SEVENTH
ANNUAL REPORT
MULTISTATE TAX COMMISSION

For the Fiscal Year
of
July 1, 1973 – June 30, 1974

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Boulder, Colorado 80301

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January 31, 1975

To the Honorable Governors and State Legislators of Member States of the Multistate Tax Commission:

I respectfully submit to you the seventh annual report of the Multistate Tax Commission.

This report covers the fiscal year beginning July 1, 1973 and ending June 30, 1974.

Respectfully submitted,

Eugene F. Corrigan

Eugene F. Corrigan
Executive Director

AN INTRODUCTION TO THE MULTISTATE TAX COMPACT

The Multistate Tax Compact is an interstate compact. It has been enacted into law by 21 states during the past eight years.

Designed to encourage uniformity in state tax laws applicable to interstate business, it also aims at improving the administration of state taxes with respect to that business. Toward this end, it contains a provision authorizing cooperative or joint auditing. The Compact also contains the Uniform Division of Income for Tax Purposes Act (UDITPA) which is used to determine how much of a corporate business's income is properly subject to taxation in each state in which it does business.

The Multistate Tax Commission is the operational agency created by, and operating on behalf of, the member states of the Multistate Tax Compact. The members of the Commission are the tax administrators of the 21 regular member states. (California also enacted the Compact in 1974, becoming the 22nd member; but its membership will become effective on January 1, 1976.)

The 21 members meet three times each year on a regular basis. They also attend an occasional special meeting. Between meetings the affairs of the Commission are supervised by an Executive Committee. This Committee consists of seven of the 21 members. It includes the Chairman, the Vice-Chairman, and the Treasurer of the Commission. It meets upon call of the Chairman.

The day-to-day activities of the Commission are conducted by a staff which is headed by the Executive Director. The headquarters office is located in Boulder, Colorado. Audit offices are maintained in Chicago and New York City.

The purposes of the Multistate Tax Compact are to:

1. Facilitate proper determination of State and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes.

2. Promote uniformity or compatibility in significant components of tax systems.

3. Facilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration.

4. Avoid duplicative taxation.

In pursuit of these purposes, the Multistate Tax Commission and the member states are seeking to establish rational ground rules for the solution of interstate tax problems.

The Multistate Tax Commission constitutes an attempt by the states to resolve interstate tax problems for the states and for business taxpayers. Its success will preserve to the states, through cooperation among themselves, the right to administer their own tax programs and the ability to do so efficiently. The alternative may be federal legislative constriction of state tax administration powers until state sovereignty itself may be a questionable entity.

The Multistate Tax Commission promotes uniformly efficient state tax administration practices. It takes an active part in implementing that uniformity. Its joint auditing program provides the type of expertise on the firing line which assures equitable treatment for taxpayers and improved compliance by them with the tax laws of its member states.

The Multistate Tax Commission differs from any other tax organization in that it provides an effective joint auditing service and in that it actually gets involved with its member states in helping them to improve compliance with state tax laws. Obvious efficiencies are derived from having experienced auditors permanently located in major cities for the purpose of auditing large corporations there for many states at the same time.

The Multistate Tax Commission recognizes that the lack of uniform tax administration practices can cause substantial problems for business. The Commission works toward uniform simplicity in compliance procedures to the fullest extent possible. It knows that uniformly equitable treatment of taxpayers is a prerequisite to good tax administration. It is therefore as concerned as is any taxpayer that all taxpayers be treated fairly.

Included among its concerns is the need to be able to assure each complying taxpayer that all other taxpayers, especially the large complex multicorporate business taxpayers, are complying with the tax laws of the states. An effective joint audit program on the part of all of those states, such as that being developed by the Multistate Tax Commission, can give that assurance.

In addition to the 22 member states referred to above, fifteen states are associate members of the Multistate Tax Commission, their Governors having requested this "observational" status. This brings to 37 the number of states which are participating in the Commission's activities in some way. As more states become associate members and as more associate member states enact the Compact, the Commission will become increasingly effective in accomplishing its purposes.

PRIOR MULTISTATE TAX COMMISSION CHAIRMEN

GEORGE KINNEAR, Washington	June 1967 - January 1970
JAMES T. McDONALD, Kansas	January 1970 - June 1971
CHARLES H. MACK, Oregon	July 1971 - June 1972
BYRON L. DORGAN, North Dakota	July 1972 - June 1974

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Commissioner of Revenue
Indiana

William E. Peters, Vice-Chairman
Tax Commissioner
Nebraska

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State Tax Commissioner
North Dakota

Richard Heath
Director of Finance
and Administration
Arkansas

John J. Lobdell
Director of Revenue
Oregon

James Spradling
Director of Revenue
Missouri

The three officers are also members of the Executive Committee. Terms of the above officers and committee members end June 30, 1975.

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ASSOCIATE MEMBER STATES

The Commission has made provision for associate membership by Section 13 of its bylaws, as follows:

13. Associate Membership

(a) Associate membership in the Compact may be granted, by a majority vote of the Commission members, to those States which have not effectively enacted the Compact but which have, through legislative enactment, made effective adoption of the Compact dependent upon a subsequent condition or have, through their Governor or through a statutorily established State agency, requested associate membership.

(b) Representatives of such associate members shall not be entitled to vote or to hold a Commission office, but shall otherwise have all the rights of Commission members.

Associate membership is extended especially for states that wish to assist or participate in the discussions and activities of the Commission, even though they have not yet enacted the Compact. This serves two important purposes: (1) it permits and encourages states that feel they lack knowledge about the Commission to become familiar with it through meeting with the members, and (2) it gives the Commission an opportunity to seek the active participation and additional influence of states which are eager to assist in a joint effort in the field of taxation while they consider or work for enactment of the Compact to become full members.

Following are listed associate member states and the effective dates of their memberships:

Alabama*	October 17, 1967
Arizona	June 7, 1968
California**	January 23, 1968
Georgia	June 11, 1971
Louisiana	October 28, 1969
Maryland	July 27, 1970
Massachusetts	January 23, 1968
Minnesota	January 26, 1971
New Jersey	October 14, 1970
Ohio	June 11, 1971
Oklahoma	June 24, 1974
Pennsylvania	January 23, 1968
South Dakota	October 28, 1969
Tennessee	June 20, 1969
Virginia	October 28, 1969
West Virginia	June 7, 1968

*Compact enacted in Alabama but not effective unless and until the United States Congress enacts legislation specifically giving its consent for the States to enter into this Compact.

**California enacted the Compact on March 23, 1974, effective January 1, 1976, on which date it will become a full member of the Multistate Tax Commission.

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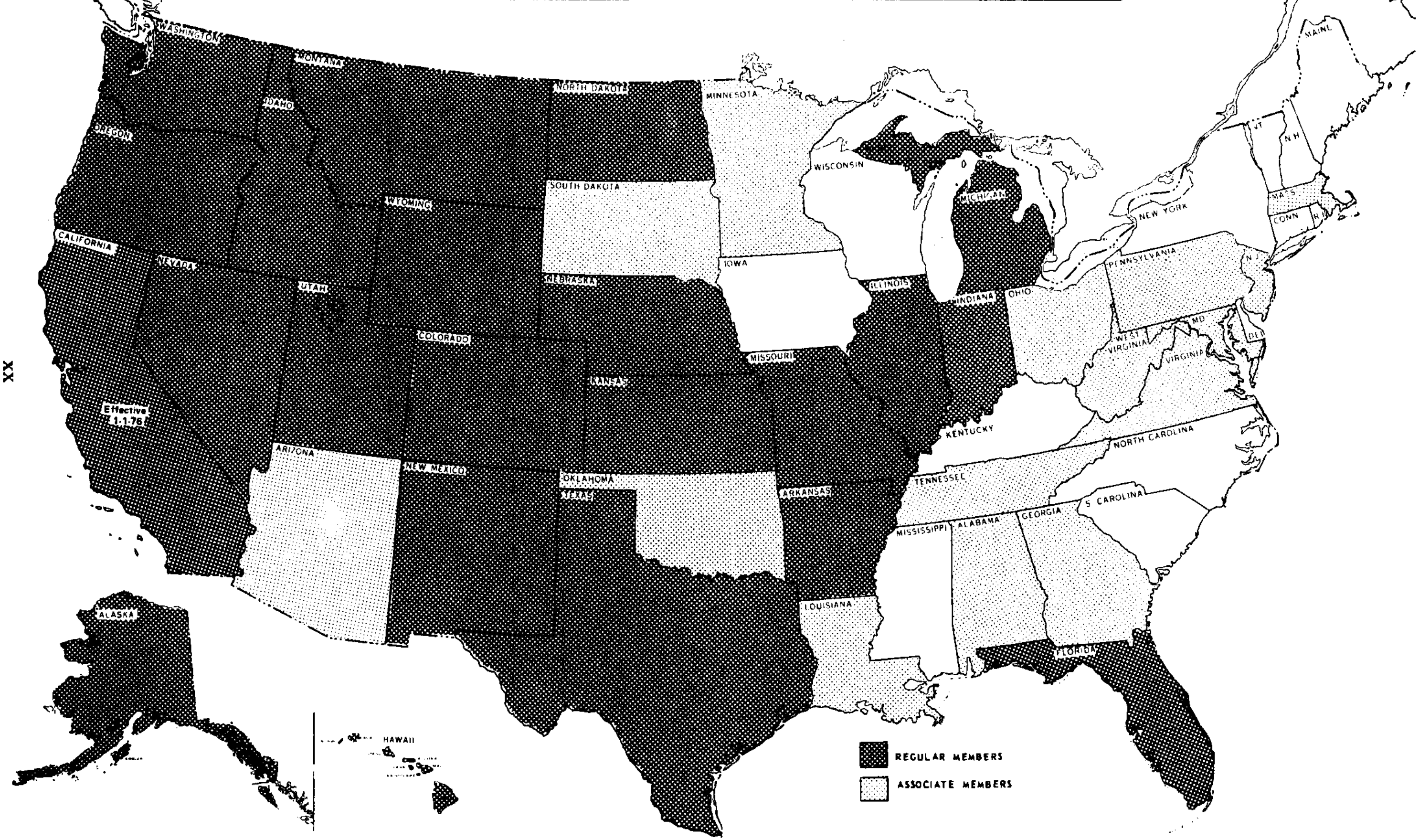
MULTISTATE TAX COMMISSION — MEMBERSHIP JULY 1, 1974



REPORT OF THE CHAIRMAN AND OF THE EXECUTIVE DIRECTOR OF THE MULTISTATE TAX COMMISSION FOR THE YEAR ENDING JUNE 30, 1974

This report reviews the Commission's activities as well as the manner in which it has affected, and has been affected by, events in the field of state taxation of multistate business during the past year.

I. MEMBERSHIP

State membership in the Multistate Tax Commission took a significant leap in 1974 with the adoption of the Multistate Tax Compact by the State of California. The Compact bill was signed by Governor Ronald Reagan on March 23, 1974. The effective date of the Compact in California has been set at January 1, 1976. Thus, California is the 22nd state to become a member of the Compact.

On June 25, 1974, the Commission welcomed the State of Oklahoma as an Associate Member State in response to a request from Governor David Hall.

As a result of the change in California's status and of the addition of Oklahoma to associate member status, state membership in the Commission now totals 37. (See Membership Map on page xx; and see Appendix A for dates of Compact enactments.)

II. UNIFORM REGULATIONS

The Multistate Tax Commission approved revised Uniform Allocation and Apportionment Regulations on February 21, 1973. Those regulations interpret the Uniform Division of Income for Tax Purposes Act (UDITPA) for administrative purposes. That Act has been adopted by 29 states (see Appendix B at page 27). Seventeen of those 29 states are members of the Multistate Tax Commission.

Adoption of regulations by the Multistate Tax Commission constitutes only a recommendation that member states adopt them. The Multistate Tax Commission has no directory powers. Nevertheless, several states have already adopted the revised regulations in substantially complete form. They include Arkansas*, California, Idaho, Nebraska, New Mexico, North Dakota, Oregon and Utah. On July 15, 1974, Illinois published proposed regulations which conform substantially with those of the Multistate Tax Commission. Alaska, Indiana, Mich-

*The Sixth Annual Report inadvertently omitted Arkansas and erroneously included Montana in this list.

igan, Montana and several other states are considering the possibility of adopting substantially similar regulations; and Texas is applying the regulations to its Franchise Tax to the extent possible.

The Multistate Tax Commission's regulations represent, and are producing significant progress toward, the type of uniform administrative practices for the promotion of which the Commission was created. A copy of these regulations is included at Appendix J of this Report.

III. UNIFORM SALES & USE TAX EXEMPTION CERTIFICATE

For many years retailers have been plagued with the problem of obtaining various types of resale and/or exemption certificates for various states with respect to non-taxable sales in or into those states.

In 1972, the Sales & Use Tax Committee of the Multistate Tax Commission began a study to determine the feasibility of designing a certificate which could be utilized for the purpose of complying with the requirements of many states.

In June of 1973, that committee, under the chairmanship of Fred O'Cheskey, New Mexico Commissioner of Revenue, reported to the Multistate Tax Commission that it had devised a proposed uniform certificate; and that many states had already indicated their approval of it for their tax purposes.

At its January 25, 1974 meeting, the Multistate Tax Commission adopted a resolution approving that certificate. The adoption of that resolution constituted a recommendation that all member sales and use tax states agree to accept that certificate with respect to non-taxable sales in or into those states. Thirty states have notified the Multistate Tax Commission of such agreement, two on the condition that an additional box for "Other (specify)" be included in the upper right hand corner. That change has been made. An additional cautionary note has been added concerning sales into Arizona.

The revised Uniform Certificate and the names of the thirty states which accept it are included at Appendix C, on page 28 of this Report. Further efforts are being made to determine which, if any, additional features may make the certificate acceptable to additional states.

IV. UNIFORM SALES & USE TAX JURISDICTIONAL STANDARD

As reported in its Third Annual Report, the Multistate Tax Commission codified a Uniform Sales and Use Tax Jurisdictional Standard in 1968. To the best of our knowledge, no state seeks to exercise jurisdiction for sales and use tax purposes over any taxpayer whose activities do not exceed the minimum set forth in that Jurisdictional Standard. The States recognize the Standard as a limitational one for jurisdictional purposes. A copy of that Standard is included as Appendix D at page 29.

V. UNIFORM FORMS

The Income Tax Committee of the Multistate Tax Commission continues its work toward the development of a uniform corporate income tax return form for use in all states which have adopted the Uniform Division of Income for Tax Purposes Act (UDITPA). That Act is part of the Multistate Tax Compact. The Committee is currently canvassing UDITPA states for the purpose of eliciting responses as to any special information which individual states may consider to be desirable on the return under the provisions of UDITPA.

VI. AUDIT ACTIVITIES

The Commission's office in New York currently consists of an area audit manager and a senior sales and use tax auditor.

The Commission's office in Chicago currently consists of the Commission's Audit Coordinator, who is also the area audit manager, and a senior corporate income tax auditor.

The Commission continues to perform joint audits on many large corporations on behalf of member states assigning those audits. Although the program is still little more than a pilot program, the performance of the audits by the Commission constitutes a service of significant value to participating states. More important, it continues to demonstrate the potential economies and efficiencies that such a program makes available. The ultimate resolution of the U.S. Steel litigation (see page 4) will, if the decision is favorable to the Commission as expected, open the way for the full development of that potential. The result will serve the purposes not only of the states through those economies and efficiencies but of the audited businesses through increased uniformity and decreased compliance burdens.

In 1974, the Multistate Tax Commission auditors completed joint corporate income tax audits of five taxpayers. The number of states participating in each audit varied, running as high as 11 in two cases. These audits constituted the equivalent of 45 individual state audits.

Commission auditors conducted sales and use tax audits of six taxpayers during 1974. States participating in each audit numbered as high as nine. These joint sales and use tax audits constituted the equivalent of 37 individual state audits.

VII. AUDIT-RELATED ACTIVITIES

The limited audit staff finds itself called upon to perform duties above and beyond those imposed by the Joint Audit Program. These duties include participation in, and presentations to, workshops and seminars which take place from time to time among the states. The most recent effort along these lines took the form of a corporate income tax seminar and workshop which was presented in Lansing, Michigan, in March of 1974. Plans are currently being made to participate in similar programs in other states.

Other demands upon the time of the audit staff include speaking appearances at various tax meetings as well as general public relations activities on behalf of the Commission, not only with respect to corporate taxpayers but also with respect to personnel of the tax administration offices of the various states.

Constant coordination between the Commission's staff and the audit staffs of participating states is a requirement not only for the proper conduct of joint audits on behalf of those states but also for proper exploration of means by which tax administration practices of the states may be moved toward more uniformity and equity in accordance with the purposes and goals of the Multistate Tax Compact.

VIII. PENDING FEDERAL LEGISLATION

Various ramifications, including those surrounding Watergate, have resulted in there being little or no activity in the United States Congress during 1974 with respect to various interstate taxation bills pending before it. Nevertheless, three drafts of proposed bills have been circularized for the purpose of exploring further the possibilities of some type of legislation which might resolve some of the problems in that field. These drafts include: 1) a so-called Consent and Combined Tax Bill which was distributed for consideration by the Executive Director of the Multistate Tax Commission; 2) a so-called N.A.T.A.-C.O.S.T. bill which was distributed for consideration in early June; and 3) a so-called second draft submitted to the N.A.T.A. Special Subcommittee on Drafting an Interstate Taxation Act by that Subcommittee's chairman, Owen L. Clarke, Deputy Commissioner of Corporations and Taxation of Massachusetts, on August 23, 1974, for consideration by that subcommittee.

The first of these drafts consists of consent to the present Multistate Tax Compact plus a suggested revised version of the Mondale Bill (S.2811) with respect to sales and use taxes. It contains no provisions with respect to corporate income taxes. The other bills are efforts to reach some accommodation between the business community and the states as to the manner in which corporate income should be attributed among the states for corporate income tax purposes. It is possible that some version(s) of one or more of these drafts may be introduced as bills during the next Congressional session.

IX. LITIGATION
(Continued from Sixth Annual Report)

A. U. S. Steel Case

The litigation in the case of *U. S. Steel et al. v. Multistate Tax Commission et al.*, has not yet reached the hearing stage. The case is still pending in the Federal Court for the Southern District of New York.

In February of 1974, the Court allowed the plaintiffs to maintain the action as a Class Action. At the same time the Court allowed twelve additional corporations to intervene in the case, while excluding one other would-be intervener. This brought to sixteen the number of plaintiffs in the case. They are United States Steel Corporation, Standard Brands Incorporated, General Mills, Inc., and the Procter & Gamble Distributing Company, original plaintiffs, plus the following interveners: Bristol-Myers Co., Eltra Corporation, Goodyear Tire & Rubber Co., Green Giant Co., International Business Machines, International Harvester Co., International Paper Co., International Tel & Tel Corp., McGraw-Hill, Inc., N L Industries, Inc., Union Carbide Corp., and Xerox Corporation.

Meanwhile, the defendants have completed, and have supplied the plaintiffs with, responses to the sixty-nine interrogatories which the plaintiffs had served upon the defendants late in 1973. The defendants are currently preparing for trial in the case.

The case is expected to be heard by a 3-judge Court. Any decision by such a Court will then be appealable directly to the United States Supreme Court. It is the hope of the Multistate Tax Commission and its members that the hearing will take place shortly and that the decision will issue shortly thereafter in order that the matter may reach the United States Supreme Court at an early date. It is important to the Commission and to the states that the issues which have been raised in the case be resolved as soon as possible. The defendants are confident that the courts will ultimately sustain the validity of the Multistate Tax Compact and of the activities of the Multistate Tax Commission.

B. North Dakota

Another legal action arose in North Dakota when North Dakota's Tax Commissioner joined other state tax administrators in assigning to the Multistate Tax

Commission the audits of IBM and International Harvester Company. When those companies refused to submit to the audits, he issued an order requiring the taxpayers to submit their records for those audits. When that order was rejected, he filed in a district court of his State a petition for orders to compel the taxpayers to comply with his prior orders.[1] The taxpayers then filed separate petitions to remove the matters from the state court system to the federal district court. The Tax Commissioner then petitioned the federal district court to remand the matters to the state courts, maintaining that the federal court did not have jurisdiction and that adequate remedies were available to the taxpayers in the state courts.

The federal district court refused to remand the cases to the state courts and stayed further proceedings in the cases before it, "pending a final determination of the Class Action involving the same issues and parties now in litigation in the U. S. District Court for the Southern District of New York." Both IBM and International Harvester are parties to the U. S. Steel suit in New York.

The effect of this decision was to put the taxpayers in the same position that would have existed had the New York court issued an injunction. In fact, no such injunction has ever been issued. A federal district court in Idaho was quick to spot this discrepancy when, some weeks later, *it did* remand a similar case to that state's courts.

C. Idaho—A Victory for the MTC

In that case,[2] the Idaho State Tax Commission had joined other States in assigning to the Multistate Tax Commission a joint audit of the Union Carbide Corporation, which is one of the sixteen plaintiffs in the U. S. Steel case in New York. The corporation refused to submit to that audit even after the Idaho State Tax Commission had issued a summons ordering it to do so. The Idaho State Tax Commission then filed a complaint in a state district court seeking an order requiring the corporation to comply with that summons. The corporation sought removal of the action to the local federal district court, pleading the pendency of the U. S. Steel case. Noting that "A stay of these proceedings is no less a suspension or restraint of the collection of a state tax than granting preliminary injunctive relief," the Idaho federal court ruled that the remedy available to the taxpayer in the state courts was adequate. That court then remanded the case to the state courts, specifically noting its disagreement with the decision of its fellow district court in North Dakota.

D. Washington—A Major Victory for the MTC

A few weeks later a county superior court in the State of Washington granted the request of the State of Washington and the Multistate Tax Commission for a summary judgment ordering a taxpayer to submit to a joint audit by the Multistate Tax Commission.[3] The Washington Director of Revenue had jointed other state tax administrators in assigning to the Multistate Tax Commission the

1. *Byron L. Dorgan, North Dakota State Tax Commissioner v. International Business Machines Corporation* (October 24, 1974), Civil Case No. A1-74-24; and *Byron L. Dorgan, North Dakota State Tax Commissioner v. International Harvester Company* (October 24, 1974), Civil Case No. A1-74-25, U. S. District Court for the District of North Dakota, Southwestern Division.

2. *Idaho State Tax Commission v. Union Carbide Corporation*, Civil No. 1-74-173 (December 13, 1974), U. S. District Court for the District of Idaho.

3. *Kinnear et al v. The Hertz Corporation*, Thurston County Superior Court, Docket No. 46573.

joint audit of the books and records of The Hertz Corporation. When that taxpayer refused to submit to the audit, the Washington State Director of Revenue filed a declaratory action on behalf of the State of Washington and the Multistate Tax Commission asking the court to uphold the joint audit provisions of the Multistate Tax Compact and to order the taxpayer to submit to the joint audit in question.

Overruling the taxpayer's contention that factual matters were in dispute and that the issue should be stayed pending the decision in the U. S. Steel case in New York, the court issued a summary judgment ordering the taxpayer to submit to the joint audit. In doing so, the court ruled that the Multistate Tax Commission has the authority to perform joint audits under the provisions of the Multistate Tax Compact, even without specific Congressional consent. This is the first court decision which has ruled on the validity of the Multistate Tax Compact and on the validity of the joint audit program of the Multistate Tax Commission. It is, therefore, an extremely important decision. The full text of the ruling is included in Appendix K of this Seventh Annual Report of the Multistate Tax Commission.

X. STATE LEGISLATION

During the year, 92 of the nation's 100 largest corporations, operating through an organization called C.O.S.T., continued their anti-M.T.C. activities as follows: 1) exerted extensive efforts to defeat the Multistate Tax Compact Bill in California; 2) sought to defeat three bills sponsored by the Department of Revenue in the State of Missouri, which bills had the purposes of enabling that state to participate in the Multistate Tax Commission's joint audit program and to share audit information with other states; 3) arranged for a bill to be introduced in Idaho to repeal the Multistate Tax Compact there; and 4) arranged for similar bills to be introduced in both houses of the Michigan legislature.

All of these efforts have failed: 1) the Compact was passed in California; 2) all three Multistate Tax Commission-oriented bills were enacted in Missouri; 3) the repealer bill in Idaho was unanimously rejected in committee; and 4) the Michigan bills also failed.

Although C.O.S.T. and the Multistate Tax Commission appear to have been at loggerheads for the past three years, there are signs of a disposition on the part of both groups to seek to resolve their differences. Leaders and representatives of both organizations have, in recent months, been expressing increased willingness to explore areas of potential agreement. There appears, therefore, to be some basis for optimism that long-standing disagreements may be resolved in coming months.

XI. CONCLUSION

The enactment of the Multistate Tax Compact by California and the addition of Oklahoma as an Associate Member state have materially increased the prestige of the Commission. Strong continued financial support from its members has enabled it to continue its joint audit program despite the financial burden imposed upon it by the U. S. Steel litigation. Increased interest from among non-member states and increased participation by member states indicate that the

Multistate Tax Commission is growing, and will continue to grow, in stature as a key organization in the movement toward uniformity and equity in the field of state taxation of multistate businesses.

COMMENTARY

George Kinnear
Chairman
June 1967 - January 1970

"In this modern day of ours, when power, authority, business and commercial activities, and all the functions of national life are shifting more and more rapidly across state lines, and more and more often calling for decisions and problem-solving that do not fit neatly into existing political-geographic compartments, the need has become imperative to meet these new situations with new techniques and new agencies."

* * *

"The Multistate Tax Compact offers the most exciting promise for progress in the field of taxation. Its possibilities for good are unlimited. It is not a new mechanism for dominating the states, but rather an association to stimulate action, state by state, by providing the necessary information which is not now available regarding many important problems; and by providing a vehicle for cooperative state action."

Charles Mack
Chairman
July 1971 - June 1972

"All of us as individual tax administrators, and the Commission itself, can only profit from the addition of the expertise and participation of every tax administrator in this country. We all look forward to the day when every state has enacted the Multistate Tax Compact and is taking full advantage of all of the opportunities which the Multistate Tax Commission offers."

* * *

"The MTC approach is the right approach and the effective approach."

Byron L. Dorgan
Chairman
July 1972 - June 1974

"The Multistate Tax Compact is a historic pioneering effort of the states to manage their own affairs."

* * *

"[The Multistate Tax Compact is] the most significant effort that the states have made in the last 50 years to improve state taxation of interstate business. . . . The Multistate Tax Compact deserves Congressional blessing."

Donald H. Clark
Chairman
June 1974 -

"Out-of-state corporations should pay the same taxes, where legally possible, as in-state corporations."

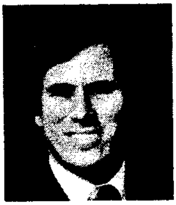
* * *

"Each out-of-state corporation should pay the same corporate income tax as each in-state corporation doing the same amount of business within a state; and vice-versa. Equity demands that. The Multistate Tax Commission provides both tax administrators and business with a means to accomplish that goal."

Frank Keesling
Partner
Loeb and Loeb,
Attorneys
Los Angeles,
California

"In order to achieve complete uniformity in allocation practices, every state which imposes a tax on or measured by income should. . .become a regular member of the Multistate Tax Compact."

MULTISTATE TAX COMMISSION COMMITTEES



ATTORNEY COORDINATION COMMITTEE

Rick Harrison, Texas, CHAIRMAN

Sigmund Aaronson, Texas
Wade Anderson, Texas
Frank Beckwith, Colorado
J. H. Broadhurst, Texas
Robert G. Brockmann, Arkansas
Morris S. Bromberg, Illinois
Calvin Campbell, Illinois
Richard Chambers, Georgia
Theodore W. de Looze, Oregon
William Dexter, Washington
James D. Douglass, Wyoming
A. D. M. Doyle, Alaska
Sydney D. Goodman, Michigan
Albert Hajjar, Pennsylvania
William L. Harris, Jr., Kansas
Al Hausauer, North Dakota
T. Bruce Honda, Hawaii
Kenneth Jakes, North Dakota
F. Kent Kalb, Nebraska
Laury M. Lewis, Montana
Willard Livingston, Alabama
Timothy Malone, Washington
John R. Messenger, Alaska
William Miller, West Virginia
Charles Otterman, California
John Owens, New Mexico
William Peters, Nebraska
Louis Plutzer, Minnesota
Richard Roesch, Michigan
Gerald Rohrer, Illinois
Robert L. Royer, Louisiana
George T. Rummel, Illinois
William S. Scovill, Illinois
James F. Senechal, Montana
John J. Sheehan, Nevada
Walter Skelton, Arkansas
Theodore Spangler, Idaho
James R. Willis, Colorado
James D. Winter, Arizona
William Wooten, West Virginia

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Sidney Glaser, New Jersey
Ernest Goodman, California
Al Hausauer, North Dakota
Vernon Holman, Utah
Edward Landerkin, New Jersey
Thure A. Lindstrom, Oregon
James T. McDonald, Kansas
Frank Medlin, Idaho
Francis Millett, Jr., Florida
A. Gerald Reiss, Missouri
Arthur Roemer, Minnesota
Richard Roesch, Michigan
Joseph Traigle, Louisiana
Vincent Yakowicz, Pennsylvania

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J. J. Bischoff, Trans World Airlines, Inc.
Roland Bixler, J-B-T Instruments
John Brundage, Coopers & Lybrand
James Devitt, Montgomery Ward
Dale Hale, Allegheny Airlines
John Parenti, Eastern Air Lines
James Peters, American Tel & Tel
Raymond Slater, U. S. Steel Corporation
William Spangler, 3 M Company
Roger Talich, Gates Rubber Company
John Tockston, United Air Lines
Cecil Wright, Holly Sugar Company

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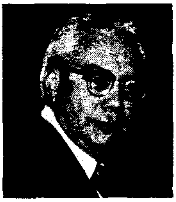
F. Nolan Humphrey, Arkansas
Robert Kerns, Montana
Robert Kessel, North Dakota
William Knipp, Missouri
Ron Loyd, New Mexico
Harvey McNutt, Wyoming
Frank Medlin, Idaho
Robert H. Munzinger, Washington
Tracy Neese, Illinois
Robert Nelson, Michigan
Tomotaru Ogai, Hawaii
Oscar Quoidbach, Oregon
Chester Zawislak, Michigan

ASSOCIATE MEMBER STATES

Harry Aubright, California
Nick Ciccarella, West Virginia
Edward Landerkin, New Jersey
Robert Nunes, California
Norman W. Schmitt, Ohio
Lyle Wendell, South Dakota



RULES & REGULATIONS COMMITTEE

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Jay Allen, Melville Shoe
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Paul Jones, Morton-Norwich Products, Inc.
Stephen W. McKessey, Coopers & Lybrand
James Peters, American Tel & Tel
Frank Roberts, Pillsbury, Madison & Sutro
Marvin Rosenblum, Gulf + Western Industries
Carl Straub, Morrison-Knudson
Arnold Weber, Southern Pacific Company

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Homer Ross, Idaho, CHAIRMAN

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Leslie Clarke, California
Harold Dixon, Georgia
R. Earl Franz, Minnesota
Sidney Glaser, New Jersey
Chandler Hewell, Georgia
Francis Hillard, Wyoming
Ben C. Holdereid, Michigan
Richard Lee, Hawaii
Ewing H. Little, Idaho
William Miller, West Virginia
Charles H. Otterman, California
Clyde L. Scott, Nevada
Norman W. Schmitt, Ohio
S. Ed Tveden, Washington
Wesley Wilber, Missouri
Brian L. Wolfberg, Illinois

Business Resource Members:
Frank Buehler, Howard Johnson's
George Lundin, Chicago Bridge & Iron

APPORTIONMENT OF 1974-1975 BUDGET

State	*Revenues Under Compact	% of Total	**Apportioned Share of 10%	**Apportioned Share of 90%	Total Share of 1974–1975 Budget
Alaska	$ 57,025.664.	.4343	$ 1,590.	$ 1,305.55	$ 2,895.55
Arkansas	295,134,429.	2.2479	1,590.	6,757.41	8,347.41
Colorado	427,235,596.	3.2542	1,590.	9,782.45	11,372.45
Florida	1,134,293,994.	8.6396	1,590.	25,971.50	27,561.50
Hawaii	323,365,813.	2.4639	1,590.	7,404.02	8,994.02
Idaho	151,688,242.	1.1553	1,590.	3,472.94	5,062.94
Illinois	2,736,786,640.	20.8450	1,590.	62,664.88	64,254.88
Indiana	779,300,952.	5.9357	1,590.	17,843.31	19,433.31
Kansas	363,705,929.	2.7702	1,590.	8,327.50	9,917.50
Michigan	2,490,839,110.	18.9720	1,590.	57,031.73	58,621.73
Missouri	769,882,255.	5.8640	1,590.	17,627.77	19,217.77
Montana	89,122,784.	.6789	1,590.	2,040.85	3,630.85
Nebraska	209,425,000.	1.5952	1,590.	4,795.33	6,385.33
Nevada	79,561,386.	.6060	1,590.	1,821.69	3,411.69
New Mexico	241,148,000.	1.8367	1,590.	5,521.30	7,111.30
North Dakota	92,061,600.	.7012	1,590.	2,107.87	3,697.87
Oregon	362,717,000.	2.7627	1,590.	8,304.95	9,894.95
Texas	1,480,702,553.	11.2781	1,590.	33,903.10	35,493.10
Utah	270,841,633.	2.0630	1,590.	6,201.58	7,791.58
Washington	730,048,774.	5.5605	1,590.	16,715.42	18,305.42
Wyoming	44,073,674.	.3356	1,590.	1,008.85	2,598.85
TOTALS	$13,128,961,028.	100.0000	$33,390.	$300,610.00	$334,000.00

*For fiscal year ending June 30, 1973
**10% in equal shares; 90% on basis of tax revenue

BUDGET PERFORMANCE REPORT

For Fiscal Year

July 1, 1973 – June 30, 1974

	Budget	*Actual*	*Actual Over (Under) Budget*
Payroll	$145,000.00	$139,157.10	$ (5,842.90)
Employees' Insurance	5,000.00	8,293.64	3,293.64
Employees' Retirement	20,300.00	22,960.64	2,660.64
Staff Travel	24,500.00	31,857.30	7,357.30
Commission Members' Travel	4,300.00	881.21	(3,418.79)
Relocation Expenses	3,000.00	982.43	(2,017.57)
Other Travel Expenses	1,500.00	222.31	(1,277.69)
Bonds & Insurance	300.00	522.00	222.00
Office Rental	14,000.00	17,325.39	3,325.39
Office Supplies & Expenses	5,000.00	3,177.22	(1,822.78)
Freight & Postage	5,000.00	3,150.54	(1,849.46)
Printing & Duplicating	6,000.00	11,790.10	5,790.10
Telephone & Telegraph	10,000.00	17,325.39	7,317.69
Books & Periodicals	3,500.00	968.46	(2,531.54)
Advertising	1,000.00	–0–	(1,000.00)
Miscellaneous	1,500.00	313.16	(1,186.84)
Conferences & Committee Meetings or Hearings	2,000.00	309.16	(1,690.84)
Professional Fees & Other Contract Services Including Electronic Data Processing	2,100.00	2,969.15	869.15
Office Furniture	1,000.00	16.00	(984.00)
Office Equipment	1,000.00	1,058.25	58.25
Contingency Account	13,000.00	–0–	(13,000.00)
TOTALS	$269,000.00	$263,271.75*	$ (5,728.25)

*An additional extraordinary expense for litigation in the case of *U. S. Steel et al.* v. *Multistate Tax Commission et al.* was incurred and paid in the amount of $67,898.12.

PLANNED BUDGET
FOR
FISCAL 1974-75
and
FISCAL 1975-76

	1974-75	*1975-76*
Payroll	$173,000.	$198,950.
Employees' Insurance	6,200.	7,130.
Employees' Retirement	24,600.	28,290.
Staff Travel	30,500.	35,075.
Commission Members' Travel	5,350.	6,153.
Relocation Expenses	3,725.	4,284.
Other Travel Expenses	1,875.	2,156.
Bonds & Insurance	800.	920.
Office Rental	19,000.	21,850.
Office Supplies & Expenses	6,200	7,080.
Freight & Postage	6,200.	7,080.
Printing & Duplicating	9,000.	10,350.
Telephone & Telegraph	15,000.	17,250.
Books & Periodicals	4,350.	5,003.
Advertising	1,250.	1,437.
Miscellaneous	1,800.	2,070.
Conferences & Committee Meetings or Hearings	2,500.	2,875.
Professional Fees & Other Contract Services including Electronic Data Processing	4,000.	4,600.
Office Furniture	1,250.	1,437.
Office Equipment	1,250.	1,437.
Contingency Account	16,150.	18,573.
	$334,000.	$384,000.
Anticipated Extraordinary Expense for Litigation	60,000.	70,000.
	$394,000.	$454,000.

JOHN M. BYRNE & COMPANY
CERTIFIED PUBLIC ACCOUNTANTS

METROPOLITAN BUILDING · SUITE 580 · DENVER, COLORADO 80202 · 303/892-1841

MEMBER
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
COLORADO SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS
NATIONAL ASSOCIATION OF ACCOUNTANTS

August 13, 1974

Multistate Tax Commission
1790 - 30th Street
Boulder, Colorado

Gentlemen:

We have examined the balance sheet of Multistate Tax Commission at June 30, 1974 and the related statements of revenue and incurred expense, changes in fund balances, and source and application of cash funds for the year then ended. Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the aforementioned financial statements present fairly the financial position of Multistate Tax Commission at June 30, 1974 and the results of its operations, changes in fund balances, and the source and application of its cash funds for the year then ended in conformity with generally accepted accounting principles applied on a basis consistent with that of the prior year.

Respectfully submitted,

John M. Byrne & Company

MULTISTATE TAX COMMISSION

Balance Sheet

June 30, 1974

ASSETS

Current Assets:		
Cash		$ 1,594
Certificates of Deposit		115,000
Assessments Receivable		14,022
Total Current Assets		130,616
Fixed Assets (Note 1):		
Leasehold Improvements	$ 591	
Office Furniture and Equipment	20,458	
	21,049	
Less: Accumulated Depreciation and Amortization	7,849	
Total Fixed Assets		13,200
Other Assets:		
Expense Account Advances	1,500	
Deposits (Note 2)	2,278	
Prepaid Pension Plan Costs (Note 3)	5,697	
Prepaid Expenses	1,149	
Total Other Assets		10,624
Total Assets		$154,440

Liabilities and Fund Balance

Current Liabilities:		
Accounts Payable		$ 18,226
Accrued Retirement (Note 3)		17,306
Total Current Liabilities		35,532
Fund Balance:		
Reserve for Employees' Retirement (Note 3)	$15,877	
Reserve for Prepaid Assessment	5,000	
Unappropriated Fund Balance	98,031	
Total Fund Balance		118,908
Total Liabilities and Fund Balance		$154,440

Accompanying Statement of Accounting Policies and Notes to Financial Statements are an integral part of this statement.

JOHN M. BYRNE & COMPANY

MULTISTATE TAX COMMISSION
Statement of Revenue and Incurred Expense
For the Year Ended June 30, 1974

Revenue:		
Assessments, Member States		$309,350
Other:		
Assessments, Legal Fees		74,000
Interest, Certificates of Deposit		6,769
Miscellaneous		70
Total Revenue		390,189
Incurred Expense:		
Salaries	$139,157	
Depreciation (Note 1)	2,267	
Retirement (Note 3)	6,982	
Employees' Insurance	8,294	
Pension Plan (Note 3)	15,978	
Staff Travel	31,857	
Commission Members Travel	881	
Relocation Expense	982	
Bonds and Insurance	522	
Office Rent	17,325	
Office Supplies	3,177	
Postage and Freight	3,151	
Printing	11,790	
Telephone and Telegraph	17,318	
Books and Periodicals	968	
Other Travel	223	
Miscellaneous	315	
Conferences, Committee Meetings and Hearings	309	
Accounting Fees	2,267	
Other Contract Services	702	
Legal Fees	67,898	
Total Incurred Expense		332,363
Excess of Revenue Over Incurred Expense		$ 57,826

Accompanying Statement of Accounting Policies and Notes to Financial Statements are an integral part of this statement.

JOHN M. BYRNE & COMPANY

MULTISTATE TAX COMMISSION
Statement of Source and Application of Cash Funds
For the Year Ended June 30, 1974

Source of Cash Funds:		
Operations, Excess of Revenue Over Incurred Expense		$ 57,826
Add Expense (Income) Not Employing Cash Funds:		
Recognition of Prepaid Assessment		(5,000)
Depreciation		2,267
Total from Operations		55,093
Cost of United States Treasury Bills Matured and Sold		125,644
Certificates of Deposit Matured		135,000
Increase in Accrued Retirement		6,982
Decrease in Prepaid Pension Plan Cost		6,724
Total Source of Cash Funds		329,443
Application of Cash Funds:		
United States Treasury Bills Purchased	$125,644	
Certificates of Deposit Purchased	190,000	
Purchase of Office Furniture and Equipment	3,417	
Purchase of Leasehold Improvements	591	
Increase in Assessments Receivable	12,911	
Increase in Expense Account Advances	300	
Increase in Deposits	1,265	
Increase in Prepaid Expenses	1,149	
Decrease in Prepaid Assessments	16,635	
Decrease in Accounts Payable	14,329	
Total Application of Cash Funds		366,241
Excess of Application of Cash Funds Over Source of Cash Funds		(36,798)
Cash Balance June 30, 1973		38,392
Cash Balance June 30, 1974		$ 1,594

Accompanying Statement of Accounting Policies and Notes to Financial Statements are an integral part of this statement.

JOHN M. BYRNE & COMPANY

MULTISTATE TAX COMMISSION
Statement of Changes in Fund Balances
For the Year Ended June 30, 1974

	Reserve for Employees' Retirement	*Reserve for Prepaid Assessment*	*Reserve for Contin-gencies*	*Unappro-priated Fund Balance*
Balance, June 30, 1973	$15,877	$10,000	$85,000	($55,720)
Add: (Deduct):				
Excess of Revenue Over Incurred Expense				57,826
Reserve for Contingencies Fund Balance at June 30, 1973 Transferred to Unappropriated Fund Balance			(85,000)	85,000
Investment in Fixed Assets Fund Balance at June 30, 1973 Transferred to Unappropriated Fund Balance (Note 1)				11,262
Net Book Value of Leasehold Improvements Abandoned .				(337)
Portion of Prepaid Assessment Recognized as Income		(5,000)		
Balance, June 30, 1974	$15,877	$ 5,000	$ –0–	$98,031

Accompanying Statement of Accounting Policies and Notes to Financial Statements are an integral part of this statement.

JOHN M. BYRNE & COMPANY

MULTISTATE TAX COMMISSION
Statement of Accounting Policies
June 30, 1974

The accounting policies employed by Multistate Tax Commission are consistent with generally accepted accounting principles. Significant policies are described below:

Accounting Method

The Commission has adopted the accrual method of accounting. Revenue is recognized in the period of assessment and expense is recognized as incurred.

Property, Plant and Equipment

All property and equipment is recorded at cost. Depreciation is provided for on the straight-line basis over the estimated useful lives of the assets.

Income Taxes

No provision has been made for income taxes, inasmuch as the Commission members are representatives of State taxing authorities.

Pension Plan

It is the Commission's policy to fund each year an amount equal to fourteen percent of the plan participants' gross salaries. All costs are actuarially determined under the entry-age-normal with frozen-initial-liability method.

It is also the policy of the Commission to accrue fourteen percent of the gross salaries of the personnel on leave of absence from State taxing authorities and make contributions to their respective plans if employment with the Commission is terminated, and the employee returns to State employment before the expiration of the leave of absence.

JOHN M. BYRNE & COMPANY

MULTISTATE TAX COMMISSION
Notes to Financial Statements
June 30, 1974

Note 1:

Upon adoption of the accrual method of accounting, June 30, 1971, the Commission recorded fixed assets, previously charged against income, as well as the related depreciation thereon from the date of acquisition in the net amount of $11,262. During the course of the current year, the Commission determined that segregation of this amount was no longer significant and the balance was transferred to the unappropriated fund balance.

Depreciation expense for the year ended June 30, 1974, calculated under the straight-line method amounted to $2,267.

Note 2:

Multistate Tax Commission leases its primary office facilities at Boulder, Colorado, under the terms of a lease agreement expiring June 1, 1977. Monthly lease rental under the agreement amounts to $567.

The Commission leases secondary office facilities in New York City, New York under terms of a sub-lease agreement expiring January 30, 1977. The annual lease rental is $7,000 subject to fuel cost adjustments.

Other office space is leased under short-term agreement.

Deposits applicable to future rental payments aggregated $1,849 at June 30, 1974.

Other deposits amounting to $429 are airline travel deposits.

Note 3:

Substantially all of the full time employees of the Commission are covered by a pension plan. Total pension expense for the year ended June 30, 1974, amounted to $15,978. Prepaid pension plan costs at June 30, 1974 amounted to $5,697. Prepaid pension plan costs result primarily from funding original past service cost in the amount of $18,300 more rapidly than the twenty year period in which this liability will be charged to expense for accounting purposes under the accounting method for pension plans adopted by the Commission. Contributions to the pension plan during the year ended June 30, 1974 amounted to $7,259.

Certain employees of the Commission are on a leave of absence from State taxing agencies. The Commission has adopted the policy of assuming the liability for contributions to the State retirement fund for these employees if they return to State employment. Expense for this purpose amounted to $6,982 for the year ended June 30, 1974, resulting in an accrued liability of $5,449 on behalf of those employees continuing on leave of absence on June 30, 1974. The remainder of accrued retirement liability in the amount of $11,857 results from certain leave of absence employees continuing employment as permanent employees of the Commission.

Note 4:

The Internal Revenue Service has denied the Commission exempt status under the provisions of Internal Revenue Code Section 501 (c)(6). However, in the opinion of legal counsel, the Commission is immune from Federal income tax as well as from other Federal taxes as an organization of a group of States or as an instrumentality of those States. Therefore, no provision has been made in the financial statements for Federal income tax liability.

APPENDIX A

MULTISTATE.TAX COMPACT ENACTMENTS

The Multistate Tax Compact has been enacted as a uniform law by the twenty-two states as shown below:

State	*Effective Date*
Kansas	August 4, 1967 *
Washington	August 4, 1967 *
Texas	August 4, 1967 *
New Mexico	August 4, 1967 *
Illinois	August 4, 1967 *
Florida	August 4, 1967
Nevada	August 4, 1967
Oregon	September 13, 1967
Missouri	October 13, 1967
Nebraska	October 23, 1967
Arkansas	January 1, 1968
Idaho	April 10, 1968
Hawaii	May 7, 1968
Colorado	July 1, 1968
Wyoming	January 24, 1969
Utah	May 13, 1969
Montana	July 1, 1969
North Dakota	July 1, 1969
Michigan	July 1, 1970
Alaska	July 1, 1970
Indiana	July 1, 1971
California	January 1, 1976 *

*The enactment of the Compact in each of these states took place on the following indicated dates:

Kansas	April 20, 1967
Washington	June 8, 1967
Texas	June 13, 1967
New Mexico	June 19, 1967
Illinois	July 1, 1967
California	March 23, 1974

Paragraph 1 of Article X of the Multistate Tax Compact provides: "This compact shall enter into force when enacted into law by any seven States. Thereafter, this compact shall become effective as to any other State upon its enactment thereof. . . ." The sixth and seventh States enacted the Compact on August 4, 1967; therefore, the effective date of the Compact for the first seven member States is August 4, 1967.

PROGRESS IN UNIFORMITY THROUGH ADOPTION OF THE UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT AMONG THE STATES

Alabama (1)
Alaska
Arkansas
California
Colorado (2)
District of Columbia
Florida (3)
Hawaii (2)
Idaho
Illinois
Indiana (2)
Kansas
Kentucky
Maine
Massachusetts (4)
Michigan
Missouri (2)
Montana (2)
Nebraska (2)
New Hampshire (5)
New Mexico
North Carolina
North Dakota
Oklahoma (6)
Oregon
Pennsylvania
South Carolina
Utah (2)
Virginia

Georgia is sometimes considered to be a UDITPA state; but its payroll and sales factors are substantially different.
West Virginia has adopted UDITPA but eliminated the sales factor

NOTES:

(1) Alabama's corporate income tax statute is vague on how the state is to determine what portion of a corporation's income is to be attributed to the state for tax purposes. On September 6, 1967, the Alabama Legislature enacted the Multistate Tax Compact, which includes UDITPA, subject to congressional enactment of a Multistate Tax Compact Consent Bill. On September 12, 1967, the Alabama Department of Revenue promulgated regulations which adopt the UDITPA provisions as the basis on which to determine the amount of a corporation's income which is attributable to a state.

(2) This state adopted UDITPA by enacting the Multistate Tax Compact.

(3) Florida enacted the Multistate Tax Compact in 1969. When it enacted its corporate income tax in 1971, it deleted UDITPA from its statutes. Yet its corporate income tax statute is substantially in accord with UDITPA.

(4) Massachusetts is included as a UDITPA state because it closely follows the UDITPA apportionment formula. Massachusetts adopted the 3-factor formula in 1920 and UDITPA codified that formula. However, rather than source, UDITPA adopted destination for sales, subject to the condition that the seller be subject to the jurisdiction of the destination state. In 1966, Massachusetts changed to destination basis, but subject to the current modification that no-nexus sales are Massachusetts sales if they are not sold by third state based salesmen. Unlike UDITPA, all income, including intangible income, is put into the Massachusetts tax base with the sole exclusion of dividends received from corporations, but not trusts or DISCS, in which the receiving corporation owns more than 15% of the voting stock.

(5) New Hampshire is included here as a UDITPA state even though its property factor is somewhat different.

(6) Although Oklahoma has not technically adopted UDITPA, its law appears to be sufficiently close to enable Oklahoma to be considered a UDITPA state.

APPENDIX C

PROGRESS IN UNIFORMITY THROUGH ACCEPTANCE OF UNIFORM FORM FOR SALES & USE TAX EXEMPTION CERTIFICATE

UNIFORM SALES & USE TAX CERTIFICATE FORM

SALES TAX EXEMPTION CERTIFICATE
MULTI-JURISDICTION

(See reverse side for instructions)

Issued to (Seller)	Address

I certify that

Name of Firm (Buyer)		
Street Address or P. O. Box No.:		
City	State	Zip Code

is engaged as a registered
- ☐ Wholesaler
- ☐ Retailer
- ☐ Manufacturer
- ☐ Lessor(*See note on reverse side.)
- ☐ Other (Specify): ______

and is registered with the below listed states and cities within which your firm would deliver purchases to us and that any such purchases are for wholesale, resale, ingredients or components of a new product to be resold, leased, or rented in the normal course of our business. We are in the business of wholesaling, retailing, manufacturing, leasing (renting) the following:

City or State	State Registration or ID No.	City or State	State Registration or ID No.
City or State	State Registration or ID No.	City or State	State Registration or ID No.
City or State	State Registration or ID No.	City or State	State Registration or ID No.

I further certify that if any property so purchased tax free is used or consumed by the firm as to make it subject to a Sales or Use Tax we will pay the tax due direct to the proper taxing authority when state law so provides or inform the seller for added tax billing. This certificate shall be part of each order which we may hereafter give to you, unless otherwise specified, and shall be valid until canceled by us in writing or revoked by the city or state.

General description of products to be purchased from the seller:

Under penalties of perjury, I swear or affirm that the information on this form is true and correct as to every material matter.

Authorized Signature (Owner, Partner or Corporate Officer)	Title	Date

(Reverse Side)

TO OUR CUSTOMERS:

In order to comply with the majority of state and local sales tax law requirements, it is necessary that we have in our files a properly executed exemption certificate from all of our customers who claim sales tax exemption. If we do not have this certificate, we are obligated to collect the tax for the state in which the property is delivered.

If you are entitled to sales tax exemption, please complete the certificate and send it to us at your earliest convenience. If you purchase tax free for a reason for which this form does not provide, please send us your special certificate or statement.

This form of certificate has been determined to be acceptable to the following states as of January 31, 1974:

Alabama	Maryland	South Carolina
Alaska	Michigan	South Dakota
Arizona	Minnesota	Tennessee
Arkansas	Missouri	Texas
District of Columbia	Nevada	Utah
Georgia	New Mexico	Vermont
Idaho	North Dakota	Virginia
Illinois	Oklahoma	Washington
Iowa	Pennsylvania	Wisconsin
Maine	Rhode Island	Wyoming

NOTE: Arizona law provides that a seller will be held liable for sales tax due on any sales with respect to which an exemption certificate is found to be invalid, for whatever reason.

Illinois, Iowa, and South Dakota do not have an exemption on sales of property for subsequent lease or rental.

CAUTION TO SELLER: In order for the certificate to be accepted in good faith by the seller, the seller must exercise care that the property being sold is of a type normally sold wholesale, resold, leased, rented, or utilized as an ingredient or component part of a product manufactured by the buyer in the usual course of his business. A seller failing to exercise due care could be held liable for the sales tax due in some states or cities.

Misuse of this certificate by the seller, lessor, buyer, lessee, or the representative thereof may be punishable by fine, imprisonment or loss of right to issue certificates in some states or cities.

SALES AND USE TAX JURISDICTION LIMITATION STATEMENT

The following is the Sales and Use Tax Jurisdiction Limitation Statement with which all states, to the best of our knowledge, comply:

SALES AND USE TAX JURISDICTION STANDARD

A vendor is required to pay or collect and remit the tax imposed by this Act if within this state he directly or by any agent or other representatives:

1. Has or utilizes an office, distribution house, sales house, warehouse, service enterprise or other place of business; or

2. Maintains a stock of goods; or

3. Regularly solicits orders whether or not such orders are accepted in this state, unless the activity in this state consists solely of advertising or of solicitation by direct mail; or

4. Regularly engages in the delivery of property in this state other than by common carrier or U. S. mail; or

5. Regularly engages in any activity in connection with the leasing or servicing of property located within this state.

This state does not seek to impose use tax collection requirements on any retailer over whom the above standard does not confer jurisdiction in this state.

APPENDIX E

SIMPLIFICATION RESOLUTION

RESOLVED that it is the position of the Multistate Tax Commission that all States should take immediate steps to enable out-of-state sellers to comply with sales and use tax collection, reporting and remittance requirements with the minimum possible effort and expense; and that, to further this purpose:

1. The Chairman appoint a committee to seek to accomplish a uniform simplified use tax return form to be submitted to the various States for adoption;

2. The Commission adopt the principle that no State should require the filing of a return or the remittance, by any out-of-state retailer, of any use tax with respect to sales of less than $100 in a calendar year;

3. The Commission adopt the principle that no State should require the filing of more than one return and remittance from any out-of-state retailer with respect to sales of less than $5,000 in a calendar year;

4. The Commission adopt the principle that, where an out-of-state seller sends into a State advertising materials with respect to which it is required to remit use tax to that State, the seller may choose to determine the tax due according to the following formula:

> The ratio of the seller's sales in and into said State to his total sales in the nation shall be applied to the cost of all materials so distributed in the nation in order to determine the tax base for such materials in said State.

Any seller choosing to use said formula for one State shall be obliged to use it for all States; and he shall be required to file with the Multistate Tax Commission an accounting of:

a. Total national sales,
b. Total sales in each State, and
c. Total cost of materials so distributed;

and he shall agree to be bound by this accounting with respect to all States.

Adopted unanimously by the
Multistate Tax Commission
at Baltimore, Maryland
on June 7, 1968.

AGREEMENT ON EXCHANGE OF INFORMATION

In the interest of furthering the mutual interests of the undersigned states represented by the undersigned officials through benefits which can be derived from the exchange of information among said states, each of said officials does hereby enter into the following Agreement for the exchange of information with every other undersigned official.

The undersigned hereby mutually agree to exchange information, to the full extent permitted by their respective laws, in accordance with the terms and limitations below:

1. For purposes of this Agreement, income tax means a tax imposed on or measured by net income, including any tax imposed on or measured by an amount arrived at by deducting expenses from gross income, one or more forms of which expenses are not specifically and directly related to particular transaction.
2. This Agreement shall be applicable with respect to:
   a. The inspection of income tax returns of any taxpayer; and
   b. The furnishing of an abstract of the return of income of any taxpayer; and
   c. The furnishing of any information concerning any items contained in any return of income of any taxpayer; and
   d. The furnishing of any information disclosed by the report of any investigation of the income or return of income of any taxpayer, exclusive of any information obtained through an agreement between any of the undersigned states and the Internal Revenue Service.
3. For purposes of this Agreement, taxpayer includes any individual, corporation, partnership or fiduciary subject to an income tax or required to file an income tax return.
4. This Agreement is not limited to a specific period of time or to returns, documents or information relating to any specific years or periods; and it will be considered to be in effect until revoked.
5. Additions and changes, including definitions, in the provisions of this Agreement, may be made by mutual consent of the proper officials of the undersigned states, and shall become an attachment to this Agreement.
6. No information obtained pursuant to this Agreement shall be disclosed to any person not authorized by the laws of the undersigned states.
7. The information obtained pursuant to this Agreement shall be used only for the purpose of administration of the income tax laws of the undersigned states.
8. This written Agreement shall not become effective between any two states until the authorized officials for both such states have signed it in the space provided below.
9. This written Agreement is not intended to revoke or supersede any other similar agreement that may have been previously entered into between any two or more of the states represented below.

10. The undersigned agree to inform each other of the current statutory provisions of their respective states concerning the confidentiality of the material exchanged and the penalties for unlawful disclosure thereof.
11. Any of the undersigned state officials may, at their discretion, refuse to furnish information disclosed in the report of any investigation while such investigation is still in progress or during such time as litigation is contemplated or in process, if the official of the state making the investigation deems it in the best interests of his state for such information to be withheld pending determination of litigation.
12. Each of the undersigned state officials hereby affirms that he is the proper official charged with the administration of the income tax laws of his state.

The above agreement has been executed by the following states under the information sharing authority granted by their statutes. The execution of the Agreement by these states constitutes the equivalent of 210 individual agreements.

SIGNATORY STATES

Alaska	Illinois	Montana
Arkansas	Indiana	Nebraska
California	Kansas	North Carolina
Colorado	Louisiana	North Dakota
Florida	Michigan	Oregon
Hawaii	Minnesota	Pennsylvania
Idaho	Missouri	Utah

THE COMBINED REPORT AND UNIFORMITY IN ALLOCATION PRACTICES BY FRANK M. KEESLING

This speech was presented at the June 25, 1974 Annual Meeting of the Multistate Tax Commission.

I felt deeply honored when I was invited to address this convention. Although there are a number of matters I should like to discuss, I have decided to devote my attention primarily to the combined return or report which originated in California in 1936. I am strongly of the opinion that the adoption of the combined report procedure by the Multistate Tax Commission would greatly further the cause of uniformity in allocation practices.

At this point, I shall briefly describe the purpose of, and the functioning of, the combined report which I shall later discuss in more detail.

Simply stated, the purpose of the combined report is to insure that the income of a business conducted partly within and partly without the taxing State shall be determined and apportioned in the same manner regardless of whether the business is conducted by one corporation or by two or more affiliated corporations. In cases where the business is conducted by one corporation, the income is computed as a unit and apportioned by means of an appropriate formula, usually the three-factor formula of property, payroll and sales. The income so attributed to the State is combined with any non-business income which the taxpayer may have from sources within the taxing State, such as interest, dividends, rentals from properties not used in the business, etc., to arrive at the taxable income.

When the combined report is employed, exactly the same procedure is followed, and the same results are obtained, in cases where the business is conducted by more than one corporation, such as 2, 20, 200, or 2,000. The number does not matter. The income is still computed as a unit just as it would be if the business had been conducted by one corporation only.

Furthermore, the income is apportioned by means of an appropriate formula; again, just as it would be if the business had been conducted by one corporation. The income so apportioned to the taxing State is combined with the non-business income, if any, of the corporation doing business in the taxing State, to arrive at the total taxable income. Thus, so far as determining the amount of business income attributable to a particular State is concerned, no advantage is obtained, and no detriment suffered, as the result of employing a number of corporations rather than one to operate the business.

Mr. Keesling is a practicing attorney who spent several years as counsel to California state tax offices in the nineteen thirties. As counsel to the California Franchise Tax Commissioner from 1935 to 1939, he fathered the combined return concept. Now in charge of the Tax Department of the Los Angeles law firm of Loeb and Loeb, of which he has been a partner since 1943, Mr. Keesling is in wide demand across the nation as an expert in tax matters involving income attribution questions.

The purpose of the Uniform Division of Income for Tax Purposes Act is to promote uniformity in allocation practices by requiring that all business income be apportioned by the use of a formula, and that various classes of non-business income be allocated in accordance with specific rules. I applaud both the purpose of the Act and the method employed, notwithstanding that it was adopted by the States primarily to prevent federal legislation in this area, and as such, has the aspects of a shotgun wedding! Unfortunately, its purpose is being frustrated in at least two significant ways.

First of all, the Uniform Act itself, unlike the Multistate Compact, provides no method or machinery for insuring uniform interpretation of its provisions. This is a serious defect. Those of you who have read *Alice's Adventures in Wonderland & Through the Looking-Glass* may recall Humpty Dumpty declaring, scornfully, "When I use a word it means just what I choose it to mean–neither more nor less." Those States which have adopted the Uniform Act, but not the Compact, are free to emulate Humpty Dumpty and interpret the Act to mean what they choose to have it mean, neither more nor less. This is not just a possibility.

The case of *Kennecott Copper Corporation v. State Tax Commission,*[1] is a dramatic illustration of just such an interpretation. Kennecott with its various subsidiaries is engaged in mining and related activities on an extensive scale. It operates a large copper mine in Utah, another in Arizona, a large smelter in Ohio; and it has sales outlets in numerous states and countries. The vast mining and financial empire is managed, controlled, and financed from the company's headquarters offices in New York City.

It would be difficult to find a better example of a unitary business than that conducted by Kennecott. Years ago the California Franchise Tax Board took the position that the income attributable to California sources should be determined by applying the three-factor formula of property, payroll and sales to the total worldwide income of the business. This position has been upheld by the California courts, and the United States Supreme Court has denied a hearing.[2] Although this policy with respect to Kennecott was instituted before California adopted the Uniform Act, it has been continued thereafter.

Utah has also adopted the Uniform Act. The regulations of the Utah Tax Commission provide that the income from a unitary business shall be apportioned in the manner prescribed in the Uniform Act, i.e., by the use of a formula consisting of the three factors of property, payroll and sales.[3] Furthermore, such regulations employ both of the classic definitions of a unitary business which originated in California many years ago. One of these is the "three unities" definition according to which a business is unitary if there is unity of ownership, unity of use, and unity of operation. The other is the "dependency or contribution" definition according to which a business is unitary if the portion within the taxing State is dependent upon or contributory to the portion without the taxing State.

In view of all this, one might reasonably expect that the Utah Tax Commission would compute the income attributable to Utah in much the same manner as was done in California. This proved not to be the case.

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1. 27 U 2d 119, 493 P 2d 632. Appeal dismissed, 409 U.S. 973, (1972).
2. *Chase Brass & Copper Co. v. Franchise Tax Board,* 10 Cal. App. 3d 496, appeal dismissed and cert. denied, 400 U.S. 961 (1970).
3. *Utah Tax Commission, Corporation, Franchise and Income Tax,* Reg. No. 8.

Instead, the Utah Tax Commission determined the income from Utah sources by a complicated process which is essentially separate accounting in nature. By this means, the Commission arrived at a taxable Utah income many times greater than the income that would have been apportioned to Utah by the use of the prescribed formula method. Even more surprising, the Utah Supreme Court by a vote of 3 to 2, the Chief Justice and one other Justice dissenting, sustained the Commission's determination.

This is a serious matter. If Utah continues to interpret the Uniform Act as it sees fit, and if other States follow suit, then the Act might as well be discarded as an exercise in futility. Hopefully, the Compact will eliminate this difficulty by insuring uniform interpretations of the Uniform Act by those States which have adopted the Compact. Although all the States which impose taxes on or measured by income have not as yet adopted the Uniform Act, let alone the Compact, I am heartened by the fact that the list of States which have adopted the Compact is growing. I am particularly pleased to know that my own State of California has recently decided to join the Multistate Tax Commission as a regular member, such membership to be effective in the near future.

The objectives of the Uniform Act are also being frustrated by the failure of many States to interpret it as requiring the use of the combined report, or some similar procedure, to apportion the income of multi-corporate businesses. The resulting disparity in allocation practices is not confined to the fact that some States, such as California and Oregon, employ the combined report, whereas, other States deal with each corporation separately regardless of the fact that it may be one of a number of commonly owned corporations engaged in the conduct of a single business.

The disparity goes deeper than that. In the case of the single corporate business, the income will be apportioned by a prescribed formula, provided, of course, the requirements of the Uniform Act are observed. Unless the combined report, or some similar procedure, is employed to apportion the income of a multi-corporate business, such income will be apportioned substantially according to separate accounting principles, which is contrary to the spirit and intent of the Act.

The point may be illustrated by a simple example. Corporation "X" is engaged in the manufacture of a product in State "A" which it sells in State "B". The operation is profitable and produces, say, an income of $1,000,000. State "A" imposes a tax on or measured by income at a fairly high rate. State "B" either does not impose such a tax, or imposes one at a lower rate. It is, accordingly, to the company's advantage to allocate as little income as possible to State "A". To accomplish this, on its books of account it charges its product to its selling division at cost, claiming that manufacturing operations do not produce income, and that income is not realized until sales are made. It files its tax return with State "A", computing its income on the basis of its books of account. Thus, it reports no income to State "A", but instead insists that its entire income is attributable to State "B" where its sales were made.

This is permitted for a number of years, but then State "A" adopts the Uniform Act which provides that business income shall be apportioned by the use of a formula. The application of the formula results in attributing some 40%, or $400,000 of the company's income to State "A". Although this result seems fair enough, the corporation does not like it. Upon the advice of counsel, it organizes a separate selling subsidiary "Y" to whom it sells its entire product at cost. In its tax returns filed with State "A", it again reports that it realized no income in that

State. Thus, notwithstanding the adoption by State "A" of the Uniform Act, the income is apportioned, as previously, by separate accounting. Hence, the purpose of the Act in requiring that all business income be apportioned by the formula method is completely frustrated.

Although there is some movement to the contrary, I am old-fashioned enough to believe that separate accounting is a reasonable method for separating non-business income from business income. It is not, however, an appropriate method for the apportionment of business income. There are several reasons for this.

First of all, the separate accounting method lends itself to manipulation. The old saw that "figures don't lie but liars figure" is apropos. There is a story about this. Once upon a time, a man advertised for an accountant. There were three applicants. Each of them was interviewed separately and was asked a simple question: "What do two and two make?" The first two applicants replied, "Four." Neither of them got the job. The third applicant did not answer immediately, but instead locked the door, pulled down the shades, and then asked the prospective employer, conspiratorily, "What do you want them to make?" He got the job!

The main objection to separate accounting is that it endeavors to treat separately what is, in fact, inseparable. Inevitably the result must be arbitrary and capricious. One-half of a bridge unconnected with another half will not function very well and will not be worth very much. But put the two halves together, and the bridge may function very well and may be quite valuable. The value, however, should not be attributed in its entirety to one-half of the bridge rather than to the other. Instead, there should be an equitable apportionment between the two. Similarly, where a business is carried on between two or more States, the income should not be computed and apportioned separately on the basis of a segment of the business, but instead should be computed as a unit and apportioned by some reasonable formula which gives weight to the location of the major factors which produce the income. This is true regardless of whether the business is operated entirely by one company, or whether it is arbitrarily divided into a number of segments each of which is operated in the name of a separate but commonly owned and controlled corporation.

In applying the separate accounting method, goods and services transferred between divisions of a single corporation, or between affiliated corporations, are often transferred at what purports to be an arms length price. This involves trying to determine what the goods or services would sell for by a willing seller to an unrelated or uncontrolled willing buyer. This figure is then used in computing the income of the divisions or affiliated corporations as the case may be.

The fair arms length price standard is hopelessly deficient in several respects. First of all, to police its application to the myriad of transfers which take place daily, monthly, yearly, would require an army of agents greater than the total number of agents employed by all the States and the Federal Government combined!

Again, in many instances the determination of a fair arms length price requires the wisdom of a Solomon. For instance, motion pictures are seldom sold in arms length transactions and there is, accordingly, nothing in the nature of a market price. Furthermore, no two pictures are alike; each picture is unique. Hence, when a producing company transfers a picture to a wholly owned distributing corporation, the determination of what the price would have been if the picture had been sold to an independent distributor, presents a hypothetical problem which is impossible of solution except on the basis of arbitrary conjecture and surmise. Similar conditions exist in many industries.

Finally, even if the arms length price standard were practical of application, the results are often capricious. Notwithstanding that all the various segments of a business may contribute to, and may even be essential to, the successful operation of the business as a whole, the use of this standard as an adjunct to the separate accounting method may reach the conclusion that some segments were highly profitable, others broke even, and still others operated at a loss.

The separate accounting versus the formula controversy is as old as State income taxation. The first case involving it, *Underwood Typewriter Co. v. Chamberlain,*[4] was decided by the United States Supreme Court in 1920, some 54 years ago. The corporation conducted its manufacturing activities in Connecticut which imposed a tax on or measured by income. Most of its sales were made in other States. As in the hypothetical example mentioned previously, the corporation took the position that manufacturing was not an income-producing activity, and that no income was realized until sales were made. Accordingly, although the corporation's income was substantial, it reported little or no income attributable to Connecticut. Connecticut reapportioned the corporation's income by the use of a formula consisting of the single factor of property, the result of which was to attribute to Connecticut some 47% of the corporation's income. The Supreme Court upheld the State, and thus approved the use of the formula method. In the course of its opinion, the Court stated, at pp. 120-1:

> " * * * The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sale in other States. In this it was typical of a large part of the manufacturing business conducted in the State. The legislature in attempting to put upon this business its fair share of the burden of taxation was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders. It, therefore, adopted a method of apportionment which, for all that appears in this record, reached, and was meant to reach, only the profits earned within the State."

Bass, Ratcliff & Gretton v. State Tax Commission,[5] decided by the United States Supreme Court in 1924, was the second case involving the issue of separate accounting versus the formula method. The taxpayer manufactured its product in England, and distributed it on an international scale. One of its sales offices was located in the State of New York. The corporation, like the Underwood Company, computed its income by the separate accounting method. However, notwithstanding the fact that the entire business was highly profitable and that a substantial volume of sales was made in New York, the conclusion was reached that the New York operations were unprofitable. New York reapportioned the income by using the same formula which Connecticut had employed, i.e., a formula consisting of the single factor of property. The State was upheld largely on the authority of the *Underwood* case.

Notwithstanding these two landmark decisions repudiating the results of separate accounting and upholding the use of a formula in the apportionment of income, the separate accounting method continued to be used extensively. Many States openly preferred it and many others, at least, permitted it. The separate

4. 254 U.S. 113, (1920).
5. 266 U.S. 271 (1924).

accounting method also received some state judicial support. Thus, the Supreme Court of Wisconsin in the case of *Standard Oil Co. v. Wisconsin Tax Commission,*[6] repudiated the use of the formula and upheld separate accounting in the apportionment of the income of a large integrated oil company. The Supreme Court of North Dakota reached a similar conclusion in *Standard Oil Co. v. Thoresen.*[7]

When I joined the staff of the California Franchise Tax Commissioner's office in 1935, the three-factor formula method was being employed to some extent, but on a somewhat haphazard, hit or miss, basis. There was no definite policy as to when it should be used. In fact, the Commissioner, Charles McColgan, favored separate accounting. On several occasions, back in those days, I heard him declare somewhat sententiously, "The best allocation can be made by the books of account!" However, he allowed me a fairly free hand. As a consequence, I shortly instituted the policy of requiring the use of the formula method to apportion the income of unitary businesses. Furthermore, I did my best to explain to the members of the auditing staff the distinction between a unitary business on the one hand, and a non-unitary business on the other.

As a result of this policy, the formula method was employed to determine the amount of income earned in California by a corporation known as Butler Brothers. The corporation operated seven wholesale department stores, one of which was located in California. Its headquarters offices from which the business was managed and controlled were located in Chicago. All goods for all seven stores were purchased centrally. The business was highly profitable. The corporation computed its California income by the separate accounting method, and reached the conclusion that it operated at a substantial loss in California. The application of the three-factor formula attributed a substantial income to the State. The taxpayer paid the resulting deficiency and brought suit to recover.

Shortly before the case was set for trial, I attended a conference in the California Attorney General's office in San Francisco, with the Deputy Attorney General in charge of the case, and representatives of the taxpayer. Following the conference, the Deputy Attorney General indicated that he agreed with the taxpayer and was willing to stipulate judgment in the taxpayer's favor.

I objected. During the course of the conference I learned that the corporation, by buying in large quantities, was able to realize a purchasing profit, i.e., it could obtain goods at a lower price than would have been possible if it had bought in small quantities. But it was able to buy in large quantities only because it sold in large quantities. Thus, there was an interdependent relationship between sales and purchases. Since California contributed to the sales, I thought California should be credited with a proportionate share of the profits.

It was finally agreed that the case would be tried on the condition that I write the briefs, which I did. The course of litigation was long and rugged. The State prevailed in the trial court. The District Court of Appeals, which is an intermediate court in California, reversed, and wrote an opinion upholding separate accounting. The California Supreme Court granted a hearing and reversed the District Court of Appeals. The United States Supreme Court sustained the the California Supreme Court. As a result, we have the case of *Butler Bros. v. McColgan*[8] which ranks with the *Underwood* and the *Bass Ale* cases, as one of the leading cases on the use of the formula method in the allocation of income.

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6. 197 Wis. 630, 223 N.W. 85 (1929).
7. 29 F.2d 708 (8th Cir. 1928).
8. 17 Cal. 2d 664, 111 P.2d 334, aff'd. 315 U.S. 501 (1941).

Shortly after joining the staff of the Franchise Tax Commissioner's office, I learned that the members of a well-known, and, in those days, highly profitable industry, were paying only the minimum franchise tax. The technique was quite simple. The property produced in California was sold to outside of the state wholly owned distributing corporations at cost. Thus, the production corporations in California filed returns showing no income from California sources. All of the income was reported by the distributing corporations, and for the most part escaped state income tax completely. This disturbed me greatly. I discussed the matter with the Commissioner and the Assistant Commissioner, and was advised that their hands were tied. Nothing could be done about it.

I was unwilling to give up so easily. The question was what to do about it. I considered the possibility of requiring a consolidated return, but abandoned the idea for a number of reasons. First of all, in a somewhat similar context, the New York Tax Commission had attempted to require the filing of consolidated returns, and had been rebuffed by the New York Court of Appeals in the case of *People ex rel. Studebaker Corp. v Gilchrist*[9] I recognized the possibility that the California courts might reach a similar result. This possibility was particularly imminent since in the case of a consolidated return, the income is not only computed as a unit, but taxed as a unit. Thus, it might well be urged that a compulsory consolidated return would be unconstitutional on the grounds that it might result in one corporation being taxed on the income of another.

Again, an affiliated group of corporations may include corporations some of which are taxed differently than the others. Such differences present virtually impossible administrative problems if the income of the group is to be combined and taxed as a unit. For example, in California, banks and financial corporations are required to pay a higher rate of tax measured by income than general business corporations. Similar differences undoubtedly exist in the laws of other States. If each corporation is taxed on its own income, these differences can be given effect. This becomes virtually impossible, however, if the income is combined with that of other corporations and the total income taxed as a unit.

The thought occurred to me that if, in the case of a single corporation doing business within and without the taxing State, it is permissible for the State to look beyond its borders and take into account the entire income of the business in order to determine the true income realized from the portion of the business conducted within the State, then why should it not be equally permissible for a State, in the case of a multi-corporate business, to look beyond the corporate lines and take into account the entire income from the business in order to determine the true income attributable to the corporation or corporations doing business within the State?

If in the case of a single corporation, the State is not compelled to make an apportionment on the basis of the taxpayer's books of account, but can disregard them and make the apportionment by applying a formula to the income from the entire business, then why shouldn't it likewise be permissible in the case of a multi-corporate business to disregard the taxpayer's books of account and apportion the income by applying a formula to the entire income of the business?

This line of reasoning appeared convincing to me and so the combined return or combined report procedure was born. Its purpose was two-fold. First, to prevent tax avoidance through the manipulation of transactions such as sales between controlled corporations, and second, to insure that the income of a

9. 244 N.Y. 114, 155 N.E. 68 (1926).

multi-corporate business should be computed and apportioned in the same manner as in the case of a single corporate business thus promoting equality and uniformity in the application of the State's tax laws. It has accomplished both of these objectives very effectively. Under the combined report procedure, inter-company transactions are eliminated, and hence it is immaterial whether they are rigged or not. So far as the second objective is concerned, the adoption of the combined report proved quite timely. California won the *Butler Brothers* case, but except for the combined report requirement, Butler Brothers could have prevailed by the simple expedient of organizing a separate corporation to operate the California store.

Back in 1936, when the combined report procedure originated, multi-corporate businesses existed but they were none too common. That situation has changed dramatically over the years. The adoption by the Congress in 1941 of a corporate surtax with a $25,000 exemption for each corporation provided a strong incentive for the incorporation of various segments of a business. I know of one instance where over 50 corporations were organized to develop one 40-acre tract of land. Many of the small loan companies have incorporated each separate loan office, with the result that the number of separate corporations in a single enterprise runs into the thousands. A similar situation exists in numerous other national and international enterprises. The combined report procedure has proven to be an effective tool to deal with this development.

Oddly enough the validity of the combined report procedure was never questioned by the corporations at which it was initially aimed, notwithstanding that its application resulted in a substantial increase in their California franchise taxes. However, its validity was subsequently challenged aggressively by another group of taxpayers. It was sustained as a reasonable allocation method by the California Supreme Court in *Edison California Stores v. McColgan.*[10]

There are several features of the combined report procedure which I should like to emphasize:

1. At the time the combined report procedure was put into operation, there were no provisions in the California law specifically authorizing it. Instead, the authority for employing it was derived from the general power and duty of the Commissioner to determine the income attributable to sources within the State and subject to the franchise tax. This is made abundantly clear in the *Edison Stores* case.

I mention this point for two reasons. First of all, there has been considerable confusion concerning the matter. Thus, some years ago Wisconsin adopted the combined report, but the Wisconsin Supreme Court repudiated it in the case of *Interstate Finance Corp. v. Wisconsin Dept. of Taxation.*[11] The Wisconsin court attempted to distinguish the *Edison Stores* case on the grounds that that case must have been based upon a peculiar provision of the California law. Nothing could be further from the truth. Instead, as stated above, the combined report procedure was adopted and upheld as a reasonable but not specifically authorized apportionment method.

I am happy to say that the Supreme Court of Oregon avoided the error made by the Wisconsin court, and sustained the use of the combined report in Oregon,

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10 30 Cal. 2d 472, 183 P.2d 16 (1947).
11 28 Wis. 2d 262, 137 N.W.2d 38 (1965).

primarily upon the authority of the *Edison Stores* case.[12]

The second reason for calling attention to the point as to the source of authority for the combined report is to make it clear that the fact that the Uniform Act does not specifically require it constitutes no barrier to its adoption by the Multistate Tax Commission and the various member States.

2. Because of its importance, I would again like to emphasize that the combined report is not the same as a consolidated return, and does not in any way result in the taxing of one corporation on or measured by the income of another. Actually the combined report is not a tax return, but constitutes something in the nature of an information return. Notwithstanding its use, each corporation doing business in the taxing State is taxed on or measured by only its own income from sources within the State. However, if the corporation doing business in the State is a member of an affiliated group conducting a business within and without the State, then instead of computing the income attributable to the State on the basis of the corporation's books of account, which may reflect the operation of only a small segment of the business, the apportionment is made with reference to the income from the entire business just as would be done if the business had been conducted by one entity.

3. Not uncommonly, two or more members of an affiliated group of corporations may be doing business in the taxing State. In such cases, after the portion of the income from the entire business which is attributable to the taxing State is determined, such amount must be further apportioned between the corporations doing business within the taxing State. This can be done by using the three-factor formula taking into account only the portions of each factor which are attributable to the taxing State.

4. As I mentioned previously, in the combined report inter-company charges of all kinds, such as inter-company sales, inter-company charges for interest, overhead or other items, are eliminated or disregarded. In this respect they are treated in the same manner as inter-division charges of a single corporation in cases where the formula method is employed.

5. The question frequently arises whether the income of corporations foreign to the United States should be included in the combined report. The answer is an emphatic "yes"; their income should be included. The apportionment should be made by attributing to each State a portion of the income from the entire business regardless of whether the business is conducted between two or more States of the United States, or between one or more of such States and one or more foreign countries. This can be accomplished only by combining the incomes of all the corporations engaged in the conduct of the business. It is immaterial whether such corporations are organized under the laws of one of the States of the United States, or under the laws of a foreign country.

6. The question also often arises as to what degree of common ownership is required in order for the income of a corporation to be included in a combined report. The rule in California is that there must be common ownership, directly or indirectly, of *more than* 50% of a corporation's voting stock before its income will be included. Common ownership of even *as much as* 50% of a corporation's voting stock is *not* sufficient for this purpose.

7. We now come to a most controversial matter. The income from what businesses should be combined? Should the combined report procedure be confined to unitary businesses? Or, should the income from all commonly owned

12. *Zale-Salem, Inc. v. State Tax Commission*, 237 Or. 261, 391 P.2d 601 (1964).

businesses be combined and be apportioned by one formula regardless of whether the businesses are unitary or separate? These are important questions.

I can state categorically that whatever policy is followed in the case of a single corporation should be followed in the case of two or more affiliated corporations. For example, suppose a corporation manufactures and sells girdles. It also handles a line of men's clothing. It likewise manufactures and sells various textiles. If the income from all of these somewhat similar but somewhat diverse operations is combined and apportioned as a unit, then the same procedure should be followed even though each division is operated by a separate but commonly owned corporation. This, however, does not answer the basic question.

In California, the use of the combined report has been confined to unitary businesses. However, the concept of a unitary business has changed and broadened over the years.

In my earlier days I was convinced that I knew the difference between a unitary business and a non-unitary business. In fact, I was so brash as to concoct a definition of a unitary business, the so-called "dependency and contribution definition." This was subsequently borrowed by the California Supreme Court in the *Edison Stores* case, and was later adopted by the California Franchise Tax Board, the successor to the California Franchise Tax Commissioner.

In the light of this definition, I was certain that I could recognize a unitary business if I saw one. I was like the young doctor who was proud of his ability to diagnose pregnancy. One day be examined an elderly woman, and after the examination advised her that she was pregnant. She laughed and said, "That is funny. Awfully funny. I am 76 years old. My husband, Abe, is 83. So you think I am pregnant?"

The young doctor replied, "It is nothing to laugh about. I have had considerable experience in these matters. I can recognize a pregnant woman when I see one, and you are pregnant."

She looked at him for a moment, then went to the telephone and dialed a number. When a voice answered, she said, "Abe, the doctor thinks I am pregnant."

Abe replied, "Darling, that is wonderful. May I ask who is calling?"

Now that I am older if no wiser, I question whether there is such a thing as a non-unitary business. Although I still believe that it is appropriate to compute non-business income separately and to allocate it specifically, I am inclined to the view that all income from commonly owned business activities should be combined and apportioned by a single formula without inquiring as to whether such activities are unitary or separate in nature. Such a policy is simple to administer and will promote uniformity.

It has been my experience that wherever there is common ownership there is a certain amount of common management, there is centralized performance of certain functions, and there are other indications of integration.

A policy which requires that the income from certain business activities should be computed and allocated separately on the grounds that such activities are not sufficiently integrated with other business activities to constitute a single unitary business will necessitate the drawing of numerous fine lines of distinction with respect to which reasonable people may well differ. Hence, any such policy will give rise to difficult administrative problems and will promote disparity rather than uniformity in allocation practices.

Moreover, such a policy works against the States and in favor of taxpayers. If a taxpayer wants the formula method to be applied across the board, it will call attention to various elements of integration and unity. If, however, it wants certain activities to be dealt with separately, such elements will be concealed and in many cases may not be discovered by State representatives.

Perhaps a reasonable compromise would be to adopt the policy set forth in the Regulations on this subject which were adopted by the Multistate Tax Commission, as well as by a number of the member States, including California. According to these Regulations, business activities which might for some purposes be regarded as separate businesses, will be considered as portions of a single business for allocation purposes if there is either operational inter-dependency, as in the case of manufacturing and selling activities, or strong central management coupled with the existence of centralized departments for such functions as financing, advertising, research and purchasing.[13]

This rule represents a serious effort to deal with the problem and has much to commend it. However, in the day-by-day application of it, it is inevitable that borderline cases will arise with respect to which different administrative agencies in the different States will reach different conclusions with respect to the same commonly-owned business activities.

8. We now come to the most important question of all. Is the combined report procedure constitutional? I am unable to predict what the Appellate Courts of all the different States will do. I can say emphatically, however, that I believe it should be held valid. Under it, each corporation doing business in the taxing State will be taxed on or measured by only its own income, and that income will be computed by methods which are fair and reasonable.

The California Supreme Court unanimously upheld the combined report procedure in a carefully reasoned opinion in the *Edison Stores* case. The Supreme Court of Oregon likewise held it valid. It is true that the Supreme Court of Wisconsin rejected it, but, as I mentioned previously, I believe that court labored under a misconception as to the California law.

If the Multistate Tax Commission sees fit to interpret the Uniform Act as requiring the use of the combined report procedure, and I earnestly hope that it will do so, that circumstance alone may prove highly salutary in obtaining judicial approval of the procedure in the various States which are parties to the Multistate Tax Compact.

Although the separate accounting method was used extensively in the past and is still being used to a considerable extent today, over the years there has been a definite movement away from separate accounting and toward more extensive use of the formula method. Several factors have contributed to this.

First of all, the United States Supreme Court, as well as the Supreme Courts of several of the States, deserve great credit for their able decisions and opinions upholding the formula method of apportionment.

The State of Massachusetts deserves great credit for contributing the three-factor formula of property, payroll and sales, commonly referred to as the Massachusetts formula. It is the best formula so far devised. It gives weight to the major income producing factors. It avoids the possibility of an arbitrary apportionment resulting from the use of a formula consisting of a smaller number of factors, on the one hand, and, on the other, avoids the administrative clumsiness of a formula consisting of a larger number of factors.

Both the National Tax Association and the Association of State Tax Administrators deserve credit for their efforts to promote the use of the formula

13. *Multistate Tax Commission*, Reg. IV.1(b); see also *California Administrative Code*, Title 18, Reg. 25120(b).

method, and particularly the three-factor formula. These efforts were not without some success. Long before the Uniform Act was adopted by many of the States most of the States used the formula method to some extent, at least, and the three-factor formula was used to a far greater extent than any other formula.

Professor William J. Pierce, who drafted the Uniform Act, and the National Conference of Commissioners on Uniform State Laws which sponsored it, also deserve great credit. Their efforts proved most timely.

In a left-handed sort of way, even Congress deserves credit for threatening to legislate in this field thereby causing many of the States to adopt the Uniform Act!

The individuals who conceived the Multistate Tax Compact, who promoted it, and who are and have been engaged in its administration, fully deserve our heartfelt thanks.

We've come a long way, but there is still a long way to go. In order to achieve complete uniformity in allocation practices, every State which imposes a tax on or measured by income should both adopt the Uniform Act and become a regular member of the Multistate Tax Commission. The Commission should promulgate regulations dealing comprehensively with apportionment problems. Furthermore, some method must be found to insure that the regulations are observed in practice by the member States.

Among other things, the combined report or similar procedure should be adopted in order that the business income of multi-corporate businesses will be apportioned by the three-factor formula rather than by separate accounting.

What has been said with respect to the Uniform Act not achieving uniformity in allocation practices unless it is interpreted as requiring the combined report or similar procedure, is equally applicable to various Congressional bills which, if enacted and held valid, would compel the States to use the formula method in the apportionment of income. If any such bill passes and does not require, or is not interpreted as requiring the combined report procedure, then uniformity will still be an unattained goal. Instead, the taxpayer, in effect, will have an option as to the allocation methods to be employed. If in any case it is desired to have the allocation made by the formula method, then the entire business will be conducted by one corporation. If, however, it is desired to have income apportioned or allocated by separate accounting, this can be achieved by the simple and relatively inexpensive technique of organizing one or more affiliated corporations in each State in which a portion or segment of the business is conducted.

APPENDIX G (continued)

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APPENDIX H

ATTRIBUTION OF CORPORATE INCOME AMONG DIFFERENT JURISDICTIONS FOR TAX PURPOSES

by

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This paper was presented at the Sixty-Sixth Annual Conference on Taxation of the National Tax Association on September 12, 1973, at Toronto, Canada.

Any nation, state or province seeking to tax the net income of a corporate business is faced with the fact that many corporate businesses derive their net income from more than one political jurisdiction. Multistate or multiprovince corporations will be earning income in two or more states or two or more provinces; and a multinational corporation will be earning its income in two or more nations as well as in political instrumentalities in each of those nations. With each political entity seeking to tax net income of the corporate business, there naturally arises the problem of arriving at a fair means of determining how much of the total income should be available for taxation by each political entity.

It is not my intention to discuss here the ramifications of that problem among nations. At the international level the problem is complicated by matters of foreign policy, relative values of currency, and national policy with respect to the social and economic needs of the nation. It *is* my intention to discuss here the ramifications of this problem within the 51 state-level taxing jurisdictions in the United States. I hope that these comments will be germane to problems which may be experienced in Canada as well.

Historically the Eastern seaboard, particularly New York City, has been the situs of the corporate movement in America. Always a leader in the commercial activity of the United States from the early settlement days forward, New York naturally led from the start in the development of all matters pertaining to economic and financial activities and, accordingly, in the development of corporations. That development required the concomitant devising of a tax system appropriate for corporations. While that system had to produce revenue for the taxing body, it also had to take into account the value of the corporate taxpayers to the locale. Therefore, it was important that the tax system not drive away corporate businesses to other parts of the nation, thereby depriving the taxing jurisdiction of the economic benefits as well as the tax benefits which could be derived from the corporations. As we shall note, this consideration has had a significant effect on the attribution of dividends for corporate net income tax purposes.

Corporate net income taxes are a relatively recent development in America. Indeed, they are in only about their sixth decade now; and many of our states have less than 30 years of experience with them. It should not be surprising, therefore, that many states are now looking closely at the system of corporate net income taxation to determine whether improvement can be made in it.

Mr. Corrigan is the Executive Director of the Multistate Tax Commission. An attorney, he has been active in the field of state and local taxation since 1956. He was Supervisor of Rules and Regulations for the Illinois Department of Revenue when, in 1969, he joined the Multistate Tax Commission in his present capacity.

A review of that system reveals that nearly every state uses a formula in determining what income of a corporate business is to be attributable to that state for tax purposes. That formula is based upon various types of corporate activity. With respect especially to manufacturing and mercantile corporations, approximately 60% of the 46 state-level taxing jurisdictions having a corporate net income tax utilize a three-factor formula consisting of a sales factor, a payroll factor and a property factor, with each factor being weighted equally. In the remaining 40%, variations of this formula are used. Thus one state uses only a property and payroll factor; another state uses only a sales factor; some states weight the three-factor formula somewhat differently; and some states are substituting a different factor, e.g., a cost of goods sold factor, for the sales factor. Nevertheless, it is clear that there has arisen in the United States a basic corporation net income taxation philosophy which relies heavily upon a formula for the purpose of attributing income to each state. The reason for the use of the formula is that no one has ever been able to say with certainty that any particular aspect of corporate activity is solely responsible for the production of income or is more important than any other aspect. The absence of any single aspect, whether it be sales, property or payroll might well preclude the production of any income whatsoever for a business. The absence of other considerations might well have the same effect.

On the face of it, then, the application of the formula to all of a corporate business's income should result in a fairly uncomplicated determination of the amount of income which should be available for taxation in each of the states in which that business is operated. This is a position which increasing numbers of states in the United States are taking. There is stiff opposition to this position, however, from a large portion of the business community. The reason is that this position necessarily incorporates within it two concepts which offend the opposition: 1) full apportionment, and 2) combination or, alternatively, consolidation.

Full apportionment involves applying the formula to all income regardless of source or nature. Opponents maintain that some income should be treated differently. They refer specifically to dividend income. They would have that income be exempt, if at all possible; alternatively, they would have it attributed to the commercial domicile of the receiving corporation. The latter provision effectively exempts dividends in all states except the state of commercial domicile from which the corporate business is operated. New York, Pennsylvania, Illinois, Massachusetts and California are the corporate domiciles of a preponderance of U.S. corporations. In all but one of those states, the corporations have successfully maintained either that the dividends should be exempted entirely by the commercial domicile state, as is the case in Pennsylvania and, for the most part, in Massachusetts; or that only a portion of the dividends should be taxed by the commercial domicile state and that that portion should be determined on a formulary basis, as is the case in New York and Illinois. The result is that only a portion, if any, of the dividends are subjected to tax anywhere. The prime exception to this position among commercial domicile states is California; but combination results in exempting most of the dividends in California since interaffiliate transactions and dividends are eliminated in the combination process.

It is difficult to find a logical reason, other than a pragmatic or political one, for treating dividends differently from royalty and interest income. Yet today many leaders of the corporate tax community will readily agree that royalty and interest income should be included in the income base subject to formulary apportionment, while at the same time maintaining that dividends should be treated differently. Their position may be based upon the fact that dividend income generally far exceeds other intangible income in amount.

Corporation representatives maintain that dividends should really be exempt anyway on the basis that the income from which they are paid has already been taxed. This makes some sense at the federal level in the United States, since the federal tax at a rate of 48% often is applied to the income from which the dividends are paid; and it does somehow offend one's sensibilities to see that same tax applied to virtually that same income when received as dividends by a parent or affiliated corporation. The situation is much different at the state level, however. Instead of one national tax, some forty-six state-level taxes are involved. Therefore, in the vast majority of cases, the dividends which a corporation in one state receives will have been derived from income which has never been taxed by that same state and which, if taxed by another state, may have been taxed at rates substantially lower than the rate in the state in which the receiving corporation is located. There would appear to be nothing naturally offensive, then, about allowing the various states to tax a corporation's dividend income, along with all of its other income, on the basis of a formulary determination.

Combination or, alternatively, consolidation is the other philosophy which is incorporated into the idea of full apportionment of all of the income of a corporate business or of a multicorporate business operation. As will be seen below, consolidation as used here is not synonymous with combination; but the two concepts are closely related.

The key words in the field of combination are "corporate business." What makes up a corporate business where that business is being done by several affiliated corporations? The concept of combination is based upon the assumption that the business should be treated the same for tax purposes whether it is being conducted by one corporation, possibly through several divisions of that corporation, or through many corporations. This unitary business concept also envisages the possibility that a single corporation may be engaged in two or more businesses or that only portions of several corporations are engaged in the same unitary business. The concept of combination is complicated further by the jurisdictional consideration that a state should apply its tax to only those corporations which are actually doing business within the state, even though the determination of the amount of income to be taxed is made by applying the formula to the total income of the multicorporate business.

Obviously this unitary business/combination approach involves the exercise of judgment on the part of the taxing authorities of each state taking that approach. Unfortunately, there is no guarantee that each state will exercise that judgment in the same way. The potential for variety in the results is obvious. Thus, if every state were to pursue this approach independently, then more than 100% of the income of one corporate business might be subject to taxation among the various states while substantially less than 100 % of another corporate business's income might be made available for taxation among those same states. Certainly some more definitive and widely used guidelines are desirable.

Equally as clear, however, is the fact that those guidelines are not to be found in prohibition of combination. Rather those guidelines are to be found in the development of a uniform approach to the application of the concept.

One such approach to bringing combination nearer to an objective standard is to be found in the concept of consolidation. As defined for the purposes of this presentation, consolidation contemplates combining the reports not only of all corporations which are engaged in the same business but of all corporations which are "affiliated." Two corporations are affiliated if more than 80% of the stock of one is owned by the other or if more than 80% of the stock of both is owned by the same third entity. This concept has the advantage of mathematical determinability. It has the defect, however, that, while the three-factor formula to which I have referred above may be proper for the mercantile and manufacturing corporations to which it is generally applied, it may not be proper, and I believe that it is not proper, for application to *all* other corporations of whatever types. Thus that same formula may not be proper for application to financial organizations, to construction contractors, to service corporations in general, to transportation corporations and public utilities in general, or to communications corporations. Since consolidation may often involve affiliated corporations from several of these types of businesses, it runs into the questionability of seeking to apply one formula to an entire group of affiliated corporations which may be involved in many different businesses.

The unitary business concept, then, appears to be the preferable concept if it can be subjected to objective standards and if those standards can be applied uniformly across the country in order to ensure fairness to both state government and corporate taxpayers alike.

I submit that the only manner in which this can be accomplished is through the auspices of an agency which would be involved in the making of such determinations and in the exercising of the necessary judgments on the part of the various states with respect to the same corporate businesses. On occasion, these judgments may even involve varying slightly from the standard formula because of special circumstances pertaining to a particular corporate business. Regardless of that consideration, however, the result would be that a taxpayer could know that that income which was attributed to one state as a result of the determination would not also be attributed to some other state and therefore be the subject of potential duplicative taxation. By the same token, each state would have the comforting knowledge not only that it was treating the corporate business fairly but that the state also was being treated fairly by the corporate business for tax purposes and that the state had available to it for taxation purposes its proper share of that corporate business's income.

While this idea is receiving increased support across the country from among corporate tax personnel and state tax administration personnel alike, there remain some philosophical and technical objections to its implementation. I have already referred to objections to the inclusion of dividends in any tax base and, more specifically, to their inclusion in any apportionable tax base of any state other than the state of commercial domicile of the receiving corporation. Also, many state tax administrators object to the idea of any centralized determination by anyone since it smacks of a federal take-over, something of which all of the states have seen too much during the last twenty-five years in the United States.

If we can accept the idea that the goal of uniformity and fairness has merit, then we should be able to move forward together toward that goal somehow. I think that there is evidence of substantial progress along that line. The course toward that goal might be acceptable to many people were it one which:

1. Would impose no limitations upon the states insofar as the apportionable tax base is concerned, but would guarantee that no state would have available to it for taxation any of the same income that was available to another state for taxation; recognizing, however, that any state could exempt any portion of that income which it had available to it for taxation;

2. Would treat a business in the same way for tax purposes regardless of whether that business was conducted through one corporation or through many corporations, i.e., would apply the unitary business/combination concept;

3. Would provide guidelines on the basis of which to apply the combination concept; and

4. Would provide for the application of the combination concept on a uniform basis among all of the states.

If this approach can be accepted, then the only remaining question would appear to be How can it best be pursued? By allowing each state to make its own determinations? By establishing a federal agency to make the determinations for the states? Or by providing for participation in the determination procedure by an organization of state tax administrators working within guidelines and objective standards to be established by them to meet the four purposes set forth above? While there may be other alternatives, these appear to be the three prime possibilities. Of the three, I believe that only the third one contains the seeds of accommodation to the needs and desires of both the states and the corporate business community.

There currently exists in America only one organization which contains the potential to serve in this suggested capacity. That is the Multistate Tax Commission. It is the only entity which exists as a result of legislative fiat from among many states, the number of which is currently twenty-one, through its charter which is known as the Multistate Tax Compact. Through the provisions of that Compact, which is uniform legislation enacted by those member states, it is the only organization for which active participation in tax administration matters is a possibility. As a matter of practice, it already participates in some of the tax administration activities of some of its member states. Included among its activities is a pilot joint audit program under which an audit of a corporate business is performed on behalf of several participating states at the same time. While this has drawn the fire of a large segment of the multicorporate business community, that opposition has mostly been generated by disputes concerning matters to which I have already referred; namely, combination, allocation and apportionment, and exemption of dividends. That opposition does not detract from the immense potential of the organization to accomplish the purposes set forth above. Operated by the tax administrators of its member states, the Multistate Tax Commission provides the best potential for a balancing of the interests of all of the states, within the suggested guidelines, with the interests of the business community.

Making sense out of corporate income attribution problems is a challenge to every government seeking to tax the net income of a multinational or multistate corporation. I think that that challenge can be met in America only if it is sought through the effective use of the Multistate Tax Commission, or of an organization substantially like it. Even federally enacted guidelines or restrictions cannot solve the problems. They can only move the areas in which the problems are to be confronted; or they can change the nature of the problems slightly. The need for the problem-solving and uniformity-encouraging organization will remain.

It is my contention that the Multistate Tax Commission can respond to that need successfully. Neither it nor the charter upon which it is based is perfect, any more than is any human being or any organization of human beings. Nevertheless, it has the potential to serve *most* of the indicated needs. Perhaps more important, it has the flexibility and the potential for change to meet the rest of those needs and to meet changing needs. I believe that any nation which has a federal form of government will need such an organization if it is ever to cope successfully with the problems of attributing among its federated states for net income tax purposes the income of multinational and multistate corporate businesses.

APPENDIX I

THE JOINT AUDIT PROGRAM OF THE MULTISTATE TAX COMMISSION

BY

FREDERICK P. CAPPETTA

This speech was presented at the 33rd Annual Institute on Federal Taxation of the New York University School of Continuing Education on November 11, 1974.

It is a pleasure to be here today to discuss with you the Multistate Tax Commission and its Joint Audit Program. My pleasure is accentuated by my understanding that this is the first time that a State segment has been offered in conjunction with the Federal program at this institute.

The Multistate Tax Commission is a young organization. It came into being on August 4, 1967. Not until February of 1969 did it have its first staff member. It now has 22 member States and 15 associate member States.[1] That's 37 States out of 50. Quite an accomplishment, I think you'll agree. And all for the purpose of achieving some semblance of uniformity and equity and order in the very complex field of interstate taxation among the States.

In 1966, there was the threat of Federal legislation which the States considered objectionable. That situation has continued to this time. In 1966 that threat caused the States to look for an alternative to the threatened legislation. Their answer was the Multistate Tax Compact. It still is. But more States are giving the Compact more support now than ever before.

The Multistate Tax Commission, which is the administrative agency of the Multistate Tax Compact, has as its purposes the following:

1. Facilitate proper determination of State and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes.
2. Promote uniformity or compatibility in significant components of tax systems.
3. Facilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration.
4. Avoid duplicative taxation.

These purposes are listed in the Compact itself.

In furtherance of those purposes, the Commission has done a variety of things. It has codified the nationally accepted jurisdiction standard for sales and

1 "California Becomes 22nd State to Enact Multistate Tax Compact," *Multistate Tax Newsletter*, May 1974

Mr. Cappetta has had some 35 years of experience in corporate financial and tax affairs. From 1955 to 1972, he served in the Chicago Branch office of the California Franchise Tax Board. He was the assistant manager of that office when he joined the Multistate Tax Commission in 1972. He was promoted to Audit Cordinator of the Multistate Tax Commission early in 1974.

use taxes. It has drafted a Uniform Sales and Use Tax Exemption Certificate which 29 States have now agreed to accept. It has sponsored a corporate income tax information sharing agreement which has been signed by 21 States to date. It is currently working on a uniform corporate income tax return form for use under the Uniform Division of Income for Tax Purposes Act (UDITPA). On a few occasions taxpayers appeared to have been subjected to duplicative taxation by two or more States; when the Commission called the matters to the attention of the respective States' tax administrators, those administrators then resolved the problems for the taxpayers. The Commission has produced a set of Allocation and Apportionment Regulations under UDITPA. Eight States have already adopted those regulations in less than two years; and a ninth, Illinois, now appears to be on the verge of adopting them. Perhaps most important of all, the adoption of the Compact itself has given a great boost to UDITPA, since UDITPA is an integral part of the Compact. The result is that 29 States now make UDITPA available for the taxpayer, many on an optional basis.

The Commission has been highly instrumental in generating among State tax administrators a broad increase in understanding of the problems which face both corporate taxpayers and State tax administrators in the field of State taxation of interstate commerce. It has accomplished this through the many, many meetings which it has conducted; meetings in which both business and State personnel have locked horns in attempts to define and to resolve those problems. The so-called Ad Hoc Committee did yeoman service along this line in 1969 and 1970. A lot of people have found fault with its product, but the 1970 Ad Hoc Bill provided us with the basis for much of the thinking and discussion which has been addressed to interstate taxation problems during the past four years.

Actually there has been a great deal of agreement concerning many of the problems. There has been very little disagreement about the sales and use tax provisions of the Ad Hoc bill or of the earlier Congressional subcommittee bill from which those provisions were mainly derived. There has been little disagreement over jurisdictional standards. But all of the discussions have foundered over a handful of key issues.

Those issues involve foreign income, dividends, combination and the throwback rule. Everyone agrees that foreign income should not be taxed by the States. The difficulty comes in trying to determine which income qualifies as foreign in nature. We'll get back to that later.

Probably the greatest disagreement whirls around dividends. Should they be attributed to the State of commercial domicile on an allocation basis; or should they be included with all other income subject to apportionment; or should some of them be allocated and some subjected to apportionment; or should they be exempted entirely; or should they be treated in some other way? This is a complicated problem the solution to which depends in part on how you determine what is foreign income and in part on whether or not you treat the taxpayer the same if he operates his business through several corporations as you do if he operates it through only one corporation. This, of course, brings up the subject of combination and the unitary business concept. I will not dwell on that other than to note that interaffiliate transactions, including dividends, are eliminated from consideration during the combination process. This means that the so-called double taxation argument concerning dividends is not applicable when combination is practiced.

You are probably asking yourself about now: When is he going to get around to his main subject, the Joint Audit Program? The answer is: Now.

The Joint Audit Program is a part of the many activities of the Multistate Tax Commission. It is a means by which the Commission seeks to accomplish its purposes, which I listed earlier. The program affects and is affected by the interstate taxation problems to which I have referred. The participating member States have established policy for, and are exercizing that policy through, the joint audit program. Consequently, those who may not like the policy tend to dislike the program. Therefore, we have the U.S. Steel lawsuit which is currently pending in a federal court here in New York against the Commission and its member States.

Meanwhile, the Joint Audit Program progresses. Our staff is small; but we have just doubled it during the past month. Joint audits are a thing not only of the present but, on a much more significant scale, of the future, whether they be performed by this Commission or by some other entity on behalf of the States. The need for joint audits exists. Their feasibility is apparent. Their future is assured.

I say this despite the fact that it has not been easy to get the program off the ground. Personnel changes have posed problems; coordination with the States has developed slowly; and the U.S. Steel litigation has not helped.

Nevertheless, we completed a couple of dozen large audits in 1973 and, with a reduced staff, about half that number in the first three quarters of this year. Significantly, where only two or three States normally participated in the early audits back in 1971 and 1972, it is not uncommon to have eight or ten, and sometimes 13, participating now.

Audit selection is the first step in any audit process. The Internal Revenue Service tries to audit every large corporate taxpayer and every individual exceeding a certain level of income; while it only spot-checks other taxpayers. The IRS knows that a small percentage of error on returns of the larger taxpayers can have substantial tax consequences. The States know this, too. So it should not surprise anyone that large multistate taxpayers draw a good deal of field audit interest from the States. Unfortunately, in the past, many of the States have not been able to devote to such taxpayers field effort comparable with that interest. They have not had the personnel and they have not had the money to do the job. Among those States which have had the personnel and the money, the effort has often been duplicative, exasperating to the taxpayer and unreasonably expensive for the States. The efficiencies and the economies of a joint allocation and apportionment audit are too apparent, I think, to need elaboration here.

Audit selection, then, is not much of a problem. It is not mere happenstance that the major opposition to the Commission is aimed at its Joint Audit Program, that that opposition consists primarily of C.O.S.T. (The Committee on State Taxation of the Council of State Chambers of Commerce) and that C.O.S.T.'s membership consists of 92 of the 100 largest corporate businesses in this country. Large, profitable businesses will always receive substantial corporate income tax audit attention from the States. Indeed, nearly all of the States are currently seeking to beef up their field audit staffs not only for out-of-state audit purposes but for in-state field audit purposes as well. You can expect, therefore, to have to devote more and more of your time to more and more field audits by States in which you do business. As that happens, I suspect that you will increasingly appreciate the fact that the economies and efficiencies of joint audits are beneficial not only to the States, but to corporate taxpayers as well.

When one or more member States have indicated an interest in a joint audit of a particular taxpayer, we notify the other States of that fact to determine how many States may be similarly interested. If enough respond affirmatively, then audit assignments and authorizations will flow from those States to the Commission; and that audit will be included in the Commission's audit inventory.

The work load of our staff will then determine how soon the taxpayer will be contacted for the purpose of arranging the initial interview. We try to allow sufficient lead time so that we and the taxpayer can arrange a mutually convenient time. A letter of confirmation is sent to the taxpayer corporation and a request is included therein for certain basic documents. This gives the tax department an opportunity to collect some of the data, to minimize waste of time once we begin the audit.

The items that we ask the taxpayer to have available are such records as Federal Forms 1120 and their supportive detail, including:

Federal Revenue Agent Reports
Federal Forms 940
Quarterly Employment Reports for each State
C.P.A. Annual Reports
Annual Reports to Stockholders
All Schedules and Other Data in Support of the Retained Copies of Tax Returns for each State Including the Apportionment Formula Schedules

We now have to make an evaluation as to the nature of the taxpayer business to be audited. Is it one or is it several corporations? In which of the auditing States is each corporation doing business? Is a consolidated federal return filed by the business? If so, we ask for identification of all of the entities being consolidated; namely those which are 80% owned by the parent. As a matter of fact, even if a consolidated federal return is not filed, our States still want us to gather full information as to all affiliates wherein more than 50% common ownership is involved.[2] The reason is that they are increasingly interested in the unitary business concept and in the combined report.

You may complain that this is a California concept. Surely, it is; and it has been for over 30 years.[3] More important: it has survived the test of litigation over the years.[4] So a California concept it is. But it is also now an Oregon concept and a Michigan concept. And recently Illinois has issued a strong indication of its intention to take the same route. Indeed all of the states for which we are currently performing audits are directing us to use the concept. The reason is that they are increasingly of the opinion that the use of that concept is a necessary prerequisite to the accomplishment of that uniformity and equity to which the Commission aspires in the corporate income tax field.

We would not want you to think that combination is a one-way street. Our states are increasingly supporting its use regardless of the results in any particular instance. They are doing so out of the conviction that it produces the best results, in the long run, for all concerned. This is true even though several of our audits

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2. Wilbur F. Lavelle, "What Constitutes a Unitary Business," *1973 Southern California Tax Institute*, p. 14, and Frank M. Keesling, "The Combined Report and Uniformity in Allocation Practices," MTC Denver Meeting, June 25, 1974

3. *Butler Brothers v. McColgan*, 17 Cal. 2d aff'd 315 U.S. 501 (1941) [formula accounting moves to the head of the class.]

4. Keesling, MTC Denver Meeting, June 25, 1974

have directly resulted in recommendations that taxpayers receive refunds from certain states.

Should the use of combination be limited to domestic corporations; or should it include foreign affiliates as well? In other words, should combination, when it is used, be applied on a nationwide or on a worldwide basis? Theoretically, at least, a unitary business is not limited by water or by foreign national boundaries or by distance.[5] As a practical matter, worldwide combination presents more difficulties than does nationwide combination, particularly where the parent is a foreign corporation. Nevertheless, those difficulties are not insurmountable, and both Oregon and Michigan currently require worldwide combination. In addition, the type of combination which Illinois appears to be considering is the worldwide one. We currently perform only a nationwide combination for those states participating in our audits, except for Oregon and Michigan.

Recently, on a joint audit, we combined a multinational corporation domestically. We left our completed workpapers with the taxpayer's representative for his verification of our computations. He rather bitterly resisted the thought of applying combination to his business as a result of what he considered minimal unitary elements, e.g. *only* a 100% flow of goods as well as identically common officers and members of the boards of directors. When he examined our papers, though, he found that worldwide combination produced a lessened tax effect in many of the States and a huge refund in one. He was now convinced that he had a worldwide unitary operation; and he has asked us to verify his computations and to make the global recommendations to all States involved in our audit. We have complied with his request.

How does one determine: 1) Whether two or more affiliated corporations are engaged in a unitary business; or 2) Which of many affiliates are so engaged? The courts have established the so-called Ownership, Operation and Use Test, on the one hand, and the so-called Dependency or Contribution test, on the other.

The *Butler Brothers* case[6] held that the unitary nature of the business of a foreign corporation engaged in a wholesale merchandise business and operating distributing houses in different states, including one in the taxing state, is established by the following circumstances: 1) unity of ownership; 2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and 3) unity of use in its centralized executive force and general system of operation. And the *Edison Stores* case[7] established that a domestic corporation which is one of several subsidiary corporations owned and managed under one centralized system located outside the state, and whose business in selling within the state merchandise received from the parent out-of-state corporation, is *dependent on or contributes to* the operation of the entire business throughout the nation; and is engaged in a unitary, not a separate, business so as to be subject to the unit rule of assessment in determining the proportion of its net income derived from business within the state for corporate income tax purposes. We have to get as many facts as possible in order to determine whether the interrelationship between the affiliates is such as to meet either of these tests. If it is, then combination will be pursued.

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5. Burns Stanley, Taxation of Interstate Business Conference, April 1970, Chicago, *Tax Foundation, Inc.* p. 58 [Foreign source income.]

6. *Butler Brothers v. McColgan*, op.cit.

7. *Edison California Stores v. McColgan*, 30 Cal. 2d 472 (1974)

We will ask for a schedule of affiliates plus the following information as to each entity:

(a) Date Acquired
(b) Date Merged, Dissolved or Sold
(c) Percent of Ownership or Control
(d) State of Incorporation and Date of Incorporation
(e) Names of Officers and Directors by Corporation and Year
(f) Nature and Description of Principal Business Activity
(g) Location of Operations
(h) Manner in which Products are Marketed
(i) Location of Accounting Records

We are going to ask for a description of the connection which existed during the audit period between the parent and the subsidiaries and among the affiliated subsidiaries themselves. The description furnished should include:

A. The extent to which operations are unitary as evidenced by centralized (in each relationship indicate the "from" corporation and the "to" corporation):
   (1) Management;
   (2) Operational Supervision;
   (3) Accounting;
   (4) Purchasing;
   (5) Advertising;
   (6) Insurance;
   (7) Financing;
   (8) Physical Facilities;
   (9) Research and Development Activities;
   (10) Preparation and Payment of Taxes;
   (11) Legal Services;
   (12) Sales Force;
   (13) Public Relations;
   (14) Employee Benefits;
   (15) Budget Preparation; and
   (16) Equipment Leasing.

B. The extent of unitary use of:
   (1) Centralized Executive Force
      (a) Board of Directors
      (b) Officers;
   (2) Interaffiliate Transfer of Personnel (Disclose Job Descriptions and Job Titles);
   (3) Master Contracts for Common Customers;
   (4) Tradenames and Trademarks;
   (5) Common Patents; and
   (6) Government Contract Negotiators.

C. An explanation of any product similarities.

D. The amounts of total sales or business done and the amounts of sales to and from affiliated corporations, by year and products involved.

E. The extent to which any of the aforementioned unitary features are evidenced by service charges or royalty and license or other payments, showing the year and the amounts from and to the respective corporations.

Sufficient competent evidential matter has to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion that I must in good conscience make to a State relative to the propriety of Combined Reporting in any particular set of circumstances. Are there the unities of ownership, use, and operations? Are there contributions or dependencies?

We must develop enough evidential matter to lead to a logical decision based on circumstances found to exist; and we must develop enough information, in the time available, to make a decision. This is where our judgment as auditors comes into play. We will never have enough information to eliminate the need for judgment. The very best that we can shoot for is enough evidence to make it likely that two prudent men would reach the same decision. I say "decision," but, in reality, we make only a recommendation. The individual State's personnel make the decision, after they have reviewed our workpapers.

In some earlier combination cases such as the *John Deere* case[8] wherein a unitary business was determined by the courts to exist, the emphasis was upon the interflow of goods between the affiliates. However, two 1963 California Supreme Court cases, the *Superior Oil* case and the *Honolulu Oil* case[9], indicated that the single most important test was not whether a subsidiary was selling a product manufactured by the parent or whether is was engaged in services or business identical or similar to those of the parent; rather, the emphasis now was on features such as common executive policy making, administrative control coordination, common financing, the interchange of technical knowhow, the interaffiliate transfer of personnel, and common overall control. These were deemed important in determining unities.

By the way, it was the taxpayers who won those cases. That cost California in the neighborhood of ten million dollars. The State had maintained that separate accounting was the proper method to use in reporting for an oil operation that occurred within and without a State. But those cases laid separate accounting to rest in California. Kansas' Supreme Court recently produced a similar result in the *Amoco* case[10], as did a lower court in Georgia in the *Henry Beck* case.[11]

In the 70's we had the *Chase Brass and Copper Company* case.[12] A study of the case will indicate both horizontal and vertical tie-ins to the economic unit. Here again we had wordage such as: "The integration of executive forces is an element of exceeding importance; it is top level management which is credited with the effect of corporate enterprise. The major policy matters are what count in our estimation of integration."

Now, let us get on to verification of the Apportionment Formula. Property, payroll and sales, equally weighted, constitute our target. We start our auditing

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8. *John Deere Plow Co. v. Franchise Tax Board*, 38 Cal. 2d 214; p. 238 2d 569 (1951) [Appeal dismissed U.S. Supreme Court May 5, 1952.] [Owned 83 other corporations; deemed one unitary business. Separate accounting may not be used.]

9. *Superior Oil Co. v. Franchise Tax Board*, 60 Cal. 2d 406 (1963)
Honolulu Oil Co. v. Franchise Tax Board, 60 Cal. 2d 417 (1973)
[Non-integrated oil companies with production sold at well site. Application of formula did not require interstate movement of goods.]

10. *Amoco Production Co. v. State of Kansas*, Kansas Supreme Court, January 26, 1974. [Section 79-3279 of UDITPA mandates formula apportionment of multistate income.]

11. *Henry C. Beck Co. v. Blackmon, Comm'r*, 48987, C-21, Georgia Court of Appeals.

12. *Chase Brass and Copper Co. v. Franchise Tax Board*, 10 Cal app 3d 496 (1970)

procedure with the totals of each of the three. Those totals will eventually serve as denominators for all of our States.

Normally, we begin with total payroll since that is usually the most readily accessible information. For this purpose, we examine the taxpayer's Federal Forms 940 for each year to determine payroll everywhere. Then, we request a breakdown of total payroll by State. This information can usually be obtained from State unemployment compensation quarterly reports and/or Federal Forms 941. Payroll verification by State has posed the smallest problem insofar as tying into the totals is concerned. Incidentally, this tie-in with totals is a most important aspect of our audits. In order to verify the totals or denominators to be used in the apportionment factors, we must request a breakdown by State for all States. In other words, the whole must be the sum of its parts; and so it is necessary to see and to examine all of the parts.

The next factor in our audit approach is the property factor. Again, we start with total property at cost, usually obtained from data support for the Schedule "L" balance sheet of the Federal Return. There are exceptions wherein we may accept a total taken from the general ledger or from book figures. But these are exceptions which are sometimes appropriate for a particular type of industry or business; or which may be accepted because the taxpayer's Federal return figures are net. Where those exceptions apply, we must then have a reconciliation and/or an explanation from the taxpayer for inclusion in our audit narrative and workpapers.

Next comes the problem of attributing property and rents by State. Property is usually segregated by type of property such as land, buildings, equipment, inventories and rents. This gives us detail which is useful in determining situs/nexus within a State. It also give us a better understanding of the taxpayer's operations or business activities such as manufacturing, sales and warehousing. Property breakdown by State, i.e. tying back to total (especially rents or leases by State), has been our most difficult single problem for reconciliation purposes. But the information necessary to verify the property factor is most important to an understanding of the taxpayer's activities overall and particularly of those within the States for which we are auditing.

The final apportionment factor is the sales or receipts factor. We begin with the total sales and/or receipts on the Federal 1120. I say "and/or receipts" because we will use those figures in accordance with the UDITPA (Uniform Division of Income for Tax Purposes Act) regulations if the taxpayer can provide us with an acceptable state-by-state breakdown of them. Since he usually cannot do so, we generally accommodate him by using net sales by State to total net sales in establishing the receipts factor ratio.

For this purpose a sales breakdown by state is required and must tie back to total sales on the Form 1120. In many cases, we have found that large amounts of sales have remained unallocated or unassigned to any State. When we find these unallocated sales, we review the taxpayer's records in order to determine where they should be assigned. If the records are insufficient for this purpose, we discuss with the taxpayer possible alternative methods for determining the amounts attributable to each State.

Under UDITPA, sales are normally attributed to the state of destination. There are two exceptions: sales to the United States Government and sales into a state in which the seller does not have jurisdictional nexus. Such sales are attributed to the state from which shipment is made. The Public Law 86-272 standard is used to determine whether or not jurisdictional nexus exists. This so-called "throw-back" rule has been the subject of a great deal of discussion and of no little criticism over the years. One excellent discussion of it is included in Peter Miller's December, 1971 Report of the Committee on Interstate Taxation of the New York Bar Association.[13] (I should note here that there seems to be increasing support, among state tax administrators, for the so-called "throw-out" rule. Under this rule, sales into a non-nexus state are excluded from the denominator as well as from all numerators of the sales factor. This has the effect of distributing those sales among all states in which the seller has jurisdictional nexus.)

A couple of property factor cases appear to have some bearing on the subject of sales attribution. In the *McDonnell Douglas* case,[14] which was decided in favor of the taxpayer, the California Supreme Court ruled that the factors to be used in apportioning unitary income by formula must give adequate weights to the elements responsible for earning the income; that certain property which was owned by the U.S. Government rather than by the taxpayer constituted a major factor in earning the taxpayer's income; and that such property must therefore be included in the property factor. The UDITPA regulations give recognition to the income earning effect of all property used in the business by providing that property used at no charge shall also be included in the property factor at a reasonable fair rental value.

In the 1970 *Montgomery Ward* case,[15] the California Supreme Court held that the statutory mandate to make an allocation on factors, including the value and situs of tangible property, is satisfied by considering all of the tangible property of the taxpayer as the denominator and, as the numerator, all of the property of the taxpayer which has a situs in, and which directly affects the net income derived from or attributable to sources within, the State. For this purpose, in-transit inventory having a destination within the State was considered to have a situs within the State and was included in the numerator of the State's property factor. This ruling was based on the premise that that property "has neither been taxed elsewhere nor used as a measure of income derived from or attributable to another taxing jurisdiction."

Those decisions relate to property. But can the quoted language not be equally applicable to sales into a non-nexus State? The fact that those sales have not been used as a measure of income derived from or attributable to another taxing jurisdiction seems to afford an excellent rationale for both the UDITPA sales attribution rule and the alternative throw-out rule.

The total accountability approach which ties sales numerators to the total sales denominator seems reasonable to me as an auditor. As a matter of fact, there seems to be strong logic in approaching the sales problem in this fashion. It enables us to account for the accuracy of the denominator by tying each component part into it and then determining where and to what extent sales are attributable. This approach also has a built-in protection for the taxpayer against duplicative taxation: sales which are included in the numerator of one State are

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13. Peter Miller, Report of Committee on Interstate Taxation, December 1971, *New York State Bar Association Tax Section*, p 37-41

14. *McDonnell Douglas Corp. v. Franchise Tax Board*, 69 Cal.2d 506 (1969) [The value of non-owned plant used by the taxpayer must be reflected in the property factor.]

15. *Montgomery Ward & Co. v. Franchise Tax Board*, 6 Cal. app. 3d 149 (1970) [Inventory in transit to California destinations must be included in the numerator of the seller's property factor.]

excluded from the numerators of all other States participating in the audit.

Occasionally, a tax representative will tell us that he has no way of tying all sales into the total on a destination basis. At that point we suggest that he contact his accounting department for the statistics. If the statistics are not available there, we may suggest that he contact the Vice President in charge of sales. We know that those statistics are available somewhere in every company. A company may cut down on accountants, on auditors or on tax personnel; but anything connected with sales gets top priority. Sales statistics are the lifeblood of all companies. We must have those statistics in order to make a proper comparison between the numerators and the denominator of the sales factor.

An examination of the statistics may reveal that certain sales were shipped to locations in States in which the taxpayer is neither taxed nor subject to taxation as a result of its *de minimus* activities within those States. We must then determine the locations from which such sales were shipped so that we can attribute them properly to their origin under UDITPA. This means that those sales will be included in the numerators of the sales factors of the States of origin.

I have said that sales are attributed to the States of origin if the taxpayer is neither taxed nor subject to tax in the State of destination. I want to clarify that statement for you. If the sales are into a State which does not impose a corporate income tax, then whether those sales are to be attributed to the State of destination will depend solely upon whether the seller has sufficient nexus in that State to confer on that State jurisdiction to impose such a tax even though the State does not do so. In other words, sales into one of the five States which do not impose a corporate income tax—they are Nevada, South Dakota, Texas, Washington and Wyoming—will not be attributed to the States of origin on the sole basis that those States do not impose such a tax. Those sales will still be attributed to those destination States if the seller's contact there is sufficient to allow those States to impose such a tax on the seller if they chose to impose such a tax.

Now let us look at sales made into one of the other 45 States. Let us assume that you appear to have sufficient nexus in that State so that you are subject to its taxing jurisdiction; but let us also assume that you are not filing returns there and are not paying applicable tax. At least one of our States takes the position that your failure to file returns and to pay applicable tax in a State into which you are making sales gives rise to a conclusive presumption that you are not subject to the jurisdiction of the latter State and that sales which have a destination in that State should be attributed to the State of origin. That presumption can generally be overcome by filing returns with the proper State and paying the applicable tax for the audit period in question.

We now turn to the distinction between apportionable business income and allocable non-business income. The nature and source of each item of income will determine into which category it falls. Here, again, we need full information in order to support any determination as to which income of your corporate business is to be treated as non-business in nature and not, therefore, apportionable among the States for which we are currently auditing. Toward that end, we do require a breakdown of the information behind the figures on lines 4 through 10 of your Federal return.

Having obtained the necessary information from you, we then use the Multistate Tax Commission regulations[16] as our guideline in recommending to

16. *Multistate Tax Commission Allocation and Apportionment Regulations*, February 21, 1973

our participating States which of your various items of income should be treated as apportionable and which as allocable.

Our efforts should now have produced enough information for us to have determined the taxpayer's apportionment formula percentage for each participating State for each year of the audit period. We apply that percentage to total apportionable income for each year to determine the amount of business income to be attributed to that State for each year. To those amounts we add any income which may be allocable to that State for each year. The totals constitute our recommendations as to what is the taxpayer's tax base for that State for the audit period in question, broken down by years.

Generally the States want us to apply their tax rate, show the tax paid and any balance due or refund payable under those recommendations. After discussing our recommendations with the taxpayer and making any corrections or adjustments which may result from that discussion and from consideration of any supplemental information, we then forward to each State that portion of the overall recommendations which pertains to that State. We also forward supporting factual information as well as a discussion of the manner in which that informtion was used in reaching our recommendations. That discussion will also indicate any aspects of the recommendations with which the taxpayer may disagree and which may not have been resolved between us and the taxpayer.

The State will now review all of the materials which we have supplied. It may ask for more information from us; which may mean that we will have to contact the taxpayer again. The State may accept the facts as presented but may revise the recommendations in accordance with its own interpretations of its law. The State may accept the recommendations and simply bill the taxpayer.

Our work is normally completed when we send our audit report to the States. Our experience has been that we have usually been able to reach accord with the taxpayer as to our recommendations. Where that has not been accomplished, we may be required to participate in hearings, both informal and formal, which may arise from the audit. The taxpayer has all of the same rights to administrative review and appeal as if the audit had been performed by auditors sent directly by the State on its behalf only.

We like to close our audits to the satisfaction of State and taxpayer alike as to the professional manner in which the audit was performed. We also like to close our audits on the basis of agreement between the State and the taxpayer as to the balance due or refund payable. That is not always possible, of course, when different interpretations may arise out of the same fact situation. One can never eliminate entirely the possibility that a particular disagreement can be resolved only through litigation. But we can conduct and close every audit on the basis of mutual respect. And we aim to do that to the full extent possible.

I have talked almost exclusively about corporate income tax audits. The reason is that those are the audits which have involved the controversial areas to which I have referred earlier, namely: taxation of dividends; treatment of foreign income; the unitary business concept and combined reporting; and the attribution of sales made to non-nexus States.

But we also have performed many sales and use tax audits; and we are continuing to do so. Virtually no problems have arisen with respect to those audits. To the best of my recollection, we have been able to get taxpayer agreement to every one of our sales and use tax audit recommendations. While the economies and efficiencies of joint audits are not quite as dramatic in this field as in the corporate income tax field, they are not less real.

Joint audits are here to stay. They are a must for the States; and, really, they are a must for business. The controversial policy matters will be resolved one of these days. Then we can all settle down to doing our respective jobs in the State and local tax field peacefully and amicably. Meanwhile, it will be to the advantage of all of us, whether we be state or taxpayer personnel, to acquaint ourselves fully with both the realities and the potential of joint audits.

APPENDIX J

MULTISTATE TAX COMMISSION ALLOCATION AND APPORTIONMENT REGULATIONS

(Applicable to Article IV of the Multistate Tax Compact and to the Uniform Division of Income for Tax Purposes Act.)

The following revised regulations were adopted by the Multistate Tax Commission on February 21, 1973. They are subject to adoption by each member state in accordance with its own laws and procedures.

The numerical references of the regulations are to Article IV of the Multistate Tax Compact and its subsections.

Prologue.—These Regulations are intended to set forth rules concerning the application of the apportionment and allocation provisions of Article IV of the Multistate Tax Compact. The apportionment rules set forth in these Regulations are applicable to any taxpayer having business income, regardless of whether or not it has nonbusiness income, and the allocation rules set forth in these Regulations are applicable to any taxpayer having nonbusiness income, regardless of whether or not it has business income.

The only exceptions to these allocation and apportionment rules contained in these Regulations are those set forth in Regulation IV.18 pursuant to the authority of Article IV.18 of the Compact.

These Regulations are not intended to modify existing rules concerning jurisdictional standards.

◆◆◆ **Reg. IV. 1. (a). Business and Nonbusiness Income Defined.** Article IV. 1. (a) defines "business income" as income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. In essence, all income which arises from the conduct of trade or business operations of a taxpayer is business income. For purposes of administration of Article IV, the income of the taxpayer is business income unless clearly classifiable as nonbusiness income.

Nonbusiness income means all income other than business income.

The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, nonoperating income, etc., is of no aid in determining whether income is business or nonbusiness income. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is "business income" or "nonbusiness income" is the identification of the transactions and activity which are the elements of a particular trade or business. In general all transactions and activities of the taxpayer which are dependent upon or contribute to the operations of the taxpayer's economic enterprise as a whole constitute the taxpayer's trade or business and will be transactions and activity arising in the regular course of, and will constitute integral parts of, a trade or business. (See Regulation IV.1.(c) for more specific examples of the classification of income as business or nonbusiness income; see Regulations IV.1.(b) and IV.2.(b)(2) for further explanation of what constitutes a trade or business.)

◆◆◆ **Reg. IV.1.(b). Two or More Businesses of a Single Taxpayer.** A taxpayer may have more than one "trade or business." In such cases, it is necessary to determine the business income attributable to each separate trade or business. The income of each business is then apportioned by an apportionment formula which takes into consideration the instate and outstate factors which relate to the trade or business the income of which is being apportioned.

Example: The taxpayer is a conglomerate with three operating divisions. One division is engaged in manufacturing aerospace items for the federal government. Another division is engaged in growing tobacco products. The third division produces and distributes motion pictures for theaters and television. Each division operates independently; there is no strong central management. Each division operates in this state as well as in other states. In this case, it is fair to conclude that the taxpayer is engaged in three separate "trades or businesses." Accordingly, the amount of business income attributable to the taxpayer's trade or business activities in this state is determined by applying an appropriate apportionment formula to the business income of each business.

[.10] Single trade or business. The determination of whether the activities of the taxpayer constitute a single trade or business or more than one trade or business will turn on the facts in each case. In general, the activities of the taxpayer will be considered a single business if there is evidence to indicate that the segments under consideration are integrated with, dependent upon or contribute to each other and the operations of the taxpayer as a whole. The following factors are considered to be good indicia of a single trade or business, and the presence of any of these factors creates a strong presumption that the activities of the taxpayer constitute a single trade or business:

[.15] **(1) Same type of business.** A taxpayer is generally engaged in a single trade or business when all of its activities are in the same general line. For example, a taxpayer which operates a chain of retail grocery stores will almost always be engaged in a single trade or business.

[.20] **(2) Steps in a vertical process.** A taxpayer is almost always engaged in a single trade or business when its various divisions or segments are engaged in different steps in a large, vertically structured enterprise. For example, a taxpayer which explores for and mines copper ores; concentrates, smelts and refines the copper ores; and fabricates the refined copper into consumer products is engaged in a single trade or business, regardless of the fact that the various steps in the process are operated substantially independently of each other with only general supervision from the taxpayer's executive offices.

[.25] **(3) Strong centralized management.** A taxpayer which might otherwise be considered as engaged in more than one trade or business is properly considered as engaged in one trade or business when there is a strong central management, coupled with the existence of centralized departments for such functions as financing, advertising, research, or purchasing. Thus, some conglomerates may properly be considered as engaged in only one trade or business when the central executive officers are normally involved in the operations of the various divisions and there are centralized offices which perform for the divisions the normal matters which a truly independent business would perform for itself, such as accounting, personnel, insurance, legal, purchasing, advertising, or financing.

◆◆◆ **Reg. IV.1. (c). Business and Nonbusiness Income: Application of Definitions.** The following are rules and examples for determining whether particular income is business or nonbusiness income. (The examples used throughout these regulations are illustrative only and do not purport to set forth all pertinent facts.)

[.10] **(1) Rents from real and tangible personal property.** Rental income from real and tangible property is business income if the property with respect to which the rental income was received is used in the taxpayer's trade or business or incidental thereto and therefore is includable in the property factor under Regulation IV.10.

Example (i): The taxpayer operates a multistate car rental business. The income from car rentals is business income.

Example (ii): The taxpayer is engaged in the heavy construction business in which it uses equipment such as cranes, tractors, and earth-moving vehicles. The taxpayer makes short-term leases of the equipment when particular pieces of equipment are not needed on any particular project. The rental income is business income.

Example (iii): The taxpayer operates a multistate chain of men's clothing stores. The taxpayer purchases a five-story office building for use in connection with its trade or business. It uses the street floor as one of its retail stores and the second and third floors for its general corporate headquarters. The remaining two floors are leased to others. The rental of the two floors is incidental to the operation of the taxpayer's trade or business. The rental income is business income.

Example (iv): The taxpayer operates a multistate chain of grocery stores. It purchases as an investment an office building in another state with surplus funds and leases the entire building to others. The net rental income is not business income of the grocery store trade or business. Therefore, the net rental income is nonbusiness income.

Example (v): The taxpayer operates a multistate chain of men's clothing stores. The taxpayer invests in a 20-story office building and uses the street floor as one of its retail stores and the second floor for its general corporate headquarters. The remaining 18 floors are leased to others. The rental of the eighteen floors is not incidental to but rather is separate from the operation of the taxpayer's trade or business. The net rental income is not business income of the clothing store trade or business. Therefore, the net rental income is nonbusiness income.

Example (vi): The taxpayer constructed a plant for use in its multistate manufacturing business and 20 years later the plant was closed and put up for sale. The plant was rented for a temporary period from the time it was closed by the taxpayer until it was sold 18 months later. The rental income is business income and the gain on the sale of the plant is business income.

Example (vii): The taxpayer operates a multistate chain of grocery stores. It owned an office building which it occupied as its corporate headquarters. Because of inadequate space, taxpayer acquired a new and larger building elsewhere for its corporate headquarters. The old building was rented to an investment company under a five-year lease. Upon expiration of the lease, taxpayer sold the building at a gain (or loss). The net rental income received over the lease period is nonbusiness income and the gain (or loss) on the sale of the building is nonbusiness income.

[.15] **(2) Gains or losses from sales of assets.** Gain or loss from the sale, exchange or other disposition of real or tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used in the taxpayer's trade or business. However, if such property was utilized for the production of nonbusiness income or otherwise was removed from the property factor before its sale, exchange or other disposition, the gain or loss will constitute nonbusiness income. See Regulation IV.10.

Example (i): In conducting its multistate manufacturing business, the taxpayer systematically replaces automobiles, machines, and other equipment used in the business. The gains or losses resulting from those sales constitute business income.

Example (ii): The taxpayer constructed a plant for use in its multistate manufacturing business and 20 years later sold the property at a gain while it was in operation by the taxpayer. The gain is business income.

Example (iii): Same as (ii) except that the plant was closed and put up for sale but was not in fact sold until a buyer was found 18 months later. The gain is business income.

Example (iv): Same as (ii) except that the plant was rented while being held for sale. The rental income is business income and the gain on the sale of the plant is business income.

Example (v): The taxpayer operates a multistate chain of grocery stores. It owned an office building which it occupied as its corporate headquarters. Because of inadequate space, taxpayer acquired a new and larger building elsewhere for its corporate headquarters. The old building was rented to an unrelated investment company under a five-year lease. Upon expiration of the lease, taxpayer sold the building at a gain (or loss). The gain (or loss) on the sale is nonbusiness income and the rental income received over the lease period is nonbusiness income.

[.20] **(3) Interest.** Interest income is business income where the intangible with respect to which the interest was received arises out of or was created in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the intangible is related to or incidental to such trade or business operations.

Example (i): The taxpayer operates a multistate chain of department stores, selling for cash and on credit. Service charges, interest, or time-price differentials and the like are received with respect to installment sales and revolving charge accounts. These amounts are business income.

Example (ii): The taxpayer conducts a multistate manufacturing business. During the year the taxpayer receives a federal income tax refund and collects a judgment against a debtor of the business. Both the tax refund and the judgment bore interest. The interest income is business income.

Example (iii): The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business, the taxpayer maintains special accounts to cover such items as workmen's compensation claims, rain and storm damage, machinery replacement, etc. The moneys in those accounts are invested at interest. Similarly, the taxpayer temporarily invests funds intended for payment of federal, state and local tax obligations. The interest income is business income.

Example (iv): The taxpayer is engaged in a multistate money order and traveler's checks business. In addition to the fees received in connection with the sale of the money orders and traveler's checks, the taxpayer earns interest income by the investment of the funds pending their redemption. The interest income is business income.

Example (v): The taxpayer is engaged in a multistate manufacturing and selling business. The taxpayer usually has working capital and extra cash totaling

$200,000 which it regularly invests in short-term interest bearing securities. The interest income is business income.

Example (vi): In January the taxpayer sold all the stock of a subsidiary for $20,000,000. The funds are placed in an interest-bearing account pending a decision by management as to how the funds are to be utilized. The interest income is nonbusiness income.

[.25] **(4) Dividends.** Dividends are business income where the stock with respect to which the dividends are received arises out of or was acquired in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the stock is related to or incidental to such trade or business operations.

Example (i): The taxpayer operates a multistate chain of stock brokerage houses. During the year the taxpayer receives dividends on stock it owns. The dividends are business income.

Example (ii): The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business the taxpayer maintains special accounts to cover such items as workmen's compensation claims, etc. A portion of the moneys in those accounts is invested in interest-bearing bonds. The remainder is invested in various common stocks listed on national stock exchanges. Both the interest income and any dividends are business income.

Example (iii): The taxpayer and several unrelated corporations own all of the stock of a corporation whose business operations consist solely of acquiring and processing materials for delivery to the corporate owners. The taxpayer acquired the stock in order to obtain a source of supply of materials used in its manufacturing business. The dividends are business income.

Example (iv): The taxpayer is engaged in a multistate heavy construction business. Much of its construction work is performed for agencies of the federal government and various state governments. Under state and federal laws applicable to contracts for these agencies, a contractor must have adequate bonding capacity, as measured by the ratio of its current assets (cash and marketable securities) to current liabilities. In order to maintain an adequate bonding capacity the taxpayer holds various stocks and interest-bearing securities. Both the interest income and any dividends received are business income.

Example (v): The taxpayer receives dividends from the stock of its subsidiary or affiliate which acts as the marketing agency for products manufactured by the taxpayer. The dividends are business income.

Example (vi): The taxpayer is engaged in a multistate glass manufacturing business. It also holds a portfolio of stock and interest-bearing securities, the acquisition and holding of which are unrelated to the manufacturing business. The dividends and interest income received are nonbusiness income.

[.30] **(5) Patent and copyright royalties.** Patent and copyright royalties are business income where the patent or copyright with respect to which the royalties were received arises out of or was created in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the patent or copyright is related to or incidental to such trade or business operations.

Example (i): The taxpayer is engaged in the multistate business of manufacturing and selling industrial chemicals. In connection with that business the taxpayer obtained patents on certain of its products. The taxpayer licensed the production of the chemicals in foreign countries, in return for which the taxpayer receives royalties. The royalties received by the taxpayer are business income.

Example (ii): The taxpayer is engaged in the music publishing business and holds copyrights on numerous songs. The taxpayer acquires the assets of a smaller publishing company, including music copyrights. These acquired copyrights are thereafter used by the taxpayer in its business. Any royalties received on these copyrights are business income.

Example (iii): Same as example (ii), except that the acquired company also held the patent on a type of phonograph needle. The taxpayer does not manufacture or sell phonographs or phonograph equipment. Any royalties received on the patent would be nonbusiness income.

◆◆◆ **Reg. IV.1.(d). Proration of Deductions.** In most cases an allowable deduction of a taxpayer will be applicable only to the the business income arising from a particular trade or business or to a particular item of nonbusiness income. In some cases an allowable deduction may be applicable to the business incomes of more than one trade or business and/or to several items of nonbusiness income. In such cases the deduction shall be prorated among such trades or businesses and such items of nonbusiness income in a manner which fairly distributes the deduction among the classes of income to which it is applicable.

In filing returns with this state, if the taxpayer departs from or modifies the manner of prorating any such deduction used in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.

If the returns or reports filed by a taxpayer with all states to which the taxpayer reports under Article IV of this Compact or the Uniform Division of Income for Tax Purposes Act are not uniform in the application or proration of any deduction, the taxpayer shall disclose in its return to this state the nature and extent of the variance.

◆◆◆ **Reg. IV.2.(a). Definitions.** (1) "Taxpayer" means [each state should insert the definition in Article II.3. or the definition in its own tax laws].

(2) "Apportionment" refers to the division of business income between states by the use of a formula containing apportionment factors.

(3) "Allocation" refers to the assignment of nonbusiness income to a particular state.

(4) "Business activity" refers to the transactions and activity occurring in the regular course of a particular trade or business of a taxpayer.

◆◆◆ **Reg. IV.2.(b)(1). Application of Article IV: Apportionment.** If the business activity in respect to any trade or business of a taxpayer occurs both within and without this state, and if by reason of such business activity the taxpayer is taxable in another state, the portion of the net income (or net loss) arising from such trade or business which is derived from sources within this state shall be determined by apportionment in accordance with Article IV.9. to IV.17.

◆◆◆ **Reg. IV.2.(b)(2). Application of Article IV: Combined Report.** If a particular trade or business is carried on by a taxpayer and one or more affiliated corporations, nothing in Article IV or in these regulations shall preclude the use of a "combined report" whereby the entire business income of such trade or business is apportioned in accordance with Article IV.9. to IV.17.

◆◆◆ **Reg. IV.2.(b)(3). Application Article IV: Allocation.** Any taxpayer subject to the taxing jurisdiction of this state shall allocate all of its nonbusiness income or loss within or without this state in accordance with Article IV.4 to IV.8.

◆◆◆ **Reg. IV.2.(c). Consistency and Uniformity in Reporting.**

[.10 **Year to year consistency.**] In filing returns with this state, if the taxpayer departs from or modifies the manner in which income has been classified as business income or nonbusiness income in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.

[.20 **State to state.**] If the returns or reports filed by a taxpayer for all states to which the taxpayer reports under Article IV of this Compact or the Uniform Division of Income for Tax Purposes Act are not uniform in the classification of income as business or nonbusiness income, the taxpayer shall disclose in its return to this state the nature and extent of the variance.

◆◆◆ **Reg. IV.3.(a). Taxable in Another State: In General.** Under Article IV.2. the taxpayer is subject to the allocation and apportionment provisions of Article IV if it has income from business activity that is taxable both within and without this state. A taxpayer's income from business activity is taxable without this state if such taxpayer, by reason of such business activity (i.e., the transactions and *activity occurring in the regular course of a particular trade or business*), *is taxable* in another state within the meaning of Article IV.3.

[.10 **Applicable tests.**] A taxpayer is taxable within another state if it meets either one of two tests: (1) If by reason of business activity in another state the taxpayer is subject to one of the types of taxes specified in Article IV.3.(1), namely: 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) If by reason of such business activity another state has jurisdiction to subject the taxpayer to a net income tax, regardless of whether or not the state imposes such a tax on the taxpayer.

[.20 **Producing nonbusiness income.**] A taxpayer is not taxable in another state with respect to a particular trade or business merely because the taxpayer conducts activities in such other state pertaining to the production of nonbusiness income or business activities relating to a separate trade or business.

◆◆◆ **Reg. IV.3.(b). Taxable in Another State: When a Corporation is "Subject to" a Tax Under Article IV.3.(1).** (1) A taxpayer is "subject to" one of the taxes specified in Article IV.3.(1) if it carries on business activities in such state and such state imposes such a tax thereon. Any taxpayer which asserts that it is subject to one of the taxes specified in Article IV.3.(1) in another state shall furnish to the [tax administrator] of this state upon his request evidence to support such assertion. The [tax administrator] of this state may request that such evidence include proof that the taxpayer has filed the requisite tax return in such other state and has paid any taxes imposed under the law of such other state; the taxpayer's failure to produce such proof may be taken into account in determining whether the taxpayer in fact is subject to one of the taxes specified in Article IV.3.(1) in such other state.

[.10 **Voluntary tax payment.**] If the taxpayer voluntarily files and pays one or more of such taxes when not required to do so by the laws of that state or pays a minimal fee for qualification, organization or for the privilege of doing business in that state, but

(A) does not actually engage in business activity in that state, or

(B) does actually engage in some business activity, not sufficient for nexus, and the minimum tax bears no relation to the taxpayer's business activity within such state, the taxpayer is not "subject to" one of the taxes specified within the meaning of Article IV.3.(1).

Example: State A has a corporation franchise tax measured by net income, for the privilege of doing business in that state. Corporation X files a return and pays the $50 minimum tax, although it carries on no business activity in State A. Corporation X is not "taxable" in State A.

[**.20 Taxability.**] (2) The concept of taxability in another state is based upon the premise that every state in which the taxpayer is engaged in business activity may impose an income tax even though every state does not do so. In states which do not, other types of taxes may be imposed as a substitute for an income tax. Therefore, only those taxes enumerated in Article IV.3.(1) which may be considered as basically revenue raising rather than regulatory measures shall be considered in determining whether the taxpayer is "subject to" one of the taxes specified in Article IV.3.(1) in another state.

Example (i): State A requires all nonresident corporations which qualify or register in State A to pay to the Secretary of State an annual license fee or tax for the privilege of doing business in the state regardless of whether the privilege is in fact exercised. The amount paid is determined according to the total authorized capital stock of the corporation; the rates are progressively higher by bracketed amounts. The statute sets a minimum fee of $50 and a maximum fee of $500. Failure to pay the tax bars a corporation from utilizing the state courts for enforcement of its rights. State A also imposes a corporation income tax. Nonresident Corporation X is qualified in State A and pays the required fee to the Secretary of State but does not carry on any business activity in State A (although it may utilize the courts of State A). Corporation X is not "taxable" in State A.

Example (ii): Same facts as Example (i) except that Corporation X is subject to and pays the corporation income tax. Payment is prima facie evidence that Corporation X is "subject to" the net income tax of State A and is "taxable" in State A.

Example (iii): State B requires all nonresident corporations qualified or registered in State B to pay to the Secretary of State an annual permit fee or tax for doing business in the state. The base of the fee or tax is the sum of (1) outstanding capital stock, and (2) surplus and undivided profits. The fee or tax base attributable to State B is determined by a three factor apportionment formula. Nonresident Corporation X which operates a plant in State B, pays the required fee or tax to the Secretary of State. Corporation X is "taxable" in State B.

Example (iv): State A has a corporation franchise tax measured by net income for the privilege of doing business in that state. Corporation X files a return based upon its business activity in the state but the amount of computed liability is less than the minimum tax. Corporation X pays the minimum tax. Corporation X is subject to State A's corporation franchise tax.

◆◆◆ **Reg. IV.3.(c). Taxable in Another State: When a State has Jurisdiction to Subject a Taxpayer to a Net Income Tax.** The second test, that of Article IV.3.(2), applies if the taxpayer's business activity is sufficient to give the state jurisdiction to impose a net income tax by reason of such business activity under the Constitution and statutes of the United States. Jurisdiction to tax is not present where the state is prohibited from imposing the tax by reason of the provisions of Public Law 86-272, 15 U.S.C.A. §§381-385. In the case of any "state" as defined in Article IV.1.(h), other than a state of the United States or political subdivision of such state, the determination of whether such "state" has jurisdiction to subject the taxpayer to a net income tax shall be made as though the jurisdictional standards applicable to a state of the United States applied in that "state." If jurisdiction is otherwise present, such "state" is not considered as without jurisdiction by reason of the provisions of a treaty between that state and the United States.

Example: Corporation X is actively engaged in manufacturing farm equipment in State A and in foreign country B. Both State A and foreign country B impose a net income tax but foreign country B exempts corporations engaged in manufacturing farm equipment. Corporation X is subject to the jurisdiction of State A and foreign country B.

◆◆◆ **Reg. IV.9. Apportionment Formula.** All business income of each trade or business of the taxpayer shall be apportioned to this state by use of the apportionment formula set forth in Article IV.9. The elements of the apportionment formula are the property factor (see Regulation IV.10.), the payroll factor (see Regulation IV.13.) and the sales factor (see Regulation IV.15.) of the trade or business of the taxpayer.

◆◆◆ **Reg. IV.10.(a). Property Factor: In General.** The property factor of the apportionment formula for each trade or business of the taxpayer shall include all real and tangible personal property owned or rented by the taxpayer and used during the tax period in the regular course of such trade or business. The term "real and tangible personal property" includes land, buildings, machinery, stocks of goods, equipment, and other real and tangible personal property but boes not include coin or currency. Property used in connection with the production of nonbusiness income shall be excluded from the property factor. Property used both in the regular course of taxpayer's trade or business and in the production of nonbusiness income shall be included in the factor only to the extent the property is used in the regular course of taxpayer's trade or business. The method of determining that portion of the value to be included in the factor will depend upon the facts of each case. The property factor shall include the average value of property includable in the factor. See Regulation IV.12.

◆◆◆ **Reg. IV.10.(b). Property Factor: Property Used for the Production of Business Income.** Property shall be included in the property factor if it is actually used or is available for or capable of being used during the tax period in the regular course of the trade or business of the taxpayer. Property held as reserves or standby facilities or property held as a reserve source of materials shall be included in the factor. For example, a plant temporarily idle or raw material reserves not currently being processed are includable in the factor. Property or equipment under construction during the tax period, (except inventoriable goods in process) shall be excluded from the factor until such property is actually used in the regular course of the trade or business of the taxpayer. If the property is partially used in the regular course of the trade or business of the taxpayer while under construction, the value of the property to the extent used shall be included in the property factor. Property used in the regular course of the trade or business of the taxpayer shall remain in the property factor until its permanent withdrawal is established by an identifiable event such as its conversion to the production of nonbusiness income, its sale, or the lapse of an extended period of time (normally, five years) during which the property is held for sale.

Example (i): Taxpayer closed its manufacturing plant in State X and held such property for sale. The property remained vacant until its sale one year later.

The value of the manufacturing plant is included in the property factor until the plant is sold.

Example (ii): Same as above except that the property was rented until the plan was sold. The plant is included in the property factor until the plant is sold.

Example (iii): Taxpayer closed its manufacturing plant and leased the building under a five-year lease. The plant is included in the property factor until the commencement of the lease.

Example (iv): The taxpayer operates a chain of retail grocery stores. Taxpayer closed Store A, which was then remodeled into three small retail stores such as a dress shop, dry cleaning, and barber shop, which were leased to unrelated parties. The property is removed from the property factor on the date the remodeling of Store A commenced.

◆◆◆ **Reg. IV.10.(c). Property Factor: Consistency in Reporting.**

[.10 Year to year consistency.] In filing returns with this state, if the taxpayer departs from or modifies the manner of valuing property, or of excluding or including property in the property factor, used in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.

[.20 State to state uniformity.] If the returns or reports filed by the taxpayer with all states to which the taxpayer reports under Article IV of this Compact or the Uniform Division of Income for Tax Purposes Act are not uniform in the valuation of property and in the exclusion or inclusion of property in the property factor, the taxpayer shall disclose in its return to this state the nature and extent of the variance.

◆◆◆ **Reg. IV.10.(d). Property Factor: Numerator.** The numerator of the property factor shall include the average value of the real and tangible personal property owned or rented by the taxpayer and used in this state during the tax period in the regular course of the trade or business of the taxpayer. Property in transit between locations of the taxpayer to which it belongs shall be considered to be at the destination for purposes of the property factor. Property in transit between a buyer and seller which is included by a taxpayer in the denominator of its property factor in accordance with its regular accounting practices shall be included in the numerator according to the state of destination. The value of mobile or movable property such as construction equipment, trucks or leased electronic equipment which are located within and without this state during the tax period shall be determined for purposes of the numerator of the factor on the basis of total time within the state during the tax period. An automobile assigned to a traveling employee shall be included in the numerator of the factor of the state to which the employee's compensation is assigned under the payroll factor or in the numerator of the state in which the automobile is licesned.

◆◆◆ **Reg. IV.11.(a). Property Factor: Valuation of Owned Property.**

(1) Property owned by the taxpayer shall be valued at its original cost. As a general rule "original cost" is deemed to be the basis of the property for federal income tax purposes (prior to any federal adjustments) at the time of acquisition by the taxpayer and adjusted by subsequent capital additions or improvements thereto and partial disposition thereof, by reason of sale, exchange, abandonment, etc.

Example (i): The taxpayer acquired a factory building in this state at a cost of $500,000 and 18 months later expended $100,000 for major remodeling of the building. Taxpayer files its return for the current taxable year on the calendar-year basis. Depreciation deduction in the amount of $22,000 was claimed on the building for its return for the current taxable year. The value of the building includable in the numerator and denominator of the property factor is $600,000 as the depreciation deduction is not taken into account in determining the value of the building for purposes of the factor.

Example (ii): During the current taxable year, X Corporation merges into Y Corporation in a tax-free reorganization under the Internal Revenue Code. At the time of the merger, X Corporation owns a factory which X built five years earlier at a cost of $1,000,000. X has been depreciating the factory at the rate of two percent per year, and its basis in X's hands at the time of the merger is $900,000. Since the property is acquired by Y in a transaction in which, under the Internal Revenue Code, its basis in Y's hands is the same as its basis in X's, Y includes the property in Y's property factor at X's original cost, without adjustment for depreciation, i.e. $1,000,000.

Example (iii): Corporation Y acquires the assets of Corporation X in a liquidation by which Y is entitled to use its stock cost as the basis of the X assets under § 334(b)(2) of the 1954 Internal Revenue Code (i.e. stock possessing 80 percent control is purchased and liquidated within two years). Under these circumstances, Y's cost of the assets is the purchase price of the X stock, prorated over the X assets.

If original cost of property is unascertainable, the property is included in the factor at its fair market value as of the date of acquisition by the taxpayer.

(2) Inventory of stock of goods shall be included in the factor in accordance with the valuation method used for federal income tax purposes.

(3) Property acquired by gift or inheritance shall be included in the factor at its basis for determining depreciation for federal income tax purposes.

◆◆◆ Reg. IV.11.(b). Property Factor: Valuation of Rented Property.

[.10 Multiplier.] (1) Property rented by the taxpayer is valued at eight times its net annual rental rate. The net annual rental rate for any item of rented property is the annual rental rate paid by the taxpayer for such property, less the aggregate annual subrental rates paid by subtenants of the taxpayer. (See Regulation IV.18.(a) for special rules where the use of such net annual rental rate produces a negative or clearly inaccurate value or where property is used by the taxpayer at no charge or rented at a nominal rental rate.)

[.15 Subrentals.] Subrents are not deducted when the subrents constitute business income because the property which produces the subrents is used in the regular course of a trade or business of the taxpayer when it is producing such income. Accordingly there is no reduction in its value.

Example (i): The taxpayer receives subrents from a bakery concession in a food market operated by the taxpayer. Since the subrents are business income they are not deducted from rent paid by the taxpayer for the food market.

Example (ii): The taxpayer rents a 5-story office building primarily for use in its multistate business, uses three floors for its offices and subleases two floors to various other businesses and persons such as professional people, shops and the like. The rental of the two floors is incidental to the operation of the taxpayer's trade or business. Since the subrents are business income they are not deducted from the rent paid by the taxpayer.

Example (iii): The taxpayer rents a 20-story office building and uses the lower two stories for its general corporation headquarters. The remaining 18 floors are subleased to others. The rental of the eighteen floors is not incidental to but rather is separate from the operation of the taxpayer's trade or business. Since the subrents are nonbusiness income they are to be deducted from the rent paid by the taxpayer.

[.20] (2) "Annual rental rate" is the amount paid as rental for property for a 12-month period (i.e., the amount of the annual rent). Where property is rented for less than a 12-month period, the rent paid for the actual period of rental shall constitute the "annual rental rate" for the tax period. However, where a taxpayer has rented property for a term of 12 or more months and the current tax period covers a period of less than 12 months (due, for example, to a reorganization or change of accounting period), the rent paid for the short tax period shall be annualized. If the rental term is for less than 12 months, the rent shall not be annualized beyond its term. Rent shall not be annualized because of the uncertain duration when the rental term is on a month to month basis.

Example (i): Taxpayer A which ordinarily files its returns based on a calendar year is merged into Taxpayer B on April 30. The net rent paid under a lease with 5 years remaining is $2,500 a month. The rent for the tax period January 1 to April 30 is $10,000. After the rent is annualized the net rent is $30,000 ($2,500 x 12).

Example (ii): Same facts as in Example (i) except that the lease would have terminated on August 31. In this case the annualized net rent is $20,000 ($2,500 x 8).

[.30] (3) "Annual rent" is the actual sum of money or other consideration payable, directly or indirectly, by the taxpayer or for its benefit for the use of the property and includes:

(A) Any amount payable for the use of real or tangible personal property, or any part thereof, whether designated as a fixed sum of money or as a percentage of sales, profits or otherwise.

Example: A taxpayer, pursuant to the terms of a lease, pays a lessor $1,000 per month as a base rental and at the end of the year pays the lessor one percent of its gross sales of $400,000. The annual rent is $16,000 ($12,000 plus one percent of $400,000 or $4,000).

(B) Any amount payable as additional rent or in lieu of rents, such as interest, taxes, insurance, repairs or any other items which are required to be paid by the terms of the lease or other arrangement, not including amounts paid as service charges, such as utilities, janitor services, etc. If a payment includes rent and other charges unsegregated, the amount of rent shall be determined by consideration of the relative values of the rent and the other items.

Example (i): A taxpayer, pursuant to the terms of a lease, pays the lessor $12,000 a year rent plus taxes in the amount of $2,000 and interest on a mortgage in the amount of $1,000. The annual rent is $15,000.

Example (ii): A taxpayer stores part of its inventory in a public warehouse. The total charge for the year was $1,000 of which $700 was for the use of storage space and $300 for inventory insurance, handling and shipping charges, and C.O.D. collections. The annual rent is $700.

"Annual rent" does not include incidental day-to-day expenses such as hotel or motel accommodations, daily rental of automobiles, etc.

[.40] (4) Leasehold improvements shall, for the purposes of the property factor, be treated as property owned by the taxpayer regardless of whether the taxpayer is entitled to remove the improvements or the improvements revert to the lessor upon expiration of the lease. Hence, the original cost of leasehold improvements shall be included in the factor.

◆◆◆ **Reg. IV.12. Property Factor: Averaging Property Values.** As a general rule the average value of property owned by the taxpayer shall be determined by averaging the values at the beginning and ending of the tax period. However, the [tax administrator] may require or allow averaging by monthly values if such method of averaging is required to properly reflect the average value of the taxpayer's perperty for the tax period.

Averaging by monthly values will generally be applied if substantial fluctuations in the values of the property exist during the tax period or where property is acquired after the beginning of the tax period or disposed of before the end of the tax period.

Example: The monthly value of the taxpayer's property was as follows:

January	$2,000	July	$15,000
February	2,000	August	17,000
March	3,000	September	23,000
April	3,500	October	25,000
May	4,500	November	13,000
June	10,000	December	2,000
	$25,000		$95,000
		Total	$120,000

The average value of the taxpayer's property includable in the property factor for the income year is determined as follows:

$$\frac{\$120{,}000}{12} = \$10{,}000$$

Averaging with respect to rented property is achieved automatically by the method of determining the net annual rental rate of such property as set forth in Reg. IV.11.(b).

◆◆◆ Reg. IV.13.(a). Payroll Factor: in General.

[.10] (1) The payroll factor of the apportionment formula for each trade or business of the taxpayer shall include the total amount paid by the taxpayer in the regular course of its trade or business for compensation during the tax period.

[.20] (2) The total amount "paid" to employees is determined upon the basis of the taxpayer's accounting method. If the taxpayer has adopted the accrual method of accounting, all compensation properly accrued shall be deemed to have been paid. Notwithstanding the taxpayer's method of accounting, at the election of the taxpayer, compensation paid to employees may be included in the payroll factor by use of the cash method if the taxpayer is required to report such compensation under such method for unemployment compensation purposes.

The compensation of any employee on account of activities which are connected with the production of nonbusiness income shall be excluded from the factor.

Example (i): The taxpayer uses some of its employees in the construction of a storage building which, upon completion, is used in the regular course of taxpayer's trade or business. The wages paid to those employees are treated as a capital expenditure by the taxpayer. The amount of such wages is included in the payroll factor.

Example (ii): The taxpayer owns various securities which it holds as an investment separate and apart from its trade or business. The management of the taxpayer's investment portfolio is the only duty of Mr. X, an employee. The salary paid to Mr. X is excluded from the payroll factor.

[.30] (3) The term "compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services. Payments made to an independent contractor or any other person not properly classifiable as an employee are excluded. Only amounts paid directly to employees are included in the payroll factor. Amounts considered paid directly include the value of board, rent, housing, lodging, and other benefits or services furnished to employees by the taxpayer in return for personal services provided that such amounts constitute income to the recipient under the federal Internal Revenue Code. In the case of employees not subject to the federal Internal Revenue Code, e.g., those employed in foreign countries, the determination of whether such benefits or services would constitute income to the employees shall be made as though such employees were subject to the federal Internal Revenue Code.

[.40] (4) The term "employee" means (A) any officer of a corporation, or (B) any individual who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an employee. Generally, a person will be considered to be an employee if he is included by the taxpayer as an employee for purposes of the payroll taxes imposed by the Federal Insurance Contributions Act; except that, since certain individuals are included within the term "employees" in the Federal Insurance Contributions Act who would not be employees under the usual common-law rules, it may be established that a person who is included as an employee for purposes of the Federal Insurance Contributions Act is not an employee for purposes of this regulation.

[.50 **Return Consistency.**] (5) In filing returns with this state, if the taxpayer departs from or modifies the treatment of compensation paid used in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.

[.55 **Return uniformity.**] If the returns or reports filed by the taxpayer with all states to which the taxpayer reports under Article IV of this Compact or the Uniform Division of Income for Tax Purposes Act are not uniform in the treatment of compensation paid, the taxpayer shall disclose in its return to this state the nature and extent of the variance.

◆◆◆ **Reg. IV.13.(b). Payroll Factor: Denominator.** The denominator of the payroll factor is the total compensation paid everywhere during the tax period. Accordingly, compensation paid to employees whose services are performed entirely in a state where the taxpayer is immune from taxation, for example, by Public Law 86-272, is included in the denominator of the payroll factor.

Example: A taxpayer has employees in its state of legal domicile (State A) and is taxable in State B. In addition the taxpayer has other employees whose services are performed entirely in State C where the taxpayer is immune from taxation by Public Law 86-272. As to these latter employees, the compensation will be assigned to State C where their services are performed (i.e., included in the denominator--but not the numerator of the payroll factor) even though the taxpayer is not taxable in State C.

◆◆◆ **Reg. IV.13.(c). Payroll Factor: Numerator.** The numerator of the payroll factor is the total amount paid in this state during the tax period by the taxpayer for compensation. The tests in Article IV.14. to be applied in determining whether compensation is paid in this state are derived from the Model Unemployment Compensation Act. Accordingly, if compensation paid to employees is included in the payroll factor by use of the cash method of accounting or if the taxpayer is required to report such compensation under such method for unemployment compensation purposes, it shall be presumed that the total wages reported by the taxpayer to this state for unemployment compensation purposes constitute compensation paid in this state except for compensation excluded under Regulation IV.13.(a). to IV.14. The presumption may be overcome by satisfactory evidence that an employee's compensation is not properly reportable to this state for unemployment compensation purposes.

◆◆◆ **Reg. IV.14. Payroll Factor: Compensation Paid in this State.** Compensation *is paid in this state if any one of the following tests, applied consecutively,* are met:

(1) The employee's service is performed entirely within the state.

(2) The employee's service is performed both within and without the state, but the service performed without the state is incidental to the employee's service within the state. The word "incidental" means any service which is temporary or transitory in nature, or which is rendered in connection with an isolated transaction.

(3) If the employee's services are performed both within and without this state, the employee's compensation will be attributed to this state:

(A) if the employee's base of operations is in this state; or

(B) if there is no base of operations in any state in which some part of the service is performed, but the place from which the service is directed or controlled is in this state; or

(C) if the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed but the employee's residence is in this state.

[.10] The term "place from which the service is directed or controlled" refers to the place from which the power to direct or control is exercised by the taxpayer.

[.20] The term "base of operations" is the place of more or less permanent nature from which the employee starts his work and to which he customarily returns in order to receive instructions from the taxpayer or communications from his customers or other persons or to replenish stock or other materials, repair equipment, or perform any other functions necessary to the exercise of his trade or profession at some other point or points.

◆◆◆ **Reg. IV.15.(a). Sales Factor: In General.** (1) Article IV.1.(g) defines the term "sales" to mean all gross receipts of the taxpayer not allocated under paragraphs (5) through (8) of Article IV. Thus, for the purposes of the sales factor of the apportionment formula for each trade or business of the taxpayer, the term "sales" means all gross receipts derived by the taxpayer from transactions and activity in *the regular course of such trade or business.* The following are rules for determining "sales" in various situations:

(A) In the case of a taxpayer engaged in manufacturing and selling or purchasing and reselling goods or products, "sales" includes all gross receipts from the sales of such goods or products (or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the tax period) held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. Gross receipts for this purpose means gross sales less returns and allowances, and includes all interest income, service charges, carrying charges, or time-price differential charges incidental to such sales. Federal and state excise taxes (including sales taxes) shall be included as part of such receipts if such taxes are passed on to the buyer or included as part of the selling price of the product.

(B) In the case of cost plus fixed fee contracts, such as the operation of a government-owned plant for a fee, "sales" includes the entire reimbursed cost, plus the fee.

(C) In the case of a taxpayer engaged in providing services, such as the operation of an advertising agency, or the performance of equipment service contracts, research and development contracts, "sales" includes the gross receipts from the performance of such services including fees, commissions, and similar items.

(D) In the case of a taxpayer engaged in renting real or tangible property, "sales" includes the gross receipts from the rental, lease, or licensing the use of the property.

(E) In the case of a taxpayer engaged in the sale, assignment, or licensing of intangible personal property such as patents and copyrights, "sales" includes the gross receipts therefrom.

(F) If a taxpayer derives receipts from the sale of equipment used in its business, such receipts constitute "sales." For example, a truck express company owns a fleet of trucks and sells its trucks under a regular replacement program. The gross receipts from the sales of the trucks are included in the sales factor.

[**.10 Exceptions.**] (2) In some cases certain gross receipts should be disregarded in determining the sales factor in order that the apportionment formula will operate fairly to apportion to this state the income of the taxpayer's trade or business. See Regulation IV.18(c).

[**.20 Return consistency.**] (3) In filing returns with this state, if the taxpayer departs from or modifies the basis for excluding or including gross receipts in the sales factor used in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.

[**.30 Return uniformity.**] If the returns or reports filed by the taxpayer with all states to which the taxpayer reports under Article IV of this Compact or the Uniform Division of Income for Tax Purposes Act are not uniform in the inclusion or exclusion of gross receipts, the taxpayer shall disclose in its return to this state the nature and extent of the variance.

◆◆◆ **Reg. IV.15.(b). Sales Factor: Denominator.** The denominator of the sales factor shall include the total gross receipts derived by the taxpayer from transactions and activity in the regular course of its trade or business, except receipts excluded under Regulation IV.18.(c).

◆◆◆ **Reg. IV.15.(c). Sales Factor: Numerator.** The numerator of the sales factor shall include gross receipts attributable to this state and derived by the taxpayer from transactions and activity in the regular course of its trade or business. All interest income, service charges, carrying charges, or time-price differential charges incidental to such gross receipts shall be included regardless of (1) the place where the accounting records are maintained or (2) the location of the contract or other evidence of indebtedness.

◆◆◆ **Reg. IV.16.(a). Sales Factor: Sales of Tangible Personal Property in this State.** (1) Gross receipts from sales of tangible personal property (except sales to the United States Government; see Regulation IV.16.(b)) are in this state:

(A) if the property is delivered or shipped to a purchaser within this state regardless of the f.o.b. point or other conditions of sale; or

(B) if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and the taxpayer is not taxable in the state of the purchaser.

(2) Property shall be deemed to be delivered or shipped to a purchaser within this state if the recipient is located in this state, even though the property is ordered from outside this state.

Example: The taxpayer, with inventory in State A, sold $100,000 of its products to a purchaser having branch stores in several states including this state. The order for the purchase was placed by the purchaser's central purchasing department located in State B. $25,000 of the purchase order was shipped directly to purchaser's branch store in this state. The branch store in this state is the "purchaser within this state" with respect to $25,000 of the taxpayer's sales.

(3) Property is delivered or shipped to a purchaser within this state if the shipment terminates in this state, even though the property is subsequently transferred by the purchaser to another state.

Example: The taxpayer makes a sale to a purchaser who maintains a central warehouse in this state at which all merchandise purchases are received. The purchaser reships the goods to its branch stores in other states for sale. All of taxpayer's products shipped to the purchaser's warehouse in this state is property "delivered or shipped to a purchaser within this state."

(4) The term "purchaser within this state" shall include the ultimate recipient of the property if the taxpayer in this state, at the designation of the purchaser, delivers to or has the property shipped to the ultimate recipient within this state.

Example: A taxpayer in this state sold merchandise to a purchaser in State A. Taxpayer directed the manufacturer or supplier of the merchandise in State B to ship the merchandise to the purchaser's customer in this state pursuant to purchaser's instructions. The sale by the taxpayer is "in this state."

(5) When property being shipped by a seller from the state of origin to a consignee in another state is diverted while enroute to a purchaser in this state, the sales are in this state.

Example: The taxpayer, a produce grower in State A, begins shipment of perishable produce to the purchaser's place of business in State B. While enroute, the produce is diverted to the purchaser's place of business in this state in which state the taxpayer is subject to tax. The sale by the taxpayer is attributed to this state.

(6) If the taxpayer is not taxable in the state of the purchaser, the sale is attributed to this state if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state.

Example: 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 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.

(7) If a taxpayer whose salesman operates from an office located in this state makes a sale to a purchaser in another state in which the taxpayer is not taxable and the property is shipped directly by a third party to the purchaser, the following rules apply:

(A) If the taxpayer is taxable in the state from which the third party ships the property, then the sale is in such state.

(B) If the taxpayer is not taxable in the state from which the property is shipped, then the sale is in this state.

Example: 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.

◆◆◆ **Reg. IV.16.(b). Sales Factor: Sales of Tangible Personal Property to United States Government in this State.** (1) Gross receipts from sales of tangible personal property to the United States Government are in this state if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state. For the purposes of this regulation, only sales for which the United States Government makes direct payment to the seller pursuant to the terms of a contract constitute sales to the United States Government. Thus, as a general rule, sales by a subcontractor to the prime contractor, the party to the contract with the United States Government, do not constitute sales to the United States Government.

Example (i): A taxpayer contracts with General Services Administration to deliver X number of trucks which were paid for by the United States Government. The sale is a sale to the United States Government.

Example (ii): The taxpayer as a subcontractor to a prime contractor with the National Aeronautics and Space Administration contracts to build a component of a rocket for $1,000,000. The sale by the subcontractor to the prime contractor is not a sale to the United States Government.

◆◆◆ **Reg. IV.17. Sales Factor: Sales Other than Sales of Tangible Personal Property in this State.**

[.10] **(1) In General.** Article IV.17. provides for the inclusion in the numerator of the sales factor of gross receipts from transactions other than sales of tangible personal property (including transactions with the United States Government); under this section gross receipts are attributed to this state if the income producing activity which gave rise to the receipts is performed wholly within this state. Also, gross receipts are attributed to this state if, with respect to a particular item of income, the income producing activity is performed within and without this state but the greater proportion of the income producing activity is performed in this state, based on costs of performance.

[.15] **(2) Income Producing Activity: Defined.** The term "income producing activity" applies to each separate item of income and means the transactions and activity directly engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit. Such activity does not include transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor. Accordingly, income producing activity includes but is not limited to the following:

(A) The rendering of personal services by employees or the utilization of tangible and intangible property by the taxpayer in performing a service.

(B) The sale, rental, leasing, licensing or other use of real property.

(C) The rental, leasing, licensing or other use of tangible personal property.

(D) The sale, licensing or other use of intangible personal property.

The mere holding of intangible personal property is not, of itself, an income producing activity.

[.30] **(3) Costs of Performance: Defined.** The term "costs of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer.

[.40] (4) Application.

[.402] (A) In General. Receipts (other than from sales of tangible personal property) in respect to a particular income producing activity are in this state if:

(a) the income producing activity is performed wholly within this state; or

(b) the income producing activity is performed both in and outside this state and a greater proportion of the income producing activity is performed in this state than in any other state, based on costs of performance.

[.404] (B) Special Rules. The following are special rules for determining when receipts from the income producing activities described below are in this state:

(a) Gross receipts from the sale, lease, rental or licensing of real property are in this state if the real property is located in this state.

(b) Gross receipts from the rental, lease, or licensing of tangible personal property are in this state if the property is located in this state. The rental, lease, licensing or other use of tangible personal property in this state is a separate income producing activity from the rental, lease, licensing or other use of the same property while located in another state; consequently, if property is within and without this state during the rental, lease or licensing period, gross receipts attributable to this state shall be measured by the ratio which the time the property was physically present or was used in this state bears to the total time or use of the property everywhere during such period.

Example: Taxpayer is the owner of 10 railroad cars. During the year, the total of the days each railroad car was present in this state was 50 days. The receipts attributable to the use of each of the railroad cars in this state are a separate item of income and shall be determined as follows:

$$\frac{(10 \times 50 =)\ 500}{3650} \times \text{Total Receipts} = \text{Receipts Attributable to this State}$$

(c) Gross receipts for the performance of personal services are attributable to this state to the extent such services are performed in this state. If services relating to a single item of income are performed partly within and partly without this state, the gross receipts for the performance of such services shall be attributable to this state only if a greater proportion of the services was performed in the state, based on costs of performance. Usually, where services are performed partly within and partly without this state, the services performed in each state will constitute a separate income producing activity; in such case the gross receipts for the performance of services attributable to this state shall be measured by the ratio which the time spent in performing such services in this state bears to the total time spent in performing such services everywhere. Time spent in performing services includes the amount of time expended in the performance of a contract or other obligation which gives rise to such gross receipts. Personal service not directly connected with the performance of the contract or other obligation, as for example time expended in negotiating the contract, is excluded from the computations.

Example (i): Taxpayer, a road show, gave theatrical performances at various locations in State X and in this state during the tax period. All gross receipts from performances given in this state are attributed to this state.

Example (ii): The taxpayer, a public opinion survey corporation, conducted a poll by its employees in State X and in this state for the sum of $9,000. The project required 600 man hours to obtain the basic data and prepare the survey report. Two hundred of the 600 man hours were expended in this state. The receipts attributable to this state are $3,000.

$$\frac{200}{600} \times \$9{,}000 = \$3{,}000$$

◆◆◆ **Reg. IV.18.(a). Special Rules: In General.** Article IV.18. provides that, if the allocation and apportionment provisions of Article IV 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:

(1) separate accounting;

(2) the exclusion of any one or more of the factors;

(3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

(4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Article IV.18. permits a departure from the allocation and apportionment provisions of Article IV only in limited and specific cases. Article IV.18. may be invoked only in specific cases where unusual fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results under the apportionment and allocation provisions contained in Article IV.

In the case of certain industries such as air transportation, rail transportation, ship transportation, trucking, television, radio, motion pictures, various types of professional athletics, and so forth, the foregoing regulations in respect to the apportionment formula do not set forth appropriate procedures for determining the apportionment factors. Nothing in Article IV.18. or in this Regulation IV.18. shall preclude [the tax administrator] from establishing appropriate procedures under Article IV.10. to 17. for determining the apportionment factors for each such industry, but such procedures shall be applied uniformly.

◆◆◆ **Reg. IV.18.(b). Special Rules: Property Factor.** The following special rules are established in respect to the property factor of the apportionment formula:

(1) If the subrents taken into account in determining the net annual rental rate under Regulation IV.11.(b) produce a negative or clearly inaccurate value for any item of property, another method which will properly reflect the value of rented property may be required by the [tax administrator] or requested by the taxpayer.

In no case however shall such value be less than an amount which bears the same ratio to the annual rental rate paid by the taxpayer for such property as the fair market value of that portion of the property used by the taxpayer bears to the total fair market value of the rented property.

Example: The taxpayer rents a 10-story building at an annual rental rate of $1,000,000. Taxpayer occupies two stories and sublets eight stories for $1,000,000 a year. The net annual rental rate of the taxpayer must not be less than two-tenths of the taxpayer's annual rental rate for the entire year, or $200,000.

(2) If property owned by others is used by the taxpayer at no charge or rented by the taxpayer for a nominal rate, the net annual rental rate for such property shall be determined on the basis of a reasonable market rental rate for such property.

◆◆◆ **Reg. IV.18.(c). Special Rules: Sales Factor.** The following special rules are established in respect to the sales factor of the apportionment formula:

(1) Where substantial amounts of gross receipts arise from an incidental or occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business, such gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory or plant will be excluded.

(2) Insubstantial amounts of gross receipts arising from incidental or occasional transactions or activities may be excluded from the sales factor unless such exclusion would materially affect the amount of income apportioned to this state. For example, the taxpayer ordinarily may include or exclude from the sales factor gross receipts from such transactions as the sale of office furniture, business automobiles, etc.

(3) Where the income producing activity in respect to business income from intangible personal property can be readily identified, such income is included in the denominator of the sales factor and, if the income producing activity occurs in this state, in the numerator of the sales factor as well. For example, usually the income producing activity can be readily identified in respect to interest income received on deferred payments on sales of tangible property (Regulation IV.15.(a)(1)(A)) and income from the sale, licensing or other use of intangible personal property (Regulation IV.17.(2)(D)).

Where business income from intangible property cannot readily be attributed to any particular income producing activity of the taxpayer, such income cannot be assigned to the numerator of the sales factor for any state and shall be excluded from the denominator of the sales factor. For example, where business income in the form of dividends received on stock, royalties received on patents or copyrights, or interest received on bonds, debentures or government securities results from the mere holding of the intangible personal property by the taxpayer, such dividends and interest shall be excluded from the denominator of the sales factor.

HERTZ RULING

SUPERIOR COURT OF WASHINGTON FOR THURSTON COUNTY

GEORGE KINNEAR, Director, Department of Revenue, State of Washington, and MULTISTATE TAX COMMISSION, Plaintiffs,	)	NO. 46573
vs.	)	SUMMARY JUDGMENT FOR PLAINTIFFS
THE HERTZ CORPORATION, Defendant.	)	

The plaintiffs having filed a motion for summary judgment in this cause and the motion having come on for hearing on January 17, 1975, and the Court having rendered its oral decision on that date granting the plaintiffs' motion for summary judgment after considering extensive briefs and arguments of counsel for all the parties, and the Court having found there is no material question of fact in dispute and that plaintiffs are entitled to a summary judgment as a matter of law,

IT IS HEREBY ADJUDGED AND DECREED that the plaintiffs' motion for summary judgment be granted and that the relief prayed for by plaintiffs in this cause be granted.

IT IS FURTHER ORDERED, ADJUDGED AND DECREED:

1. That Article VIII of the Multistate Tax Compact (adopted by Washington in RCW 82.56.010 and RCW 82.56.050) may be implemented by the Multistate Tax Commission and the member states of the Multistate Tax Compact that have adopted Article VIII without the consent of Congress to the Multistate Tax Compact.

2. That the Multistate Tax Commission has the power and authority pursuant to Article VIII of the Multistate Tax Compact to conduct joint sales and use tax audits of The Hertz Corporation for taxes imposed by member states of the Multistate Tax Commission and in conducting any such audits may examine any tax returns, books, records, accounts, memoranda and other data and personnel for and on behalf of its member states as provided for in Article VIII of the Multistate Tax Compact without consent of the United States Congress to the provisions of the Multistate Tax Compact.

3. That the member states of the Multistate Tax Commission that have adopted Article VIII of the Multistate Tax Compact are empowered to designate the Multistate Tax Commission to conduct a joint sales and use tax audit of The Hertz Corporation on their behalf without Article VIII and other provisions of the Compact applicable to the Multistate Tax Commission joint audit powers being consented to by the Congress of the United States.

4. That Congressional consent to the joint audit provisions of the Multistate Tax Compact (Article VIII) is not necessary since under the tests set forth in *Virginia v. Tennessee*, 148 U.S. 503 (1893), which the Court finds applicable, a joint audit by the Multistate Tax Commission does not tend to increase the political power in the states nor encroach upon or interfere with the just supremacy of the United States inasmuch as the Court determines and finds that the power of individual states to conduct an audit of any tax returns, books, records, accounts, memoranda, other data and personnel of the defendant is of state concern and is not increased by the states designating the Multistate Tax Commission to conduct such audits on their behalf.

5. That The Hertz Corporation shall make available to authorized personnel of the Multistate Tax Commission its tax returns, books, records, accounts, memoranda, other data and its personnel for the purpose of the Multistate Tax Commission conducting joint sales and use tax audits of The Hertz Corporation on behalf of the Multistate Tax Commission member states which have authorized the Multistate Tax Commission to conduct such audits for them for any taxes for which The Hertz Corporation may be liable to any of such member states.

6. That the conduct of a joint audit of the defendant's returns, books, records, memoranda and personnel by the Multistate Tax Commission on behalf of the states that have adopted Article VIII of the Multistate Tax Compact does not deny The Hertz Corporation any constitutional rights including due process or equal protection of the law under the Fourteenth Amendment to the United States Constitution and its right to be free from unreasonable searches and seizures under the Fourth Amendment of the United States Constitution.

7. That the conduct of a joint audit of the books and records, memoranda, other data and personnel of The Hertz Corporation by the Multistate Tax Commission does not constitute an unconstitutional interference of Congress' power to regulate interstate commerce under Article I, § 8 of the United States Constitution.

DONE IN OPEN COURT this 6th day of February, 1975.

HEWITT A. HENRY /S/
Judge

SLADE GORTON, ATTORNEY GENERAL

WILLIAM D. DEXTER
Assistant Attorney General

PURPOSE OF THE MULTISTATE TAX COMMISSION:

To bring even further uniformity and compatibility to the tax laws of the various states of this nation and their political subdivisions insofar as those laws affect multistate business, to give both business and the states a single place to which to take their tax problems, to study and make recommendations on a continuing basis with respect to all taxes affecting multistate businesses, to promote the adoption of statutes and rules establishing uniformity, and to assist in protecting the fiscal and political integrity of the states from federal confiscation.