IN THE SUPREME COURT OF TENNESSEE
AT NASHVILLE

VODAFONE AMERICAS HOLDINGS, INC. & SUBSIDIARIES, Plaintiffs-Appellants	)	
v.	)	No. M2013-00947-SC-R1 1-CV
RICHARD H. ROBERTS, Commissioner of Revenue State of Tennessee, Defendant-Appellee	)	

On Appeal by Permission from the Judgment of the Court of Appeals

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BRIEF OF *AMICUS CURIAE* MULTISTATE TAX COMMISSION IN SUPPORT OF DEFENDANT-APPELLEE

Joe Huddleston (#010244)
Executive Director
Helen Hecht
General Counsel
Bruce Fort
Counsel
Multistate Tax Commission
444 N. Capitol St., NW
Washington, D.C. 20001
(202) 650-0300

Counsel for Amicus Curiae
Multistate Tax Commission

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INTEREST OF THE *AMICUS CURIAE*

The Multistate Tax Commission (the Commission) was created in 1967 by the Multistate Tax Compact (the Compact). *See RIA All States Tax Guide,* ¶ 701 *et seq*. (RIA 2005).[1] The goal of the Commission is to preserve state tax sovereignty and to promote uniformity, fairness, and efficiency in state taxation of multistate businesses. The purposes of the Compact are: (1) facilitation of proper determination of state and local tax liability of multistate taxpayers, including equitable apportionment of tax bases and settlement of apportionment disputes; (2) promotion of uniformity or compatibility in significant components of tax systems; (3) facilitation of taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration; and (4) avoiding duplicative taxation. *See Multistate Tax Compact*, Art. I.[2]

Article IV of the Compact incorporates the Uniform Division of Income for Tax Purposes Act (UDITPA), the model act from which the Tennessee statutes at issue in this case are drawn. Since the Compact became effective, the Commission has engaged in efforts to research, analyze and develop uniform rules for the implementation of UDITPA.

Today, forty-seven states and the District of Columbia participate in various activities of the Commission including uniformity efforts, joint audits, multistate voluntary disclosure, training, and research. Sixteen states have legislatively established full membership. Seven additional states are sovereignty members and twenty-five are associate members.[3]

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[1] The validity of the Compact was upheld in *United States Steel Corp. v. Multistate Tax Commission,* 434 U.S. 452 (1978).

[2] *Available at* http://www.mtc.gov/The-Commission/Multistate-Tax-Compact.

[3] This brief is filed by the Multistate Tax Commission on its own behalf, and not on behalf of any particular member state. Compact Members are: Alabama, Alaska, Arkansas, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Missouri, Montana, New Mexico, North Dakota, Oregon, Texas, Utah and Washington. Sovereignty Members: Georgia, Kentucky, Louisiana, Michigan, Minnesota, New

The Commission submits this brief as *amicus curiae* in support of the Tennessee Commissioner of Revenue (the commissioner) because the ability of the taxpayer to petition for or the commissioner to require a variance from the standard formula so that it fairly represents the activities of a taxpayer in the state—an authority embodied in Section 18 of UDITPA and codified in Tennessee at T.C.A. § 67-4-2112(a) and T.C.A. § 67-4-2014(a)—is essential to the proper operation of the Act. Without this ability, taxpayers who have unconventional business structures or are engaged in new or emerging industries might be allowed to escape fair taxation, while other taxpayers might be forced to pay too much due to unfair structures.

Under the provision of UDITPA granting authority to apply alternative apportionment methods, the same provision at issue in this case, the Commission has adopted model rules for recommendation to the states, including general rules for the use of such authority on an *ad hoc* basis as well as rules setting out special industry apportionment methods.[4] As discussed in this brief, the Commission has supported the efforts of states to use this authority so that the apportionment formula applied in specific situations fairly reflects the taxpayer's sales activity in the state and to promote uniformity in the sourcing of sales for purposes of the apportionment formula.

Jersey, and West Virginia. Associate Members: Arizona, California, Connecticut, Florida, Illinois, Iowa, Indiana, Maine, Maryland, Massachusetts, Mississippi, Nebraska, New Hampshire, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Vermont, Wisconsin, and Wyoming.

[4] *See* the Commission's model General Allocation and Apportionment Regulations, as well as MTC Model Reg. IV.18.(e). Special Rules: Airlines. [Adopted July 14, 1983]; MTC Model Reg.IV.18.(d). Special Regulation: Construction Contractors. [Adopted July 10, 1980]; MTC Model Reg.IV.18.(j). Special Rules: Publishing. [Adopted July 30, 1993]; MTC Model Reg. IV.18.(f). Special Rules: Railroads. [Adopted July 16, 1981]; MTC Model Reg.IV.18(h). Special Rules: Television and Radio Broadcasting. [Adopted August 31, 1990; amended April 25, 1996]; and MTC Model Reg. IV.18.(i). Special Rules: Telecommunications and ancillary service providers. [Adopted July 31, 2008], *available at* http://www.mtc.gov/Uniformity/Adopted-Uniformity-Recommendations.

SUMMARY OF ARGUMENT

The issue in the instant case is whether the commissioner properly exercised his authority to vary the standard apportionment formula in order to fairly reflect Vodafone's activities (and, therefore, its net earnings and net worth) for purposes of Tennessee franchise and excise taxes.

The lower courts in this case held that if the proper application of the standard formula would exclude from the Tennessee sales factor all of the taxpayer's service receipts from Tennessee customers, as Vodafone contends it would, then that formula does not "fairly represent" the business activities of the taxpayer in Tennessee. The courts further held that the alternative formula applied under the commissioner's variance was reasonable. These findings are entirely consistent with the purpose behind UDITPA's formula and the purpose for including the variance authority as part of UDITPA's provisions.

It is not possible to avoid these conclusions by relying on an interpretation of a regulation that would effectively nullify the authority granted to the commissioner by the General Assembly.[5] Nor is it possible to maintain that the adoption of a standard formula somehow conveys an immutable "policy choice," since this would also effectively nullify the rights granted to taxpayers and the authority granted to the commissioner. This does not leave that authority untethered from any guiding principles. Rather, as the commissioner here has amply demonstrated, the exercise of the authority in this case is easily supportable by the general principles underlying UDITPA.

ARGUMENT

The standard formula used by Tennessee is based on the Uniform Division of Income for Tax Purposes Act (UDITPA),[6] drafted by the National Conference of Commissioners on

[5] Tenn. Comp. R. & Regs. 1320-06-1-.35.
[6] *Available at* http://www.uniformlaws.org/shared/docs/uditpa/uditpa66.pdf.

Uniform State Laws in 1957. UDITPA was adopted by Tennessee in 1976.[7] Virtually every state which imposes taxes measured by income uses some variation of UDITPA. The purpose of UDITPA is to set out a formula for apportioning the earnings of multi-state businesses among the states. Historically, states that imposed tax on business income came to realize that dividing up the income of an integrated multistate business using geographic accounting was unworkable.[8] The basis of formulary apportionment as embodied by UDITPA is that earnings arise from the activities undertaken by a taxpayer in every state in which it operates, and those activities can be measured by readily identified and verifiable "factors," so that it is possible to use these factors to reasonably apportion the income of an integrated business among the states. UDITPA uses the combined average of three factors for this purpose: in-state property, in-state payroll, and in-state gross receipts (or "sales"). The first two factors represent the contribution made to income generation by factors of "production." The "sales" factor, by contrast, represents the contribution to income generation made by the market. Tennessee has chosen to "double-weight" the sales factor.

The drafters of UDITPA recognized that no one formula would fairly measure the income-generating attributes of every business, in every circumstance, and also recognized the inherent problems of applying the standard formula to every industry. So in addition to the standard formula, the drafters of UDITPA included Section 18, which grants to the taxpayer the right to petition for a variance or to the revenue commissioner broad authority to vary the standard apportionment formula when necessary to fairly reflect the taxpayer's business

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[7] *Sherwin-Williams Co. v. Johnson*, 989 S.W.2d 710, 711 (Tenn. Ct. App. 1998).
[8] See, e.g., *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 120-121 (1920).

activities in the state.[9] Section 18 was codified into Tennessee's statutes (with certain differences, discussed infra at p. 19) as T.C.A. § 67-4-2014 and T.C.A. § 67-4-2112(a).[10]

A. The use of the term "unusual" in Rule 1320-6-1-.35 cannot properly be interpreted so as to effectively nullify the authority granted to the commissioner.

The taxpayer's case relies heavily on a claim that Tenn. Comp. R. & Regs. 1320-06-1-.35 significantly limits the authority of the commissioner to vary the standard apportionment formula. That regulation[11] provides, in pertinent part, that equitable apportionment should be invoked: "only in specific cases where unusual fact situations (which ordinarily will be unique and non-recurring) produce incongruous results under the [standard apportionment formula]."

The taxpayer's argument appears to be that there is no "unusual" fact situation here because it conducts its multistate activities in a manner similar to other businesses providing telecommunications services in the state. (Appellants' Brief, p. 24) Assuming this is true as a factual matter, the taxpayer's reading of the regulation—that a circumstance is not "unusual" as long as it is not *uncommon* among members of the same industry or some other subgroup—

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[9] *Id.* at 12-13.

[10] Because Tennessee's relevant franchise tax ("net worth") statutes appear to be substantially identical to its excise tax statutes this brief will only reference the latter. T.C.A. § 67-4-2014(a) provides:
(a) If the tax computation, allocation or apportionment provisions of this part or chapter 2 of this title do not fairly represent the extent of the taxpayer's business activity in this state, or the taxpayer's net earnings, the taxpayer may petition for, or the department through its delegates 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 (1) or more of the formula factors;
(3) The inclusion of one (1) or more additional apportionment formula factors that will fairly represent the taxpayer's business activity in this state;
(4) The use of any other method to source receipts for purposes of the receipts factor or factors of the apportionment formula numerator or numerators; or
(5) The employment of any other method to effectuate an equitable computation, allocation and apportionment of the taxpayer's net earnings or losses that fairly represents the extent of the business entity's activities in Tennessee.

[11] The regulation follows a model regulation adopted by the Multistate Tax Commission in 1973. The cited language was substantially amended by the Commission in 2010. *Available at*: http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/AllocaitonandApportionmentReg.pdf.

would preclude the use of an alternative formula in the vast majority of cases. It would preclude the use of the authority even if the circumstance in question is unique to the particular industry and not otherwise shared by the vast majority of taxpayers generally. It would preclude the use of an alternative formula even if the circumstance in question emerged after the standard formula was adopted and was not identified by the commissioner until the circumstance had become more widespread. Furthermore, this interpretation would preclude the use of an alternative formula in any case where the fact situation at issue is not uncommon even if the situation clearly produces incongruous results under the standard formula. Obviously, if the regulation were applied in this way, it would defeat the very purpose of T.C.A. § 67-4-2014.

Regulations should be applied in harmony with statutes and not in contradiction to them.[12] Here, the General Assembly granted broad authority to the commissioner to act—without limitation—if the standard apportionment provisions do not fairly represent the extent of the taxpayer's business activity in this state. It would be a significant limitation, as well as one not found in the statute, to proscribe the use of authority simply because a particular taxpayer's circumstances are not uncommon within some subset of taxpayers. Moreover, this would place the commissioner in the position of being the arbiter of what is or is not common for every industry group or sub-class of taxpayers, rather than simply determining when the standard formula does not fairly reflect the taxpayer's activities in the state. This cannot be the proper reading of the term "unusual" in this context.

The taxpayer is not the first to argue that the language of the model regulation substantially limits the statutory grant of authority. The authority to vary the standard formula

[12] A regulation cannot impose substantive requirement beyond those found in statute. *See, e.g.*, *Wright v. Tenn. Peace Officer Standards & Training Comm.*, 277 S.W.3d 1 (Tenn. Ct. App. 2008)(where General Assembly authorized limited exceptions to use of expunged convictions, administrative agency could not create additional exceptions); *Tidwell v. RCA Corp.*, 528 S.W.2d 179, 181 (Tenn. 1975).

has been upheld in numerous circumstances in which the fact situations at issue were not unusual in the sense of being "uncommon" within a particular subset of taxpayers, including selling investments held in working capital accounts,[13] selling advertising for phone books,[14] "factoring" accounts receivable,[15] or transferring ownership of intangible assets into a holding company.[16]

The same regulation relied on by the taxpayer in this case was also at issue in the *Matter of the Protest of Wal-Mart Stores, Inc*., where the taxpayer argued that its "income-producing activity" from licensing intangible property to its parent corporation in exchange for royalty payments occurred in Delaware, where it maintained its only employee and limited physical property. Arguing that thousands of corporate taxpayers had set up similar holding company arrangements, the taxpayer argued that its arrangement could not be considered "unusual." The hearing officer disagreed, writing:

> [T]he real issue in this case is not whether the fact pattern presented by WMR was unusual from a numeric standpoint, but whether it was unusual within the context of UDITPA. A review of the regulations under § 7-4-19 makes it clear that application of an alternative apportionment formula depends on the nature of a taxpayer's business, not on the number of taxpayers engaged in that business. No one would dispute that there are many banks, railroads, airlines, and trucking companies operating within the United States. Nonetheless, corporations engaged in these businesses are subject to the equitable adjustment provisions of §7-4-19.
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> Decision & Order No. 2006-007, p. 26.

Microsoft Corporation v. Franchise Tax Board, 139 P.3d 1169, 1182 (Ca. 2006), concerned the question of whether gross proceeds from overnight investments of working capital should be included in the sales factor, and attributed to the location where those investment

[13] *Sherwin-Williams v. Tennessee*, 989 S.W.2d 710 (Tenn. Ct. App. 1998); *Microsoft v. Franchise Tax Board*, 139 P.3d 1169 (Cal. 2006).
[14] *BellSouth Advertising v. Chumley*, 308 S.W.3d. 350 (Tenn. Ct. App. 2009).
[15] *Union Pacific v. Idaho*, 28 P.3d 375 (Id. 2004).
[16] In re *Wal-Mart Stores, Inc., New Mexico*. Admin. Decision No. 2006-07, *available at* http:www.tax.state.nm.us/d&o/dno2006_07.pdf, *Comptroller Of The Treasury v. Syl, Inc*., 825 A.2d 399 (Md. 2003).

activities were performed. This had the effect of diluting the sales factor in states in which the taxpayer sold goods and services, thus under-representing the contribution of the market states in generating income. There, as here, the taxpayer argued that the model regulation precluded the revenue agency from correcting the distortion under Section 18 because such churning of overnight deposits was not an unusual factual situation. The California Supreme Court rejected the argument, saying:

> Again, we disagree. Systematic oversights and undersights are equally a matter of statutory concern. Nothing in the language of Regulation section 25137 persuades us otherwise. While Revenue and Taxation Code section 25137 "ordinarily" applies to nonrecurring situations, it does not apply only to such situations; the statutory touchstone remains an inquiry into whether the formula "fairly represent[s]" a unitary business's activities in a given state, and when it does not, the relief provision may apply.

139 P.3d at 1181.

Accord, *Sherwin-Williams Corp. v. Tennessee*, 989 S.W.2d 710, 716 (Tenn. Ct. App. 1998)(upholding use of variance to prevent understatement of Tennessee receipts factor from inclusion of treasury sales). In that case, the court wrote:

> However what can a state do when faced with a statutory scheme which does not fairly represent the taxpayer's income attributable to that state? The three factor apportionment formula applied is clearly set out in Tennessee's version of the Uniform Distribution of Income for Tax Purposes Act (UDITPA). The goal of the UDITPA is not pinpoint mathematical accuracy but fair apportionment. *See* Tenn. Code Ann. § 67–4–804(b) (1998) [Tenn. Code Ann. § 67–4–804 was re-codified at Tenn. Code Ann. § 67-4-2004 in 1999]. The discretion accorded the Commissioner as well as the bilateral ability to request a variance evidence this goal.

In *Union Pacific Corporation v. Idaho State Tax Commission*, 83 P.3d 116 (Id. 2004), the taxpayer sold, or "factored," its accounts receivable to a third party, a practice engaged in to improve cash flows. The definition of "sales" in UDITPA is broad, encompassing "all gross receipts of the taxpayer not allocated under sections 4 through 8 of this Act." UDITPA, § 1. The taxpayer saw an opportunity to dilute its Idaho sales factor by including its receipts from factoring receivables together with its receipts from selling transportation services in the sales factor denominator. The taxpayer relied on the same model regulation at issue here to argue that Idaho was precluded from using Section 18's alternative apportionment provisions[17] because factoring accounts receivable was not an "unusual" activity. 83 P.3d at 120. Unimpressed, the Idaho Supreme Court held that the effect of two different accounting systems (cash and accrual) resulting in the double-counting of receipts from sales was "unusual" even if the underlying situation was not. The Court also pointed out that eliminating the double-counting was necessary to more accurately reflect the marketplace for the taxpayer's activities, the purpose of Section 18. *Id*. at 121.

The taxpayer's reading of Rule 1320-06-1-.35 was also recently rejected by the Tennessee Court of Appeals, in *BellSouth Advertising & Publishing Corp. v. Chumley*, 308 S.W.3d. 350 (Tenn. Ct. App. 2009). The taxpayer in that case solicited "Yellow Pages" advertising from in-state customers through independent contractors, published the telephone books outside of the state, and used other independent contractors to actually distribute the books within the state. Soliciting advertising for publication outside and later distribution inside the state is not an uncommon situation, nor is it likely to be unique and non-recurring. The Court of Appeals found that the "unusual factual circumstances" justifying a departure from the standard apportionment formula under Rule 1320-06-1-.35 can refer to situations where, as here, the location of "income-producing activity, as measured by costs of performance" fails to reflect the marketplace for the taxpayer's services. 308 S.W.3d at 360. The taxpayer's attempts to distinguish the *BellSouth* decision in this case are entirely unconvincing.

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[17] Idaho Tax Commission Rule 27,4.18.a. (1991).

It is worth noting that, not only did the drafters of UDITPA anticipate that there would need to be broad authority to vary the standard formula in order to fairly reflect a taxpayer's activities in the state in certain circumstances, they also recognized that the activities of some types of industries—in particular, utilities—were unlikely to fit the standard formula at all, and therefore explicitly excluded communications utilities from the scope of the model statute.[18] UDITPA's drafters could not easily have anticipated the nationwide trend of utility deregulation which began in the 1980's, but the model statute they promulgated gave revenue agencies the necessary authority to adopt special apportionment formulas where required.

John S. Warren, California's representative to the National Conference of Commissioners on Uniform State Laws, which approved UDITPA, recognized that UDITPA's equitable apportionment provisions would be necessary to fairly apportion income in a number of common industries in an article written in 1967:

> [U]nusual situations, which should be excepted from the application of general rules, frequently arise. Such situations may be impossible to anticipate or difficult to describe with sufficient precision to permit drafting of a provision in the statute setting forth precisely the rules to be applied. Accordingly, it is common in allocation statutes to include a general relief provision authorizing the administrator to depart from the general rule if necessary to obtain fair or equitable results.

Frank M. Keesling & John S. Warren, *California's Uniform Division of Income for Tax Purposes Act (Part I)*, 15 U.C.L.A. L. Rev. 156, 170 (1967).

In short, the term "unusual" in Rule 1320-06-1-.35 and the model regulation on which it is based refers not to uncommon situations, but to situations—including, potentially, entire industries—where application of the standard apportionment formula fails to fairly reflect activities that give rise to the taxpayer's income. No court has applied the model regulation in

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[18] See *Official Comment* to UDITPA Section 1, 7A U.L.A. 147-148; *Also available at* http://www.uniformlaws.org/shared/docs/uditpa/uditpa66.pdf, p. 5

the manner urged here to so limit the authority to apply an alternative apportionment method, for it would undercut the very purpose of the statute.

B. The taxpayer's assertion that the authority to vary the standard apportionment formula cannot be used to contravene a purported legislative "policy choice" would also effectively negate the authority.

The taxpayer argues that in adopting a standard formula that uses cost-of-performance rules to source receipts from the sale of services, the General Assembly made a policy choice that the commissioner cannot alter. (Brief of Appellants, pp. 35-36.) The taxpayer, however, cites no evidence of in support of this theory, other than the adoption of the standard formula itself. Using that same logic, it is possible to argue that, by adopting UDITPA's standard formula, the General Assembly made a number of unalterable policy choices: (1) to use formulary apportionment rather than separate accounting to determine business earnings in the state; (2) not to include factors other than property, payroll or sales; (3) not to exclude any of these three factors; and (4) to use particular sourcing rules for attributing receipts to the state. But to argue that such "policy choices" somehow control simply cannot be squared with the explicit grant to the commissioner of specific authority to: (1) *use separate accounting* rather than formulary apportionment; (2) *include factors* other than property, payroll and sales, (3) *exclude any of these three factors*; and (4) *use a different sourcing rule for attributing receipts to the state*. T.C.A. § 67-4-2014(a)(emphasis added).

No doubt recognizing the conflict inherent in this argument, the taxpayer attempts to elevate this particular "policy choice," which it contends is embodied in the standard sourcing rule on which it relies. But the taxpayer provides no evidence to support its suggestion that the General Assembly intended for the standard formula ever to exclude significant amounts of receipts from sales to Tennessee customers from the Tennessee apportionment factor, regardless of the circumstances. Such an argument fails in light of the specific authority granted to the commissioner to alter this very rule if necessary to fairly reflect a taxpayer's activities in the state.

Nor is it possible to maintain that the cost-of-performance rule reflects a clear intent for sales of services to be sourced, in every case, to the state of "origin." (Brief of Appellants, pp. 19-23.) Application of the cost-of-performance rule to source receipts under the standard formula may not, in all cases, result in the sourcing of sales to a state where the customer is located. But there is also no dispute that, in many cases, this will indeed be the result—even in the case of multistate service businesses. No policy choice favoring a so-called "origin" based sourcing can therefore be deduced from the legislature's adoption of cost-of-performance as the standard sourcing rule. (Had the General Assembly wished to clearly express a preference for sourcing service receipts to the state of origin, it could have done so.)

The taxpayer does not cite a single case, academic treatise, law review or any other authority in support of the proposition that the drafters of UDITPA or the legislatures who subsequently adopted the Act were concerned with sourcing service receipts to the origin state or the place of production. To the contrary, the history of the states' adoption of UDITPA in the 1960's and 1970's and the context of the inclusion of Section 17 within the Act presents a very different picture of its function.

The history of UDITPA and the unique importance of the sales factor as a reflection of the marketplace is well-summarized in an article written by the taxpayer's expert witness, Professor John Swain, in *Reforming the State Corporate Income Tax: A Market State Approach to The Sourcing Of Service Receipts,* 83 Tulane L. Rev. 283 (2008). In the late 1950's and early 1960's, Congress concerned itself with state taxation of interstate businesses[19] and was

[19] *See, e.g.*, P.L. 86-272 (1959), *codified at*: 15 U.S.C. §§ 381-384, granting broad immunity for interstate businesses whose only contact with a state was solicitation of sales for tangible personal property.

considering preemptive legislation that would have used a two-factor (property and payroll) formula. This formula would have deprived "market" states of a significant portion of their tax bases. As Professor Swain notes, the states adopted UDITPA, in large part, to hold off congressional proposals that would have forced states to use this two-factor formula which did not reflect the marketplace as a generator of income:

> The UDITPA version of the sales factor was unquestionably intended to acknowledge the contribution of market states to the production of income.
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> Despite the generally recognized need for uniformity, UDITPA was not an overnight sensation. Only a handful of states had adopted it when, in 1964, the Special Subcommittee on State Taxation of Interstate Commerce of the House Committee on the Judiciary (Willis Committee) "evoked a storm of virtually unanimous protest" from state taxing authorities by recommending abandonment of the sales factor in favor of a federally mandated, two-factor property-payroll formula. At that time, twenty-four states employed destination-based sales factors in their apportionment formulas, and many other states used sales factors of other varieties. The states reacted quickly to stave off federal intervention by creating the Multistate Tax Compact, which went effective in 1967.
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> 83 Tulane L. Rev. 294-5.

Neither does Professor Swain suggest that the use of the cost-of-performance rule for services (versus the delivery rule for the sales of tangibles) was a policy choice to use "origin" sourcing for services by the drafters of UDITPA. Rather, Professor Swain posits that because most interstate service providers in 1957 were exempt from UDITPA's coverage, and because services were usually delivered in-person, the place of performance would typically represent the marketplace:

> UDITPA was designed for manufacturing and mercantile businesses, excluding, by its original terms, financial organizations, public utilities, and "the rendering of purely personal services." Additionally, when UDITPA was first promulgated in 1957, it was much more reasonable to assume that customer location would correlate with the place of the performance. Thus, place of performance may have been an acceptable proxy for the market state. This is no longer the case for many services.
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> Moreover, the framers of UDITPA expected that the equitable apportionment

> provisions of section 18 would provide ample authority for the development of alternative apportionment methods for service businesses.

Id. at 299-300.

The taxpayer's argument assumes, as it must, that the proper application of the standard formula, and particularly the location of costs associated with "earnings-producing activity," as that term is used in the cost-of-performance rule, would result in the receipts from the taxpayer's services being sourced to another state. It should be noted, however, that there is a reading of the term "earnings-producing activity" that looks to each separate transaction and the specific income-producing activity that makes that transaction possible. This interpretation, which it does not appear the taxpayer is applying, would increase the likelihood that receipts from provision of services in interstate commerce will be sourced to the state where the customer is located. This is also the interpretation generally given to "income-producing activity" by the Commission when it adopted its comprehensive apportionment regulation in 1973. Tennessee adopted those regulations with minor variations in 1977, a year after the General Assembly adopted UDITPA. Tenn. Comp. R. & Regs. 1320-06-1-.34 provides in part that:

> (2) Earnings Producing Activity; Defined. The term "earnings 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.
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> (4) Usually, where [personal] 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 cases, the gross receipts from the performance of services attributable to this state shall be measured by the ratio which the time spent in performing the services in this state bears to the total time spent in performing the services everywhere.

While the regulation does not address multistate utility services, the regulation does represent a long-standing interpretation of the statute that favors apportionment of service income among states where services are performed, which would tend to source receipts to where the customer is located, and would also tend to avoid sourcing receipts from a multistate service business to a single state where the taxpayer incurs a predominant amount of the overall costs of doing business.

Over the last decade, a number of states have moved to "market-based" sourcing rules for providers of services and intangible products. In part, this is in recognition that the use of market-based sourcing is not as difficult as the drafters of UDITPA originally imagined. In fact, in July of 2014, the Commission formally adopted a model amendment to certain sections of UDITPA for the states' consideration, including replacing the current cost-of-performance rule in Section 17 with a market-based approach based on where services are "delivered" to the taxpayer's consumers.[20] The Commission is currently drafting model regulations to implement these market-based sourcing rules.

The policy expressed in T.C.A. § 67-4-2014 is that income should be fairly apportioned to the state in proportion to the amount of the taxpayer's income-producing activity in this state. The commissioner's use of customer billing addresses to source to Tennessee the receipts from sales of cell phone services in this state furthers that policy, and is completely consistent with the General Assembly's authorization to do so as embodied in T.C.A. § 67-4-2014. Achieving a fair apportionment of income is surely the most "essential" policy choice in UDITPA, and Section 18 is unambiguous in providing the commissioner with the authority to modify the standard apportionment formula when necessary to achieve that policy result.

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[20] *See* http://www.mtc.gov/Uniformity/Article-IV.

C. The commissioner's use of his authority here is constitutional, comports with the goal of fairly reflecting the taxpayer's activities in the state, and is reasonable in light of other considerations.

The General Assembly placed two limitations on the commissioner's use of the authority to vary the standard apportionment formula under T.C.A. §67-4-2014. First, it can only be used if the standard formula fails to "fairly represent the extent of the taxpayer's business activity in this state, or the taxpayer's net earnings… ." Second, the alternative method, while it may include "any other method to effectuate an equitable computation . . . that fairly represents the extent of the business entity's activities," must be "reasonable." § 67-4-2014(a)-(a)(5).

Here, after reviewing the taxpayer's application of the standard formula to the years in question, the commissioner identified several cogent reasons for concluding that this formula did not fairly represent the extent of this taxpayer's business activity in the state: (1) the taxpayer could have (and originally did) use a primary place of use method to locate sales; (2) the taxpayer's standard formula eliminated a substantial portion of sales to Tennessee customers from the sales factor; (3) the proper application of the standard formula's cost-of-performance rule was much more difficult to verify; (4) in contrast, the primary place of use methodology was readily substantiated; and (5) the method used by the taxpayer to attribute costs under the cost-of-performance method led to receipts not being sourced to any state. *Vodafone Americas Holdings Inc. v. Roberts*, No. M2013-00947-COA-R3CV, 2014 WL 2895900, at *12-14 (Tenn. Ct. App. June 23, 2014), *appeal granted* (Nov. 20, 2014).

Whether the commissioner properly exercised his authority depends on a number of considerations: (1) whether the alternative formula violates federal or state constitutional safeguards; (2) whether the alternative formula fairly reflects the taxpayer's activities; (3) whether the alternative formula unduly disrupts existing uniformity in state apportionment rules;

(4) whether the alternative formula will require the taxpayer to apportion income in such a way that it is subject to tax on greater than 100% of its total multistate income; (5) whether the alternative formula is administrable; and (6) whether a variance would be fair and just to the taxpayer and the public at large under all of the relevant circumstances. See *20th Century Fox Film Corp. v. Department of Revenue,* 700 P.2d 1035, 1043 (Or. 1985). Each of these considerations supports the commissioner's variance here.

1. Use of the alternative formula is constitutional.

Application of an alternative apportionment formula cannot violate state or federal constitutional standards. As Professor William Pierce noted in his often-cited 1957 article explaining the operation of the newly-promulgated UDITPA, Section 18 authority was intended to have two functions. First, it was to serve as a means of achieving fair apportionment where application of the standard formula would be so unreasonable or arbitrary that the tax would be considered unconstitutional. Second, it "gives both the tax collection agency and the taxpayer some latitude for showing that for the particular business activity, some more equitable method of allocation and apportionment could be achieved." William J. Pierce, *The Uniform Division of Income for State Tax Purposes,* 35 Taxes 747, 748 (Oct., 1957). The application of T.C.A. § 67-4-2014 here meets the requirements of both the state and federal constitutions.

a. The authority provided in Section 18 of UDITPA and adopted in some form in the majority of states including Tennessee does not constitute unlawful delegation of legislative authority under the Tennessee Constitution.

Tennessee is certainly not unique in having a constitutional provision[21] placing the power of taxation solely in the hands of the legislature. But despite the widespread adoption of

[21] Tenn. Const. Art. II, § 28 .

UDITPA and its variance authority in almost every state which imposes a tax measured by income, no court in the country has ever questioned the delegation of authority to grant variances to the apportionment formula to the executive branch of the state.[22] Rather, similar powers granted to state tax commissioners to set or modify income apportionment formulas have long been upheld. In *Pacific Fruit Express Co. v. McColgan*, 153 P.2d 607 (1944), the California appeals court found that a state statute that granted the state tax administrative agency the general authority to adopt apportionment methods was not an unconstitutional delegation of legislative authority. In *Columbia Gulf & Transmission Co. v. Barr*, 194 So.2d 890, 893 (Miss. 1967), the Mississippi Supreme Court held that a statute granting the commissioner plenary authority to determine "the portion of such taxable income attributable to sources within the state" by "processes or formulas of general apportionment, prescribed by the commissioner, with the approval of the governor" was a lawful delegation of fact-finding authority. A similar challenge to an income apportionment statute in New York City which gave the city's tax commissioner broad authority to adjust the standard formula was rejected by that state's appellate court, because the statute required the formula to be reasonable and that determination was reviewable by a court:

> Subdivision 8 of Section R 46–4.0 does not give the Commissioner unlimited discretion. It does provide standards. The Commissioner may adjust the allocation percentage if it "does not properly reflect the activity, business, income or capital of a taxpayer within the City" (emphasis added). The word "properly" sets a standard by which an administrative agency can operate (*Matter of Elite Dairy Products v. Ten Eyck*, 271 N.Y. 488, 3 N.E.2d 606). In that case the Court of Appeals said that the rule of reason must be used to see if one comes within the standard set by the word "properly."

[22] Hellerstein, *State Taxation*, ¶ 9.20 (3d ed.)(2014).

Barney's, Inc. v. Department of Finance of City of New York, 93 A.D.2d 642, 645-6 (N.Y. App. Div. 1 1983).

Notably, T.C.A. § 67-4-2014 actually provides more guidance to the commissioner on the use of variances than that found in UDITPA's Section 18. T.C.A. § 67-4-2014 gives specific authority to the commissioner to change the *methodology* used for calculating the receipts factor, a legislative recognition of the need for flexibility in calculating that factor for achieving an appropriate division of income. By contrast, UDITPA's Section 18 provides only that particular factors can be added or disregarded as appropriate, although it also includes the catch-all provision that "any other method" may be used to "effectuate an equitable allocation and apportionment." In addition, T.C.A. § 67-4-2014(d) provides that an alternative formula, once adopted, must continue in effect until circumstances change or the department gives reasonable and prospective notice that the variance will be withdrawn.

b. The alternative formula applied in this case meets the requirements of the Due Process Clause and Commerce Clauses of the U. S. Constitution.

The alternative formula applied by the commissioner easily meets the four-part test for the constitutionality of state taxes affecting interstate commerce established by the U.S. Supreme Court in the landmark case of *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). The state's tax imposition must: (a) be applied to an activity with a substantial nexus to the taxing state; (b) be fairly apportioned; (c) be non-discriminatory towards interstate commerce; and (d) be fairly related to services provided by the state. It does not appear that the taxpayer contests that its tax liability under the alternative formula would run afoul of any of these tests. Nevertheless, the values underlying the fair apportionment rule are worth noting.

The U.S. Supreme Court in *Container Corp.* set forth a two-part standard for determining whether a tax on interstate activity was fairly apportioned. The first test is "internal consistency," described by the court as "the formula must be such that, if applied by every jurisdiction, no more than all the unitary business' income would be taxed." *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 169 (1983). If every state applied Tennessee's formula using in-state billing addresses to calculate the sales factor for cell phone services, all of the taxpayer's receipts would be sourced to some state, but no receipts would be sourced to multiple states, precisely satisfying this first test.

The second test is "external consistency," a test requiring that "the factor or factors used must actually reflect a reasonable sense of how income is generated." *Id*. The alternative apportionment method in this case uses a proportional system for measuring receipts based on the charges billed to customers in each state. The standard formula as applied by the taxpayer, in contrast, would assign all of the receipts to the state with the greater preponderance of income-producing activity. This means that a single state would receive 100% of the receipts from the sale of cell-phone services to all customers everywhere, while the other states would receive nothing. This all-or-nothing result would obtain even if that single state had only 2.0001% of the costs of income producing activity and the other 49 states each had 1.9999%. So, it is the standard formula, not the equitable formula employed by Tennessee, which would arguably risk violation of the external consistency requirement if applied in the manner urged by the taxpayer.

2. The alternative formula fairly represents the taxpayer's business activities in Tennessee related to its net earnings.

The alternative formula which achieves a proportional result in sourcing receipts from services more accurately reflects the taxpayer's in-state activity than the all-or-nothing rule that the taxpayer claims would result from the proper application of the cost-of-performance sourcing rule. The taxpayer's case essentially rests on the assumption that the targeting and maintenance of a market for services is not an earnings-producing activity. But the history of the drafting and adoption of UDITPA by the states shows quite the opposite is true. As Professor Swain notes, the states adopted UDITPA in part because of the concern that proposed federal legislation would not have considered the contributions of "the marketplace" in the apportionment formula. Swain, *Reforming the State Corporate Income Tax*, at 295.

3. Sourcing receipts from the sale of interstate telecommunications services to the billing address of the customer does not unduly interfere with existing uniformity in state rules.

While complying with constitutional requirements and questions of fair representation are the primary concerns when applying an alternative apportionment method under Section 18 or T.C.A. § 67-4-2014, other considerations may properly inform the commissioner's exercise of discretion. An important consideration identified by the Oregon Supreme Court in *20th Century Fox Film Corp.* was whether use of an alternative apportionment formula would upset existing uniformity among the states. 700 P.2d at 1041. In that case, the state argued that in determining the value of the taxpayer's property in the state, the "market value" of the films held in local movie theatres should be considered, instead of the "cost of acquisition" of the raw film on which movies had been printed. This variance was found permissible in part because it would not conflict with uniform rules established for the particular area.

In July of 2008, relying on the authority of UDITPA's Section 18, the Commission adopted a model rule for the states' consideration in apportioning the income of telecommunications service providers. The rule was the culmination of years of study and consultation with the public, tax practitioners, state tax officials, and industry representatives.

See MTC Model Reg. IV.18.(i). Special Rules: Telecommunications and Ancillary Service Providers. Referencing the Federal Mobile Telecommunications Sourcing Act of 2004, P.L. 106-252 (codified at 4 U.S.C. §§ 116-126), the model rule sources receipts of cell-phone services to the customer's "place of primary use" which in turn is established with reference to the customer's street address. *See* Regulation 18.(i).(3)(C). The model regulation, which has been adopted by eight states,[23] essentially sources cell phone service receipts in a nearly identical manner to the alternative formula applied here.

The taxpayer in this case makes no claim that it has been subject to inconsistent sourcing requirements by any state. Instead, the record indicates that the taxpayer's originally-filed returns were prepared using a customer location basis for sourcing its receipts, and the taxpayer now has claims for refund pending in 11 states based on the results of a cost-of-performance study commissioned for that purpose. (Appellee's Brief, p. 36.)

Other states have recently received refund claims based on such "cost-of-performance" studies for businesses operating in the utility sector. Utilities generally share the characteristic that they employ a system for the delivery of services to individual customers. Yet the courts are not in agreement as to whether all the "system-wide" cost is relevant to the cost-of-performance analysis under the standard apportionment formula. *See, e.g., AT&T Corp. & Includible Subsidiaries v. Dep't of Revenue*, No. TC 4814, 2012 WL 119850 (Or. T.C. Jan. 12, 2012) (rejecting taxpayer claims that receipts from Oregon customers should be sourced outside the state based on the costs for the taxpayer's overall system incurred by the taxpayer outside the state); *contra, Comm'r of Revenue v. AT&T Corp.*, 970 N.E.2d 814 (Mass. 2012). *Cf.*, *Cable*

[23] Hellerstein, *State Taxation*, ¶10.10[1] (3d ed.)(2014).

One, Inc. v. Idaho State Tax Comm'n, 337 P.3d 595 (Id. 2014)(finding that preponderance of income-producing activity necessary to provide cable and internet service to Idaho customers occurred in Idaho, rejecting the "systems-wide" cost approach).

In sum, there is no evidence in the record which would suggest that the states have applied an apportionment rule contrary to the alternative apportionment rule adopted by Tennessee for use in this case. The approach taken by Tennessee in this case comports with the proposed model rule adopted by the Commission in 2008.

4. The alternative apportionment method imposed by the commissioner here would not subject more than 100% of this taxpayer's income to state tax.

Another consideration identified by the Oregon Supreme Court in *20th Century Fox Film Corp.* is whether the alternative apportionment methodology would further UDITPA's twin goals of ensuring that the taxpayer's income is not subject to multiple taxation or "nowhere" taxation. As a matter of comity and fairness, when applying an alternative formula, the commissioner may consider whether the alternative would subject the taxpayer to multiple taxation. (Similarly, when responding to a request from a taxpayer for variance, the commissioner may consider whether that the alternative formula requested would result in "nowhere" income.) In this case, the taxpayer failed to present any evidence that the alternative formula would result in "double-counting" of its receipts or double taxation of its earnings or net worth.

5. The alternative apportionment method is not unduly burdensome as applied here or in other similar circumstances.

The drafters of UDITPA were sensitive to concerns about the ease of administration of and compliance with the standard formula. For instance, UDITPA uses original acquisition costs for real and personal property for determination of the property factor instead of current market values or depreciated values.[24] It is also appropriate in applying an alternative formula for the commissioner to weigh practical considerations of compliance burdens and administrative ease. Nothing in the record here suggests that the use of customer billing addresses to determine the sourcing of receipts will present administrative difficulties for the taxpayer. Indeed, the taxpayer had already filed returns for the period at issue using that methodology. It appears that the method chosen by the commissioner will result in a reduced administrative burden, both on the taxpayer and the revenue department, given the complexities of locating and valuing the costs of performance associated with the income producing activities in the state.

The commissioner may also consider the effects any variance will have on similar taxpayers, assuming the variance could be extended to others, in furtherance of the goal of preserving equity among similarly-situated taxpayers. That is, tax administrators may consider whether the employment of an alternative formula might create disparities in tax burdens if the principles and methodologies underlying a particular variance were extended to other taxpayers.

The "location of billing address" methodology chosen by the commissioner in this case could easily be extended to other utilities, and may already be in use by them as it had been by the taxpayer. The taxpayer contends that any such "portability" of normative principles and methodologies to similar taxpayers and industries means that the commissioner abused its discretion in adopting that alternative in this case (since the case is not "unusual," as the taxpayer argues). (Appellant's Brief, pp. 18, 29.) The opposite is true. The commissioner's exercise of the authority is supported if the method applied can be applied to similarly situated taxpayers since the ability of the commissioner to promote fair apportionment is thereby enhanced.

[24] *See* UDITPA § 11, *available at* http://www.uniformlaws.org/shared/docs/uditpa/uditpa66.pdf.

CONCLUSION

The Tennessee General Assembly recognized that in order to ensure equitable results in applying formulary apportionment to taxation of businesses with multistate operations, some flexibility in application of the standard formula would be required. The circumstances of this case present a particularly compelling example of why that flexibility is necessary—to avoid a clear misalignment of economic reality which arguably would result under a particular application of the standard apportionment formula. The General Assembly invested the Commissioner of Revenue with the authority to carry out the task of varying the apportionment method, subject to judicial review, and it was well within the power of the General Assembly to do so. A holding that the authority is limited in the way the taxpayer contends would be unprecedented in over a half-century of litigation over UDITPA's operation and application. Accordingly, for the reasons set forth above, the Commission urges this Court to affirm the holding of the Court of Appeals.

Respectfully Submitted,

Joe Huddleston (#010244)
Executive Director
Helen Hecht
General Counsel
Bruce Fort
Counsel
Multistate Tax Commission
444 N. Capitol St., NW
Washington, D.C. 20001
(202) 650-0300

Counsel for Amicus Curiae
Multistate Tax Commission

CERTIFICATE OF SERVICE

I hereby certify that a true and accurate copy of the foregoing Brief and accompanying Addendum has been served upon the following persons via U.S. Mail, first-class postage prepaid this 30th day of JANUARY, 2015 as follows:

Talmage M. Watts, Esq.
Tennessee Attorney General's Office
Tax Division
425 Fifth Avenue North
Nashville, TN 37242

Michael D. Sontag
Stephen J. Jasper
Bass, Berry & Sims
150 Third Avenue South, Suite 2800
Nashville, TN 37201