Abstract

Standard formulary apportionment, as currently adopted by states which impose a corporate level income tax on multistate corporations, may have a distortive effect in instances where the corporation has income through operation of IRC Section 481. This paper proposes an alternate method of apportionment and demonstrates the merits of the method relative to standard apportionment on two dimensions, preservation of the intent of IRC Section 481 and conformity to the fair apportionment requirements of the United State Constitution. The paper concludes that the alternate method of apportionment guarantees external consistency, one of the tests of fair apportionment, and the absence of duplication or omission of income, while standard apportionment does not guarantee either.

STATE TAXATION OF ACCOUNTING METHOD CHANGES

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Introduction

Thirty three years have passed since the Supreme Court of the United States articulated what is now the standard for judging the constitutionality of state taxes in *Complete Auto Transit, Inc. v Brady*.[1] Over the course of that time, practically every aspect of state apportionment and allocation of income, critical components in the constitutionality of an income tax, has been the subject of litigation at the state and federal level. However, one broad aspect of apportionment that has received curiously little attention at the judicial level is the proper state apportionment of income stemming from a change in accounting method as prescribed by Section 481 of the Internal Revenue Code (hereafter referred to as "IRC"). With the exception of one case that reached the California Court of Appeals and a handful of appeals addressed by administrative decisions by the California State Board of Equalization, the issue has seemingly gone unnoticed by taxpayers and legislators alike.

Unlike income from the regular business operations of a corporation, adjustments to taxable income resulting from the application of Section 481, referred to as "Section 481 income or losses" throughout the remainder of this paper, are recognized in a year which may or may not have a relationship, as measured by standard formulary apportionment[1], with a corporation's activities within a state in the year of recognition[2]. The lack of legislative and judicial attention seems to suggest that states believe that application of the standard apportionment provisions to

[1] 430 U.S. 274 (1977).

Section 481 income or losses meets the constitutional standards for state apportionment of income and that it preserves the intent and spirit of Section 481. This paper examines the constitutionality of standard apportionment in the context of Section 481 income or losses and addresses the question of whether standard apportionment is in conflict with its adoption by the states. The paper then proposes an alternative method of apportionment based on the corporation's apportionment factors in prior years.

Part I provides a brief summary of state income taxation and an explanation of apportionment in general. Part I also provides two hypothetical situations which are used to illustrate the consequences of standard apportionment on two vastly different corporate taxpayers, one who does not significantly shift its business activities from one state to another over time and another which does so, significantly changing its apportionment factors across tax years. The hypotheticals are also used to illustrate the application of Section 481 to state income taxation. Finally, the hypotheticals serve to illustrate the relative merits of the alternate method of apportionment proposed.

Part II provides a discussion of the constitutional standard for fair apportionment and examines the constitutionality of standard apportionment as applied to Section 481 income or losses. Part III examines Section 481 and asks whether standard apportionment preserves its intent. Part IV introduces an alternate method of apportionment and concludes that while standard apportionment may pass constitutional muster in many situations, our alternative method of apportionment is relatively "fairer" as defined by the Supreme Court and should be adopted as a matter of policy rather than as an alternative requiring a showing of distortion. We also find that

our proposed method guarantees an absence of omission or duplication of taxable income at the state level, while standard apportionment does not do so unless the corporation's apportionment factors remain constant across tax years.

Part I: State Income Taxation, Examples of Computation

Although there is a great degree of variation in the computation of corporate income tax at the state level, it is essentially determined in almost all states by applying the state tax rate to apportioned adjusted federal taxable income[3]. Corporations use federal taxable income as the starting point for computing their state income tax liability. Certain adjustments are made to federal taxable income for difference in state and federal law. Multistate corporations then multiply adjusted federal taxable income by an apportionment factor which is, in theory, intended to reflect the portion of their multistate business conducted within each state[4]. Once again, while there is variation in the apportionment formula across states, it is typically based on the ratio of the corporation's property, payroll and sales within the state of interest to the corporation's property, payroll and sales everywhere. Finally, this amount, referred to as ***post-apportioned taxable income*** throughout the remainder of this article, is multiplied by the state corporate income tax rate to arrive at the corporation's state income tax liability. In addition to a general apportionment formula, a majority of states have provisions which allow either the taxing authority or the taxpayer to use an alternative apportionment methodology in the event that the use of standard apportionment does not fairly represent (i.e., distorts) the extent of the taxpayer's business activity in the state. The party that invokes distortion has the burden of proof. A survey of cases involving an argument of distortion reveals the subjective nature of the

concept as courts and revenue agencies have been hard-pressed to set an objective measure of what is to be considered distortive.

We use the following two hypothetical examples throughout the paper for illustration purposes.

Hypothetical example 1

Company A conducts business in states X and several other jurisdictions during Years 1 through 10. In connection with its unitary business, the company owns securities in a publicly traded company. The company purchased the securities on January 1 of Year 1 at a cost of $100. The fair market value of the securities as of December 31 of Year 9 was $200. The company had a 60% apportionment factor in state X each year from Year 1 through Year 10.

While Company A had no operational taxable income in any year in question, in Year 10 it changed its accounting method from an impermissible method to a mark-to-market method, triggering a Section 481 adjustment to income of $100 related to the securities[5]. Since the company reported no income on the appreciation of the securities in Years 1 through 9 (as it was employing an impermissible method of accounting), it is required to recognize income in Year 10 which it would have recognized in Years 1 through 9 had it been on the market to market method in all years.

From a state income tax perspective, using standard apportionment, Company A would have post-apportioned taxable income of $60 in State X (Section 481 income of $100 x .6) in Year 10.

Since the company did not generate federal taxable income in Year 1 through 9, it would have post-apportioned taxable income of $0 in state X in Years 1 through 9.

Hypothetical example 2

Company B is identical in every respect to Company A except that in Year 10 Company B relocates some property and payroll to State X, resulting in a Year 10 apportionment factor of 90% in that state.

From a state income tax perspective, using standard apportionment, Company A will have post-apportioned taxable income of $90 in State X (Section 481 income of $100 x .9) in Year 10. Since the company did not generate federal taxable income in Years 1 through 9, it will have post-apportioned taxable income of $0 in State X in Years 1 through 9.

It should be noted at this time that the two companies had identical apportionment factors in the two states in Years 1 through 9, during which time the income on the securities would have been recognized if the correct accounting method has been used.

Part II: Constitutional Standard of Fair Apportionment

Scholars have pointed to the fact that while “fair apportionment” is a long-standing and well-accepted element of the Supreme Court’s state tax jurisprudence, it is a lower order constitutional value, a concept intended to ensure an absence of discrimination against interstate commerce and of extraterritorial taxation, in addition to ensuring due process, which are the higher order constitutional values[6]. Nevertheless, since fair apportionment, as defined by the Supreme Court, achieves these goals, the remainder of the paper will focus on the Court’s definition of fair apportionment as the standard against which an apportionment provision’s constitutionality should be judged.

Discrimination against interstate commerce and extraterritorial taxation of multistate businesses are principles that the Supreme Court of the United States has dealt with for over a century. As early as 1891, the Court introduced the language of “fair” apportionment as a requirement for taxing such businesses[7]. Rather than tracing the history of the application of the Commerce Clause and Due Process Clause in the context of state taxation, we examine the constitutionality of standard apportionment applied to Section 481 income under the standard for apportionment articulated by the Court in *Container Corporation of America v. Franchise Tax Board*[8]. In *Container*, the Supreme Court applied the four prong test that it had established in *Complete Auto Transit Inc. v. Brady*[9].

Container Corp and fair apportionment

In *Complete Auto*, the Supreme Court established a four prong test for constitutionality of a tax under the commerce clause, with fair apportionment as the third prong of the test. The concept of fair apportionment was subsequently refined by the Court, perhaps most objectively by its decision in *Container Corp*. According to the Court in *Container Corp.*, fair apportionment implies that a tax must be both internally and externally consistent. The Court went on to defined those two terms as follows:

> Having determined that a certain set of activities constitute a 'unitary business', a State must then apply a formula apportioning the income of that business within and without the state. Such an apportionment formula must, under both the Due Process and Commerce Clauses, be fair. The first, and again obvious, component of fairness in an apportionment formula is what might be called internal consistency-that is the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business's income being taxed. The second and more difficult requirement is what might be called external consistency-the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated. The Constitution does not invalidate an apportionment formula whenever it may result in taxation of some income that did not have its source in the taxing State…. Nevertheless, we will strike down the application of an apportionment formula if the taxpayer can prove

> by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportions to the business transacted in that State'.

The Court was clear in its intent not to find unconstitutional any tax which *may* result in taxation of income that is out of proportion with a corporation's conduct of business in the state, as apportionment is not an exact science but a method of estimation. A tax or apportionment scheme will fail the external consistency test only if it would *necessarily* result in taxation of income which is not rationally connected to business conducted in the state. A similar standard of external consistency was articulated by the Court in *Allied Signal v. Director, Division of Taxation*[10]. In *Allied Signal*, a case which dealt with a transactional tax, as opposed to a tax on income, the Court stated that the Constitution requires a taxing state to have a sufficient nexus with both the taxpayer and the activity or value it seeks to tax. The Court stated that "[i]n the case of a tax on an activity, there must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax." External consistency appears to be an extension of this standard, sometimes referred to as transactional nexus. In summary, in order for a tax (including the apportionment scheme which results in the tax) to be constitutional it must pass the internal consistency test and must necessarily result in taxation of income with a reasonable sense of how income is generated.

We now turn to the constitutionality of standard apportionment of Section 481 income or loss under this standard. Standard apportionment will certainly meet the internal consistency test. If all states required apportionment of Section 481 income or loss of corporations using apportionment factors in the year of recognition, taxpayers would always pay tax on exactly

100% of their taxable income. This can easily be shown using the hypotheticals in Part I. Assuming that State X and other jurisdictions all require standard apportionment of Section 481 income (and the same apportionment formula), it is a mathematical certainty that company A and company B will each pay aggregate state income tax on exactly 100% of adjusted federal taxable income.

The more interesting and difficult question is whether standard apportionment of Section 481 income or loss would violate external consistency. Once again using Hypotheticals 1 and 2, it is clear that in the event a corporation does not change its state apportionment factors across tax years (as in Hypothetical 1), standard apportionment will provide a reasonable estimation of the amount of the income in question to be taxed by each state. But it is equally clear that the taxpayer in Hypothetical 2 will pay a disproportionate amount of tax in State X in Year 10. Standard apportionment would attribute 90% of the Section 481 income to State X when only 60% of the same income would have been apportionment to State X if the taxpayer had used the correct accounting method from inception. This method results in what one may easily characterize as an unreasonable connection between the tax and the taxpayer's activity.

Standard apportionment will result in a different tax liability in State X for the two companies even though their business activity in those states was identical when the income from the appreciated securities was generated.

It is unclear, given the precedent cited above, whether the Supreme Court would find the application of standard apportionment to a 481 adjustment to be a violation of the Due Process

Clause and the Commerce Clause. As illustrated in our example, it is likely that the application of standard apportionment to a 481 adjustment may not, in specific fact patterns, fairly represent the extent of the taxpayer's business activity in a state. The objective of this paper is to demonstrate not that standard apportionment is unconstitutional on its face when applied to a 481 adjustment, but that the proposed alternative method of apportionment, which could be adopted by states as a general rule, would not violate the due process or commerce clause and more accurately reflect the income associated with the taxpayer's activity in the state. In addition, the alternative apportionment method proposed would preserve the intent of Section 481 as discussed in Part III.

Part III: Internal Revenue Code Section 481 and Changes in Accounting Method

An optimal method of apportioning 481(a) income among states would not only pass constitutional muster and fairly represent the extent of the taxpayer's business activity in a state, but would also preserve the intent of IRC Section 481. Section 481 requires taxpayers who either voluntarily or involuntarily change their method of accounting to compute an increase or decrease in taxable income based on possible duplication or omission of income resulting from the change in accounting method. Specifically, Section 481 states that "in computing the taxpayer's taxable income for any taxable year, if such computation is under a method of accounting different than the method under which the taxpayer's taxable income for the preceding year was computed, then there shall be taken into account those adjustments which are deemed to be necessary solely by reason of the change in order to prevent *amounts* to be duplicated or omitted…" The adjustment referred to in Section 481 is computed by applying the new method of accounting to all prior years affected and computing the cumulative effect of the change in all prior years.

For example, suppose a taxpayer switches from cash to accrual accounting at the beginning of Year 2. In January of Year 2 the taxpayer pays an expense related to the previous year. The taxpayer did not deduct the amount under the cash method in Year 1 because she had not paid it in that year. Likewise, the taxpayer cannot deduct the amount under the accrual method in Year 2 because it relates to the previous year. Had the taxpayer been on the accrual method of accounting in Year 1, she would have recognized the expense in that year. Therefore a 481 adjustment in the amount of the expense would be made in Year 2 so that the expense is not

omitted in computing the taxpayer's taxable income. Note that the adjustment is made to taxable income, regardless of its affect on tax paid.

It should be noted that the *amount*s referenced in Section 481 is clearly a reference to taxable income, which is the amount against which the tax rate is applied in arriving at tax owed by the taxpayer. It is the contention of the authors that in order to preserve the intent of Section 481, a state income tax scheme must ensure that *post-apportioned taxable income*, the state equivalent of federal taxable income, is not omitted or duplicated at the state level in any state which adopts Section 481. The inability of standard apportionment to avoid duplication or omission can easily be demonstrated using Hypothetical 2 above.

In Hypothetical 2, had Company B used its new accounting method in prior years, it would have recognized $60 of aggregate post-apportioned taxable income in Years 1 through 9 in State X . Additionally, it would have recognized no income in Year 10. An apportionment methodology which preserves the intent of Section 481 should result in aggregate post-apportioned taxable income of $60 in State X.

Standard apportionment clearly results in a duplication of post-apportioned taxable income in State X. Under standard apportionment, Company B would compute its state taxable income by applying the apportionment factor for the year of recognition to income recognized in such year. In the case of Company B, it would report no taxable income in Years 1 through 9, and $90 of taxable income in State X in Year 10, for an aggregate of $90 of taxable income.

In order to ensure proper application of Section 481, adjustments related to specific income years should be separately apportioned at the state level using the taxpayer's apportionment factor for the year to which the adjustment is related. Company B should apportion the Section 481 income it recognizes in Year 10 using its apportionment factors from Years 1 through 9 to avoid duplication of post-apportioned taxable income in some states and omission of such income in other states.

The proposed method of apportionment would guarantee an absence of omission or duplication of income.

Part IV: Alternate Method of Apportionment and Conclusion

As has been demonstrated throughout this paper, standard apportionment requiring the application of a formulary apportionment factor to all business income recognized in a particular year without consideration of whether the income has a closer rational relationship with the taxpayer's activities in a different year, fails to guarantee the absence of omission or duplication of post-apportioned state taxable income. In addition, while it may be constitutional based on the Supreme Court's current definition, it does not preserve external consistency in any situation in which the taxpayer shifts payroll and/or property from one state to another across tax years, placing the burden of proving distortion on taxpayers.

The simple alternative proposed here is to apportion Section 481 income or loss based on the taxpayer's apportionment factor *of the year to which the Section 481 adjustment is related.* In the example from Part I, the Section 481 income of Company A and Company B would be apportioned to States X based on each company's apportionment factor in Years 1 through 9, as those are the years to which the Section 481 adjustment is related.

The rationale of the proposed alternate method of apportionment has been applied in a limited number of instances, but nevertheless has a basis in judicial application of apportionment. Based on our research, one California Appellate Court case, two administrative decisions and an administrative rule represent all instances in which the issue addressed in this paper has been judicially or legislatively addressed. Most prominently, in *Tenneco West, Inc. v Franchise Tax Board of the State of California*[11], the California Court of Appeals held that apportionment of

income from installment sales on the basis of factors existing in the year of receipt of income resulted in apportionment based on activities having no connection to the activities producing the income. At issue was the proper apportionment of income from installment sales of real property.

The taxpayer in *Tenneco West* contended that installment sales income should be allocated by the apportionment formula computed for the year in which the income is reported, while the FTB pressed for a holding based on its own Legal Ruling No. 413, which states that factors of the year of sale should be utilized in apportioning the gain or loss regardless of the installment sale election. The rationale of Legal Ruling No. 413, as interpreted by the California Court of Appeals, is that departure from the general annual accounting method is justified in instances where there would be distortion resulting from use of "an apportionment factor which does not fully reflect the activities which give rise to the income…"

In siding with the Franchise Tax Board, the Appellate Court held that the income should be apportioned based on the apportionment factors of the year of activity. Similarly, in Appeal of Donald M. Drake Company[12], a California State Board of Equalization decision, the Board looked to the year of the taxpayer's activity in determining the proper apportionment factor to apply to income recognized in a year which differs from the year of activity. In Appeal of Drake, the taxpayer conducted business as a contractor. A portion of the taxpayer's income from its regular business activity was accounted for by the completed-contract method of accounting, whereby receipts are not included in gross income, and expenses are not allowed as deductions,

until the year the contract to which they relate is completed. This is in contrast to the general constructive receipt standard for accrual method taxpayers.

The State Board of Equalization denied the taxpayer's claim that all federal income should be apportioned using apportionment in the year of recognition due to California's adoption of the federal rules for year of recognition. The Board decided that the FTB's attempt to match the taxpayer's business activity with its California apportionment was appropriate, stating that the purpose of apportionment was to "reflect the items of property, payroll and sales which relate to business activity in that particular year".

The foregoing cases demonstrate that at least at the state level the alternative proposed in this paper has been found to create a stronger rational relationship between a taxpayer's activity and in-state taxation of its income. As argued throughout, extension of this principle from specific applications to a general policy would guarantee internal and external consistence in all fact patterns and would ensure that post-apportioned taxable income is not omitted or duplicated in any state as it would result in a direct matching of the taxpayer's level of business activity and income in each year that the taxpayer has conducted business in the state.

Opponents of our proposed method may argue that allowing alternate apportionment in the event that standard apportionment results in distortion (which a majority of states allow upon a showing by the taxpayer) corrects the problem inherent in standard apportionment. However, as

a showing of distortion is itself a subjective matter, from a general policy perspective it appears to be inferior to a general rule that avoids distortion in all cases.

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[1] For purposes of this paper, standard apportionment refers to the application of a corporation's property, payroll and sales *in the year of recognition* to its federal taxable income for that year in arriving at state taxable income.
[2] For purposes of this paper, we assume state adoption of IRC Section 481. In other words, in addressing the policy question of which apportionment methodology should be adopted, we assume that the state in question is in conformity with Section 481.
[3] The paper abstracts from the concept of direct allocation, which is the assignment of certain types of income to specific states, and assumes that all income is business income subject to apportionment.
[4] In the event a corporation conducts all of its activities within the borders of one state, state income tax liability would be determined by applying the state income tax rate to federal taxable income.
[5] This paper abstracts from the specific recapture rules of Section 481 and assumes that the entire Section 481 adjustment is recognized in the year of change. This assumption does not affect any of our conclusion and is made in order to simplify the computational examples.
[6] *The Meaning Of Fair Apportionment And The Prohibition Of Extraterritorial State Taxation*, 71 Fordham L. Rev. 149 (2002).
[7] *Maine v. Grand Trunk Ry. Co.*, 142 U.S. 217 (1891); *Pullman's Palace Car Co. v. Pennsylvania*, 141 U.S. 18 (1891).
[8] *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983).
[9] *Complete Auto Transit, Inc. v. Brady*, 430 U.S., 274 (1977).
[10] *Allied Signal v. Director, Division of Taxation*, 504 U.S. 768 (1992).
[11] *Tenneco West, Inc. v Franchise Tax Board of the State of California*, 234 Cal. App. 3rd 1510 (1991)
[12] Appeal of Donald M. Drake Company, California State Board of Equalization (February 3, 1977)