived, however, since shortly after the decision, Oregon amended its laws to exclude from the sales factor gross receipts from the sale of securities and other intangible assets, unless the receipts were derived from the taxpayer's primary business activities.

Sherwin-Williams litigated this same issue in Tennessee and Indiana. In *Sherwin-Williams Co. v. Johnson,* [52] a Tennessee appellate court found that while the return of principal was "gross receipts," Tennessee was justified in invoking the state's "equitable relief" statute. In *Sherwin-Williams Co. v. Indiana Department of State Revenue,* the Indiana Tax Court held that principal proceeds are not included in the sales factor. [53]

Lessons learned. The "churning" cases offer some important lessons. Taxpayers should think broadly about the meaning of "gross receipts," and consider sales of derivatives, hedges, and foreign currency exchanges, investments in mutual funds, receivable factoring, and other similar transactions involving securities, both long and short term. Should the taxpayer include return of principal in gross receipts? The state tax planner should question a state tax return that reports a sales factor denominator equal to line 1c ("gross receipts or sales, less returns and allowances") of the taxpayer's federal Form 1120 ("U.S. Corporation Income Tax Return"). In that situation, the taxpayer likely has failed to consider corporate treasury department activity. Moreover, is that activity carried on in a jurisdiction that could assert that "churned" receipts should be reported in the sales factor numerator? If, under a strict reading of the state's statute, such a risk exists, does the taxpayer have exposure under FIN 48? How likely is it that the taxpayer would obtain equitable relief in a case where "churning" creates an increase in tax liability? Can the taxpayer relocate treasury operations?

Taxpayers should be mindful that states increasingly seem to be using their UDITPA §18-type alternative apportionment powers, as evidenced by many of the "churning" cases. Arguably, apportionment based solely on receipts, or where extra weight is given to the sales factor, might produce "distorted" results more often than might the standard three-factor apportionment. In fact, one might argue that states using a single-factor methodology are inherently "unfair." [54] How likely is the state to require alternative apportionment? To what extent do "churned" receipts move the apportionment needle?

Taxpayers might seek to segregate corporate treasury operations in a separate entity, with the objective of increasing the chances of including in the sales factor denominator proceeds from the sale of short-term securities, etc. With a separate and distinct treasury function, the taxpayer probably has a better defense against a state challenge based on the argument that treasury is not a separate income-producing activity. Similarly, if a taxpayer is engaged in receivable factoring, the segregation of such activity in a separate subsidiary might lead to a different sales factor. Conversely, segregating treasury functions into a separate entity could be a double-edged sword. In unitary states, segregation might bolster the taxpayer's position to include "churned" receipts. Removing the treasury department from an entity, however, would probably have a negative impact in separate-filing states since "churned" receipts would no longer exist in the separate entity.

Beyond looking at the corporate treasury department, taxpayers should consider the opportunity, and trap, associated with wide variations in profit margins within a single entity or within a unitary group. From an opportunity standpoint, taxpayers should consider petitions for separate accounting, or separate apportionment, of divisions with divergent profit margins. Conversely, taxpayers should be wary of the state's power and propensity to invoke UDITPA §18-type provisions.

Finally, taxpayers in the "financial services" industry—in the broadest sense of that phrase—should take an expansive view of "gross receipts" considering the myriad investment activities that typify a financial services company. Brokerage companies, banks, and even data processing companies dealing with payroll and other financial assets should carefully consider the relevance of the "churning" strategy and look for opportunities to build denominator—and to avoid getting "trapped" in a sales-factor numerator.

Sales Factor Issues and Opportunities in E-Commerce

Among the most significant issues in connection with the sales factor in e-commerce are: (1) the blurred line as to tangible vs. intangible property, and (2) electronic delivery.

Tangible vs. intangible personal property.

UDITPA §§15 through 17 set forth the rules under which a multistate taxpayer determines its sales factor. Under §16, receipts from sales of tangible personal property generally are sourced to the state in which the property is delivered to the purchaser. Under §17, receipts from sales of other than tangible personal property generally are sourced to the state in which the greater proportion of the income-producing activity is performed, based on costs of performance. While nearly all states follow the UDITPA §16 rules for sourcing sales of tangible personal property, many states do not follow §17 with regard to sales of other than tangible property.

In determining which sales factor rule to follow, one must first determine if the item being sold is "tangible personal property." Unfortunately, UDITPA does not include a definition of that phrase. This lack of a definition may not have been a problem when UDITPA was drafted in 1957. In today's high-tech economy, however, many products sold by taxpayers that appear to be intangible may be treated as tangible property. The form in which an item is sold often determines whether the item is treated as tangible. For example, an intangible item such as software is usually treated as tangible if it is sold on a tangible medium, such as a compact disc.

In general, the states have been slow to pass laws to define tangible property for apportionment purposes. In states that have failed to provide adequate guidance in this area, taxpayers should closely examine their products to determine if an apportionment advantage can be gained based on the tangible/intangible classification of the product. Where sales-factor guidance is ambiguous, taxpayers should research the tangible/intangible property rules that apply to other types of taxes, especially the sales tax. When a product includes both tangible and intangible elements (e.g., a machine tool that includes installed software to assist in operating the tool), taxpayers should consider whether it is permissible—and advantageous—to divide the product into its tangible and intangible components. Finally, as part of this process, taxpayers must make sure that their accounting is consistent with the position they take on their state tax returns. For example, if a taxpayer decides to separate its product into tangible and intangible components, listing the two components separately on the invoice or, perhaps even better, issuing separate invoices might be advisable.

Example. The opportunity created by the tangible/intangible property inconsistency is illustrated by the following example: A software vendor in state A has a significant market in state B, which offers no guidance as to whether software that is sold electronically is treated as tangible or intangible property. State A, which does not employ throwback, treats sales of electronically delivered software as the sale of tangible personal property (i.e., sales generally are sourced to the customer's location). In this instance, the taxpayer potentially could treat state B sales as "nowhere" sales. That is, for state A tax purposes, the vendor could source these software sales to state B as sales of tangible personal property, which are attributed to the purchaser's state. For state B tax purposes, the vendor could source these sales to state A as sales other than sales of tangible personal property, and thus attributed to the vendor's state, where the activity, based on costs of performance, occurs.

Confusion in a couple of states. The guiding authority on software sales in California and Texas illustrates the level of confusion related to the tangible/intangible property issue. With regard to software, California's approach under sales and use tax law is inconsistent with its approach under franchise tax law. Software sold over the Internet and delivered electronically apparently is not subject to California sales tax. The State Board of Equalization considers the transaction to be a nontaxable sale of an intangible. [55] For sales-factor apportionment purposes, however, California seems to have little official guidance regarding whether the electronic delivery of software is a sale of tangible property. Given this lack of authority, a reasonable approach for sales-factor purposes might be to follow the sales tax rule and source sales of electronically delivered software as sales of other than tangible personal property. Nevertheless, based on informal discussions with the Franchise Tax Board, it appears that the FTB holds the opposite view, i.e., the electronic sale of software is the sale of tangible property.

In calculating the tax base under Texas's new "margin tax" (which generally replaced the state's franchise tax, effective 1/1/08), taxpayers compute the taxable margin by subtracting from total revenue either (1) cost of goods sold or (2) compensation. [56] In determining "cost of goods sold," "goods" means "real or tangible personal property sold in the ordinary course of business," and "tangible personal property" includes "a computer program." [57] Thus, for purposes of computing the taxable margin, software is tangible personal property. In contrast, however, under proposed regulations regarding apportionment for purposes of the margin tax, computer software is treated as an intangible. [58]

Electronic delivery: "cyber-docks" and "drop-shipped downloads."

The new high-tech economy gives taxpayers the opportunity to interpret old rules under a changing paradigm with respect to transportation and delivery. Consider the electronic transmission of computer software or an audio file: Is it considered a "delivery" of tangible personal property? In this context, is the Internet a common carrier? What is the destination of the item sold? From where does the "shipment" originate for purposes of throwback? If the customer has multiple servers in different locations, how can the seller know which server receives the electronic transmission? If the purchaser takes "possession" in the form of a download to a server at headquarters and then e-mails the software to one or more different locations, what is the "ultimate destination" for states that use such destination to source sales for apportionment purposes? Moreover, if the taxpayer takes "possession" by using an "unlock key" (e.g., a code used to access the program) and downloading the software from the seller's server, does this constitute a virtual "dock sale"? In this latter fact pattern, where is the "dock"?

Before attempting to answer these questions, a review of the current rules applicable to tangible personal property in general is useful. In a "dock sale," a purchaser, using its own vehicles, picks up goods at the seller's place of business (e.g., at the loading dock). If the purchaser then immediately transports the goods outside the seller's state, the question is whether the sale is sourced to the state where the goods were picked up, or the state to which they are then transported (e.g., the purchaser's place of business). The states lack uniformity on this issue. [59] Furthermore, for states that source sales of tangible personal property to the destination state, if the transportation of the property includes both an intermediate and a final destination, which is controlling for sales sourcing purposes?

Destination vs. delivery. In *McDonnell Douglas Corp. v. Franchise Tax Board,* [60] the taxpayer was a Maryland corporation that manufactured commercial and military aircraft and aircraft parts that it sold to customers around the world. Most of the commercial aircraft was delivered to customers at the taxpayer's facility in Long Beach, California, or at a facility in Yuma, Arizona. The customers then arranged for transportation of the aircraft to an ultimate destination. The dispute focused on whether sales of aircraft manufactured and delivered in California for use outside the state should be included in the numerator of the California sales factor.

The California Court of Appeal held that the sales were properly sourced to the ultimate state of destination and, thus, were not California sales. The relevant statutory language (in Cal. Rev. & Tax. Code §25135) states: "Sales of tangible personal property are in this state if: (a) The property is delivered or shipped to a purchaser ... within this state regardless of the f.o.b. point or other conditions of the sale." The court agreed with the taxpayer that "the emphasis in the statute should be placed on the words 'purchaser ... within this state' and therefore the statute should be interpreted to exclude from subdivision (a), and hence from inclusion in the sales factor, sales from aircraft delivered in California, but destined for use in other states, since the purchaser is not 'within this state.'" In reaching this conclusion, the court cited several decisions of other states' courts that indicated a general consistency that the "destination" of the goods, rather than the "place of delivery," is determinative. [61] In light of these other court decisions, the California court found that use of a "destination" sourcing rule promoted "the primary purpose of UDITPA, that is to ensure uniformity among the states in taxation matters."

Another significant case dealing with sales destination (and one of the cases cited by the court in *McDonnell Douglas*) is *Department of Revenue v. Parker Banana Co.* [62] Parker was a U.S. company that imported bananas into Florida and sold them to various wholesalers. Some of the wholesalers were based outside of Florida and came into the state with refrigerated trucks to pick up the bananas for transportation out-of-state. Parker treated all sales to non-Florida purchasers as non-Florida sales. The Florida Department of Revenue contended that the only non-Florida sales were those where the out-of-state purchasers employed common carriers to pick up the goods. The Department reasoned that purchasers using their own trucks took delivery in Florida and thus the sales were sourced to Florida. The Florida Supreme Court disagreed with the Department and held that the purchaser must be in the state in order to generate a Florida sale.

Application to e-commerce. Given the split in the states' use of the "dock sale" rule vs. ultimate destination, together with the ambiguities regarding the sales factor in e-commerce, taxpayers seemingly have several possible interpretations of any given transaction. Consider the following scenarios:

Scenario 1: A software vendor is located in a state that employs a throwback rule and that treats software sales as sales of tangible personal property. The state provides no guidance regarding sourcing sales of electronically transmitted software. In this situation, the vendor could set up a computer server in a state that does not employ throwback, and transfer the software to that server for delivery to the ultimate customer. Still, the vendor would need to consider the implications of the "double throwback" rule, should the origination state have one. (The double throwback rule, noted briefly above, applies to certain drop shipments: A seller in state A fills an order for a purchaser in state B by having the seller's supplier in state C ship the goods directly to the purchaser. If the seller is not taxable in either B or C, the double throwback rule would attribute this sale to state A, the location of the office that originated the sale.)

Scenario 2: A software vendor routinely "sells" its programs by granting purchasers a password for purposes of downloading the program. The vendor has a server in state A, which has a dock sale rule. In this situation, the software vendor should consider relocating the server because there is a risk that state A will consider this transaction a "cyber dock sale" and attribute to state A all sales via the server. The vendor should consider locating the host server in a jurisdiction without an income tax.

(In these examples, of course, the software vendor must also consider its obligation to collect sales or use tax from the purchaser.)

Conclusion

In summary, the old rules clearly have not caught up with the new reality. Determining whether a sales transaction involves tangible personal property, intangibles, or services is important for tax directors as they attempt to gauge tax liability in view of Sarbanes-Oxley, FIN 48, and the pressures to reduce the effective tax rate. Continued uncertainty should not be the status quo. The states need to adapt their laws to the new economy. In the meantime, creative companies can take reasonable positions to take advantage of the opportunities with respect to the sales factor. **[]**

Exhibit 1. Inbound Sales

Part A	Destination Kansas (Finnigan)			Everywhere			
	Parent: no Kan. nexus	Subsidiary: Kan. nexus	Total	Parent	Subsidiary	Total	Kansas factor
Sales	10,000[1]	5,000	15,000	20,000	10,000	30,000	0.50
Double-weight							0.50
Payroll	0	1,000	1,000	4,000	2,000	6,000	0.167
Property	0	1,000	1,000	8,000	4,000	12,000	0.083
Apportionment factor per Finnigan							0.313

Part B	Destination California (Joyce)			Everywhere			
	Parent: no Cal. nexus	Subsidiary: Cal. nexus	Total	Parent	Subsidiary	Total	Calif. factor
Sales	10,000[2]	5,000	15,000	20,000	10,000	30,000	0.167
Double-weight							0.167
Payroll	0	1,000	1,000	4,000	2,000	6,000	0.167
Property	0	1,000	1,000	8,000	4,000	12,000	0.083

Apportionment factor per Joyce	0.146

[1]: In Kansas, under Finnigan, included in sales factor numerator.
[2]: In California, under Joyce, excluded from sales factor numerator.

Exhibit 2. Outbound Sales From Kansas (Finnigan)

To highlight the effect of outbound sales, the first set of columns reflects the factors in the non-taxing states (i.e., outside Kansas). Thus, to determine the Kansas apportionment percentage, the numerator of each Kansas factor is the difference between the "everywhere" amount and the applicable "outside Kansas" amount.

	Destination: Outside Kansas			Everywhere			
	Parent: nexus/no nex.	Subsidiary: all nexus	Total	Parent	Subsidiary	Total	Kansas factor
Sales	5,000/15,000[1]	2,000	22,000	20,000	10,000	30,000	0.267
Double-weight							0.267
Payroll	0	4,000	4,000	1,000	5,000	6,000	0.333
Property	0	10,000	10,000	1,000	11,000	12,000	0.167
Apportionment factor per Finnigan							0.258

[1]: Potential 15,000 throwback to Kansas but, under Finnigan, Excluded from sales factor numerator because subsidiary has nexus in destination state.

Exhibit 3. Outbound Sales From California (Joyce)

To highlight the effect of outbound sales, the first set of columns reflects the factors in the non-taxing states (i.e., outside California). Thus, to determine the California apportionment percentage, the numerator of each California factor is the difference between the "everywhere" amount and the applicable "outside California" amount.

	Destination: Outside California			Everywhere			
	Parent: nexus/no nex.	Subsidiary: all nexus	Total	Parent	Subsidiary	Total	Calif. factor
Sales	5,000/15,000[1]	2,000	22,000	20,000	10,000	30,000	0.767
Double-weight							0.767
Payroll	0	4,000	4,000	1,000	5,000	6,000	0.333
Property	0	10,000	10,000	1,000	11,000	12,000	0.167
Apportionment factor per Joyce							0.509

[1]: Under Joyce, 15,000 is thrown back to California and included in the sales factor numerator because parent has no nexus in destination state.

Article endnotes

1

Georgia (2008), Iowa, Illinois, Maine, Michigan (2008), Nebraska, New York, Oregon, Texas, and Wisconsin (2008).

2

Arkansas, Arizona, California, Connecticut, Idaho, Indiana, Kentucky, Louisiana (manufacturing, merchandising), Massachusetts, Maryland (but single sales factor for manufacturing), Minnesota, North Carolina, New Hampshire, New Jersey, Ohio, Oklahoma, Pennsylvania, South Carolina, Tennessee, Utah, Virginia, Vermont, West Virginia.

3

The equally weighted three-factor apportionment formula is sometimes referred to as the "Massachusetts formula," after the first state to use it.

4

Alabama, Alaska, District of Columbia, Delaware, Hawaii, Kansas, Mississippi (generally may use one or more factors), Missouri, Montana, North Dakota, and Rhode Island.

5

See, e.g., Moorman Mfg. Co. v. Bair, 437 US 267, 57 L Ed 2d 197 (1978), in which the U.S. Supreme Court upheld Iowa's single sales factor apportionment regime.

6

Report of the Special Subcommittee on State Taxation of Interstate Commerce of the House Committee on the Judiciary, H. Rep't No. 1480, 88th Cong., 2d Sess. (1964). Legislation was proposed but not enacted. See H.R. 11798, 89th Cong., 1st Sess. (1965).

7

See UDITPA §15.

8

Id.

9

UDITPA §18 states: If the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable: (a) separate accounting; (b) the exclusion of any one or more of the factors; (c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or (d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

10

See Multistate Tax Commission Allocation and Apportionment Regulations (MTC Reg.) IV.18.(c)(1). See also, e.g., 18 Cal. Code Regs. §25137(c)(1)(A).

11

MTC Reg. IV.18.(c)(3).

12

UDITPA §16(a).

13

UDITPA §16(b).

14

15 USC §§381-384, the "Interstate Commerce Tax Act." P.L. 86-272 does not protect other types of activities in a state and does not apply to non-income taxes (e.g., sales or use taxes) or to the sale of intangibles. See Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co., 505 US 214, 120 L Ed 2d 174 (1992), which was analyzed in Marcus and Lieberman, "Does *Wrigley* Clarify 'Solicitation' for Purposes of Taxing Interstate Commerce?," 2 J. Multistate Tax'n 148 (Sep/Oct 1992). See also Lieberman, "MTC

Guidelines on P.L. 86-272 Implement the U.S. Supreme Court's Decision in *Wrigley,*" 5 J. Multistate Tax'n 52 (May/Jun 1995).
15

The jurisdictions that employ a throwback rule are Alabama, Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Illinois, Indiana, Kansas, Maine, Massachusetts, Mississippi, Missouri, Montana, New Hampshire, New Mexico, North Dakota, Oklahoma, Oregon, Rhode Island (eff. 7/7/07), Utah, Vermont, and Wisconsin. The following states do not have a throwback rule: Arizona, Connecticut, Delaware, Florida, Georgia, Iowa, Kentucky, Louisiana, Maryland, Michigan, Minnesota, Nebraska, New Jersey, New York, North Carolina, Ohio, Pennsylvania, South Carolina, Tennessee, Virginia, and West Virginia. Texas repealed its throwback rule, effective for tax years ending after 2007, as part of its new "margin tax," which was analyzed in Jackson and Wellington, "Major Tax Reform in Texas: An Overview of the State's New Margin Tax," 16 J. Multistate Tax'n 8 (October 2006).
16

UDITPA §3.
17

Cal. State Bd. of Equalization, 84-SBE-092, 6/27/84.
18

271 Ill. App. 3d 700, 648 NE2d 1089 (1st Dist., 1995), *aff'g* Cir. Ct. of Cook County, Docket No. 91L50730, 8/17/93, *app. den.* 163 Ill.2d 552, 657 N.E.2d 618 (1995).
19

Although the Dover doctrine requires a taxpayer to actually pay tax in the destination states, it is sufficient for Illinois purposes that the taxpayer pay a franchise or corporate stock tax, which need not necessarily be based on or measured by net income.
20

Ind. Dept. of State Revenue Ltr. of Finding No. 98-0568, 10/1/01.
21

Mass. App. Tax Bd., No. C255116, 4/3/03, 2003 WL 1787975 .
22

N.J. Admin. Code §18:7-8.7(d). For more on this scheme, see, e.g., Sollie and Gutowski, "New Jersey's Throw-Out Rule: Audits Have Begun, Prepare Your Strategy Now," 14 J. Multistate Tax'n 14 (October 2004).
23

W.Va. Code §11-24-7(e)(11)(B).
24

MTC Reg. IV.16.(a)(7).
25

Id.
26

For more on this pronouncement, with a particular focus on state tax matters, see Sutton, Jorgensen, and Yesnowitz, "State Tax Issues Regarding FASB Interpretation No. 48: Accounting for Uncertainty in Income Taxes," 16 J. Multistate Tax'n 18 (January 2007). FASB Statement No. 109 (SFAS 109) is entitled *Accounting for Income Taxes.* FASB is the designated organization in the private sector for establishing standards of financial accounting and reporting. These standards, which govern the preparation of financial reports, are officially recognized by the Securities and Exchange Commission (SEC) and the AICPA. For more information, see the Board's website at www.fasb.org.
27

Cal. State Bd. of Equalization, No. 66-SBE-070, 11/23/66.
28

Cal. State Bd. of Equalization, No. 88-SBE-022, 8/25/88 (Finnigan I), *reh'g den.* No. 88-SBE-022-A, 1/24/90 (Finnigan II, which also specifically overruled Joyce).
29

Cal. State Bd. of Equalization, No. 99-SBE-005, 4/22/99, *amended on denial of reh'g* Cal. SBE, No. 99-SBE-005-A, 9/1/99. For more on California's actions in this area, see

Shop Talk, "California SBE Reverses *Finnigan,* Returns to *Joyce* Apportionment Rule," 9 J. Multistate Tax'n 40 (July 1999).

30

Ariz. State Bd. of Tax App., No. 395-85-I, 2/5/87.

31

339 SE2d 118 (S.Car., 1986).

32

South Carolina does not use the unitary method, but it does use pre-apportionment combination (i.e., the tax bases of the "consolidated members" are aggregated and multiplied by an aggregated apportionment factor).

33

Kan. Rev. Rul. 12-91-1, 1/1/91.

34

Note 18, *supra.*

35

40 App Div 3d 49, 830 NYS2d 614, 2007 WL 609857 (3d Dept., 2007).

36

The U.S. Supreme Court has issued several decisions on state and local taxation under the Foreign Commerce Clause (which generally refers to the application of the Commerce Clause, U.S. Const., Art. I, §8, Cl. 3, to foreign commerce). See, Rhines, Sutton, and Yesnowitz, "When Does the Federal Foreign Commerce Clause Restrict State Taxation?," 16 J. Multistate Tax'n 6 (August 2006).

37

UDITPA §1(h).

38

See note 15, *supra,* and related text.

39

Of the states with a throwback rule (see note 15, *supra*), only Massachusetts and Wisconsin do not throw back foreign (i.e., non-U.S.) sales.

40

See 15 USC §381(a).

41

Cal. State Bd. of Equalization, 82-SBE-307, 6/29/82, *reh'g den.* 10/26/83.

42

Alaska, Colorado (under the three-factor method), Hawaii, Illinois, Indiana (or foreign country's standards), Kansas, Maine, Missouri, Montana, North Dakota, Oklahoma, and Oregon.

43

Multistate Tax Comm'n Review, Vol. 1986, No. 4 (November 1986), page 4.

44

In contrast, of course, taxpayers states generally have the opposite motivations when a taxpayer has a state net operating loss.

45

For example, in one case discussed in the text below (Microsoft), such securities proceeds represented 73% of the taxpayer's gross receipts.

46

California is considering proposed amendments to the FTB regulations (18 Cal. Code Regs. §25137(c)(1)(D)) that would exclude treasury function receipts from both the numerator and denominator of the sales factor for apportionment purposes. See "Agenda—Franchise Tax Board Meeting (11/28/07)" on the FTB website at www.ftb.ca.gov/law/meetings/agendas/112807/3c.pdf (select "Item 3c, Proposed Regulation 25137(c)(1)(D)").

47

39 Cal.4th 750, 47 Cal. Rptr. 3d 216, 139 P3d 1169 (2006), *reh'g den.* 10/25/06.

48

Cal. Super. Ct., No. CGC 05-442465, 4/11/07.
49

18 Cal. Code Regs. §25137(a).
50

39 Cal.4th 773, 47 Cal. Rptr. 3d 233, 139 P3d 1183 (2006), *reh'g den.* 10/25/06. Both the Microsoft and GM decisions were analyzed in greater detail in Hull, "California High Court Rules on 'Gross Receipts' for Purposes of the UDITPA Sales Factor," 17 J. Multistate Tax'n 8 (May 2007).
51

14 OTR 384, 1998 WL 712725 (Tax Ct., 1998), *aff'd* 329 Or. 599, 996 P2d 500 (2000). The Tax Court decision was discussed in Shop Talk, "Oregon Court Permitted Gross Investment Receipts in UDITPA Sales Factor," 9 J. Multistate Tax'n 42 (Mar/Apr 1999).
52

989 SW2d 710 (Tenn. Ct. App., 1998).
53

673 NE2d 849 (Ind. Tax Ct., 1996).
54

As noted above, in Moorman Mfg. Co. v. Bair, *supra* note 5, the U.S. Supreme Court upheld Iowa's single sales factor apportionment regime. With so many states placing emphasis on the sales factor, is the U.S. burdened with apportionment systems that adversely impact interstate commerce? In his dissent in Moorman, Justice Blackmun stated: "Single-factor formulas are relics of the early days of state income taxation. The three-factor formulas were inevitable improvements and, while not perfect, reflect more accurately the realities of the business and tax world. With their almost universal adoption by the States, the Iowa system's adverse and parochial impact on commerce comes vividly into focus. But with its single-factor formula now upheld by the Court, there is little reason why other States, perceiving or imagining a similar advantage to local interests, may not go back to the old ways. The end result, in any event, is to exacerbate what the Commerce Clause, absent governing congressional action, was devised to avoid."
55

See 18 Cal. Code Regs. §§1502(f)(1)(D) (for prewritten, or canned, programs) and (f)(2) (for custom programs).
56

Tex. Tax Code Ann. §171.101(a)(1). A taxpayer's margin may not exceed 70% of total revenue. *Id.*
57

Tex. Tax Code Ann. §§171.1012(a)(1) and (a)(3)(A). As defined in §151.0031, "computer program" includes "electronic media."
58

See proposed 34 Tex. Admin. Code §3.591(e)(3). This rule is based on a prior rule §3.557(e)(6), which governs apportionment for the now-repealed earned surplus component of the old Texas franchise tax. The proposed regulations were published in the Texas Register, available on the website of the Secretary of State at www.sos.state.tx.us/texreg/archive (select "September 14, 2007").
59

Alabama, Arkansas, Delaware, Florida, Illinois, Kansas, Mississippi, Rhode Island, Texas, Utah, and West Virginia, and the District of Columbia use the "dock sale" rule to source the sale to the state in which goods are "picked up." For more on dock sales, see, e.g., Kopp, "Does the Destination Rule Control the Situs of Dock Sales?," 5 J. Multistate Tax'n 156 (Sep/Oct 1995).
60

26 Cal App 4th 1789, 33 Cal Rptr 2d 129, 1994 WL 493299 (2d Dist., 1994). This case was discussed in Hull, "California: In-State Deliveries to Out-of-State Purchasers Excluded," 5 J. Multistate Tax'n 65 (May/Jun 1995).
61

Texaco, Inc. v. Groppo, 215 Conn. 134, 574 A2d 1293 (1990); Pabst Brewing Co. v. Wisconsin Dept. of Revenue, 130 Wis.2d 291, 387 NW2d 121 (1986); Lone Star Steel Co. v. Dolan, 668 P2d 916 (Colo., 1983); Strickland v. Patcraft Mills, Inc., 251 Ga. 43, 302 SE2d 544 (1983); Olympia Brewing Co. v. Comm'r of Revenue, 326 NW2d 642 (Minn., 1982); Dept. of Revenue v. Parker Banana Co., 391 So 2d 762 (Fla., 1980); Dupps Co. v. Lindley, 62 Ohio St. 2d 305, 405 NE2d 716 (1980).

62

Id.