A Tale Of 2 State Tax Sourcing Decisions: The Va. Court's Path

By **Bruce Fort** (March 28, 2023)

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The Supreme Courts of Virginia and Pennsylvania recently construed two separate sections of the Uniform Division of Income for Tax Purposes Act, or UDITPA, but took drastically different paths in interpreting and applying the provisions of the venerable act.[1]

The results in both cases are controversial, or at least outside the mainstream of previous interpretations of the act's provisions.

At 65 years old, UDITPA is clearly showing its age — surviving in something like its original form in only a handful of states — but many of its provisions still provide the foundation for apportioning business profits in the great majority of states.

No single agreed-upon model for the allocation and apportionment of business income has emerged to replace it. It follows that we should try to agree on the best means of interpreting its provisions.

Part one of this article examines how the Virginia Supreme Court's recent use of a textualist approach to statutory construction in Virginia Department of Taxation v. R.J. Reynolds Tobacco Co. precluded consideration of UDITPA's broader purposes.

Part two will consider whether intentionalism, as employed by the Pennsylvania Supreme court in its recent decision in Synthes USA HQ Inc. v. Commonwealth is the more appropriate means of construing UDITPA's phrases given its many latent ambiguities and reliance on equitable alternatives.

A Tale of Two Cities: Textualism in Richmond

UDITPA employs three evenly weighted factors to determine the extent of a taxpayer's business activity in the states in which it operates. The formula is then used to approximate the taxpayer's relative earnings in those states.

There is no serious disagreement among scholars or courts that the property and payroll factors were intended to represent the contributions of the state of production to income generation. Nor is there any serious disagreement that the sales factor was intended to represent income-generating contributions of the marketplace.

Currently, the great majority of states either weight the sales factor more heavily in their apportionment formulas or rely exclusively on the sales factor in determining how income should be apportioned.

Although the equally weighted three-factor formula was described by the U.S. Supreme Court in its 1983 Container Corporation of America v. Franchise Tax Board decision as the benchmark by which other formulas should be measured,[2] only Hawaii, Kansas, North Dakota and Oklahoma continue that standard for all taxpayers.[3]

In R.J. Reynolds, the Virginia Supreme Court considered how to apply UDITPA's property factor calculation.[4] The operation of UDITPA's property factor is described in three

sections of the act.

Section 10 provides that the factor should be calculated by comparing property used in the state to property used everywhere. Section 11 provides that property owned by the taxpayer should be valued at original costs, while Section 12 provides for averaging the value of property at the beginning and end of the tax year.

The Virginia court focused its attention on a single word in Section 10 — namely, what it means for the taxpayer to have "used" property it owned during the tax year, for purposes of including that property in the numerator and denominator of the taxpayer's property factor.

The property at issue in R.J. Reynolds — tobacco — is so closely identified with Virginia's history and culture that it appears on one of the original seals of the Colony of Virginia.[5] Like many agricultural products, tobacco must be aged before it is ideally suited for consumption. Tobacco generally is aged for one to two years before it is ready for processing into cigarettes. As fortune would have it, the climate of Virginia is ideal for such aging to occur.

The tobacco is placed in a warehouse with natural ventilation and allowed to do its thing, with virtually no human involvement after that. R.J. Reynolds buys a lot of leaf tobacco, ages it in a large Virginia warehouse and then ships the product to North Carolina for processing into cigarettes.[6]

In response to recommendations from the National Conference of Commissioners on Uniform State Laws, Virginia adopted UDITPA in 1960.[7] Virginia continues to employ a UDITPA-based statute, including UDITPA's property factor calculation, with a minor modification, as Virginia Code Section 58.1-409.[8]

Virginia also adopted many provisions in the Multistate Tax Commission's 1973 Model General Allocation and Apportionment Regulation, including the model's directives for applying UDITPA's property-factor sections, with several modifications.[9]

One sentence of the MTC's model regulation that Virginia incorporated into its own regulation provides that, "property under construction during the taxable year (except inventorial goods in process) shall be excluded from the property factor until actually used."[10]

UDITPA Property Factor's Ambiguous Nature

To the Virginia court, there was no ambiguity in how the term "used" was employed in the statute describing the property factor, and thus the court determined it was bound by the plain meaning of the statute. This finding precluded consideration of how the Legislature might have viewed that phrase in the context of UDITPA as a whole.

The court explained:

This Court will look no further than, and is bound by, the plain meaning of the word "used," i.e., "to put into action or service" or "[t]o employ for the accomplishment of a purpose." Webster's Third New International Dictionary 2523 (1993); Black's Law Dictionary 1853, 1855 (11th ed. 2019).

We are required to defer to the circuit court's finding of fact that the storage of the leaf

tobacco in the Danville Facilities is not necessary for the aging process. The leaf tobacco will age regardless of where it is kept. In fact, the circuit court found, and Lorillard's witness testified, that Lorillard does "absolutely nothing" to the leaf tobacco and that the leaf tobacco "just sits there" in the warehouse where it is stored.[11]

The court briefly discussed 23 Virginia Administrative Code Section 10-120-160(A)(4), but concluded that the regulation did not "contemplate aging agricultural raw materials in its categories of property that are used," holding that the tax department's reliance on analogies drawn from the regulation were "unnecessary and inapposite."[12]

Significantly, the Virginia court stressed that the taxpayer and the tax department had both agreed that "there is no ambiguity in the Code's employment of the term 'used.'"[13] Black's Law Dictionary defines "ambiguity" in part as "doubtfulness or uncertainty of meaning or intention."[14]

Where the parties to a dispute agree that a word or phrase is unambiguous, but advance completely divergent meanings for the word or phrase in good faith, it should be incumbent upon a court to inquire further whether the term might be ambiguous after all.

Is the phrase "used in this state during the tax period" ambiguous? Returning to Black's Law Dictionary, three relevant types of ambiguity are identified: (1) calculated ambiguity; (2) latent ambiguity; and (3) patent ambiguity.

"Used in the state" would be considered a latent ambiguity: It is susceptible to multiple interpretations when applied to particular circumstances.

As it happens, other courts have had occasion to consider the application of "used" in constructing UDITPA's property factor, and it is unfortunate that the Virginia court did not consider those precedents.

In Alaska, Department of Revenue v. Amoco Production Co., the question presented was whether oil and gas leases in the state should be included in the property factor, where the leases had been declared to be unproductive in a prior year.[15]

The Supreme Court of Alaska's 1984 decision noted that exploration and development of such property was the core of the taxpayer's unitary business, and all property connected to that activity was accordingly used by the taxpayer as contemplated by UDITPA.

Similarly, the Massachusetts Supreme Judicial Court in 1990 had the occasion to consider whether an oil company's undeveloped acreage should be included in the taxpayer's property factor denominator in Commissioner of Revenue v. Exxon Corporation.[16]

The commissioner of revenue argued against it, noting that the taxpayer conducted no tests on the property, did no drilling and in fact never touched the property during the tax year. The Massachusetts court was unimpressed by the argument, holding that "although the unoperated acreage may not be producing income directly, the search [for new sources of petroleum and natural gas] … contributes directly to the taxpayer's income-generating activity."[17]

The same court reached a similar conclusion a year later in regarding a utility's ownership of two power plants then under construction, holding in Commissioner of Revenue v. New England Power Company, where the construction was necessary to meet regulatory mandates for future service needs, that the property was being used during the tax

year.[18]

The court might also have looked to UDITPA's official comments, promulgated in 1957 but significantly amended in 1966, for guidance in construing "used in the state."

The commentary to Section 10 provides that:

The property is to be included in the numerator and denominator is property producing the net income to be apportioned. If net income from property is allocated property under Section 5 through Section 8, such property should be excluded in constructing the fraction.[19]

The comment suggests that the relevant inquiry is whether the property can be considered part of the taxpayer's unitary business. R.J. Reynolds' stores of tobacco drying out in its Virginia warehouse would surely be considered an asset of the unitary business, even though it would not be manufactured into cigarettes until the following the tax year.[20]

The distinction between property intended for use in the unitary business and property intended for use outside the unitary business was carried forward in the MTC's Model General Allocation and Apportionment Regulation.

The model regulation provides that, except for property under construction, property that is acquired for unitary business purposes, including reserves, should be included in the property factor. The provisions of the 1973 Model General Allocation and Apportionment Regulation have been adopted, to varying degrees, by virtually all UDITPA states, including Virginia, bringing considerable uniformity to the application of UDITPA.[21]

The latent ambiguities of UDITPA's property factor provisions are not limited to when property is used in the business. Almost every phrase in the three sections pertaining to the calculation of the factor have been debated and litigated at one point or another.

Examples include:

- The Supreme Court of Oregon's 1986 decision in Atlantic Richfield Co. v. Department of Revenue, considering whether the factor should include intangible drilling costs;[22]

- The Supreme Court of Connecticut's 1995 decision in Foodways National Inc. v. Commissioner of Revenue, considering whether a contractual agreement for warehouse space constitutes a "lease;"[23]

- The Supreme Court of North Dakota's 1987 decision in International Mines and Chemical Corp. v. Heitcamp, considering whether a mileage credit is a "sublease" of a railroad car or something else;[24]

- The New York State Appellate Division, Third Department's 2012 decision in Matter of Meridith Corp. v. Tax Appeals Tribunal considering whether the value assigned to videotaped television programming should include rebroadcast rights;[25] and

- The Ohio Supreme Court's 1987 decision in Illinois Tool Works Inc. v. Lindley, considering whether property leased to another is "used" by the taxpayer.[26]

The Criticality of Determining Whether Ambiguity Exists

Certainly, there is nothing unusual in the Virginia court's rigid dichotomy between ambiguous and nonambiguous terms, nor the extent to which that finding dictated the court's conclusion as to the Legislature's intent.

Every court now holds that unless there is finding that a particular word or phrase is susceptible to multiple reasonable interpretations, the court cannot consider any extrinsic evidence of legislative intent at all.

"We are all textualists now," Justice Elena Kagan famously proclaimed in her 2015 tribute to the late Justice Antonin Scalia's contributions to jurisprudence, and that has been especially true in the field of taxation.[27]

But does this binary approach make sense when applied to UDITPA, or any one provision within it? The act contains just 19 substantive sections, many of them only a single sentence long.

We should not assume that the drafters of UDITPA believed that they could dedicate just 1,659 words to establish the definitive rules by which the incomes of every business operating within the U.S. should be divided among 51 taxing jurisdictions — or that a single word or phrase in a particular provision could do so.

The drafters of the Internal Revenue Code, by comparison, believed it necessary to use at least 2,412,000 words to establish the tax liability of our citizenry and businesses, and then felt it advisable to add another 7 million words in the federal tax regulations to clarify and to fill in some important gaps in the code itself.[28]

It would be a mistake, therefore, for courts to apply the same analytical tools and assumptions in construing the states' adopted versions of UDITPA as they apply to the federal tax code.

The structure of UDITPA, its brevity, and in particular its equitable apportionment provisions suggest that UDITPA was intended to guide tax administrators and taxpayers operating in good faith in reaching uniform and equitable results. That is, UDITPA's terms were never intended to be applied in a dogmatic fashion that would defeat the broader purposes of the statute.

The Peculiar Role of Ambiguity in Tax Litigation

While Virginia's brief-in-chief in the R.J. Reynolds appeal remains under seal, it is easy to understand why the state may have declined to raise the potential ambiguity of the

provision to support its argument.

In too many cases, the canon of statutory construction that ambiguities in tax statutes are to be resolved against the tax agency has been applied almost as a statutory command, rather than a rule to be employed as a last resort when no extrinsic evidence of legislative intent is available.[29]

It is a rule in search of a reason to justify it.[30] It is also a rule that makes no sense in the context of interpreting UDITPA's provisions, because UDITPA is not a tax imposition statute.

The Ohio Supreme Court's 2008 decision in U.S.B. Financial Services Inc. v. Levin is one of the few cases to discuss why that particular canon of statutory construction has no application in the context of apportionment disputes.[31]

The court considered the matter in the context of a taxpayer engaged in general banking and securities trading, the latter activity being conducted primarily outside Ohio.

The taxpayer argued that UDITPA's gross receipts definition should be construed in its favor to allow its securities trading receipts to be counted at gross, not the net amount actually realized on sales.

The court wrote:

[UDITPA] does not define the subjects of taxation; instead, it sets forth the method for determining the Ohio share of an interstate business. Any particular construction of the apportionment formula might cut in favor of a taxpayer in one case but against a taxpayer in the next. … As a result, logic militates against applying the [statutory construction canon] in this context.[32]

Ambiguity in UDITPA as a Whole

If the property factor calculations of UDITPA — which on the surface appear so straightforward — can be considered ambiguous, does that suggest that all of UDITPA's provisions could similarly be considered to be ambiguous? In a word, yes.

To be sure, the extent of latent ambiguity in UDITPA is not as all-encompassing as, say, author Mary McCarthy's 1979 critique on the Dick Cavett show of Lillian Hellman's work: "Every word she writes is a lie, including 'and' and 'the.'"[33]

But the extent of latent ambiguity in the act should not be underestimated. The very first phrase of UDITPA, prefacing the definitional section, contains a latent ambiguity: "As used in this Act, unless the context requires otherwise."

One could read "requires" as something necessary to avoid contradiction with another term in the statute, or perhaps just an inequitable result, or perhaps it could mean "necessary to avoid an irrational result."

This can also be seen as an example of what Black's Law Dictionary describes as a calculated or deliberate ambiguity — a purposeful decision to leave a little play in the joints.

By contrast, the first full sentence in UDITPA following that preface — Article I's definition of business income — was surely not intended to be ambiguous. Yet the definition is infamous for its patent ambiguities as well as its latent ambiguities.[34] It may be the most

ambiguous sentence ever written into a tax statute.

For 60 years, courts have struggled with its cipher-like instructions and twisted sentence structure without ever reaching a final resolution as to its meaning. The Kansas Supreme Court was the first appellate court to confront the definition, in the 1968 case Western Natural Gas Co. v. McDonald, gamely suggesting UDITPA's drafters may have wanted to reflect the distinction between ordinary sales of inventory and bulk sales in the Uniform Bulk Sales Act.[35]

Some courts thought the phrase contained two tests — transactional and functional — while some saw a single test,[36] and still other courts saw a "liquidation exception" to the functional test.[37]

The California Supreme Court did its best to end the long-standing debate over the business income definition in the 2001 Hoechst-Celanese v. Franchise Tax Board decision.[38]

By the time the California court took up the business/nonbusiness distinction in 2001, the definition's ambiguity was beyond dispute, allowing the court to consider extrinsic evidence of legislative intent.

The court explained that the enigmatic functional test was lifted verbatim from a series of ancient State Board of Equalization cases holding that income from the sale of noninventory assets constituted unitary business income.[39]

The court then noted that the official comments to UDITPA also supported the view that the sale of assets used in the unitary business constituted business income.

But the decisive factor for the court was fulfilling UDITPA's purpose of bringing uniformity to state taxation. The court wrote:

Although courts in other jurisdictions that have adopted the UDITPA have disagreed over the existence of a separate functional test, the state legislatures in these jurisdictions have not. In four of the five states where the state court rejected the functional test, the state legislature amended the definition of business income to include such a test.[40]

Despite the Herculean efforts of the California Supreme Court, Hoechst-Celanese did not end the controversy over the business income definition, even in California.[41] Nonetheless, the decision should serve as a guide for other courts in construing UDITPA's phrases by giving consideration to what the act as a whole intended to accomplish.

We have now covered the first sentence of UDITPA. To close the loop, it should be noted that the last sentence of UDITPA, instructing that the provisions of UDITPA "are to be liberally construed to effectuate its general purpose to make uniform the laws of the states that enact it," is another example of calculated or deliberate ambiguity.[42]

Reasonable people can disagree on what a liberal construction might entail and whether it includes disregarding some of the words of the statute in order to further the statute's larger purposes.

UDITPA's instructions for allocating and apportioning income were intended as a guideline for achieving uniformity across taxing jurisdictions.

While those instructions may appear to be straightforward when read in isolation,

application to particular circumstances will quickly reveal their latent ambiguities. Those ambiguities can be successfully navigated by reference to model regulations, official comments, decisions in other jurisdictions, and most importantly, by giving consideration to UDITPA's overarching purposes.

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[1] 7A West's Uniform Laws Annotated, Part 1, 141 (West Pub. 2002), available at: Uniform Laws Commission, Division of Income for Tax Purposes - Uniform Law Commission (uniformlaws.org) (last visited February 2023).

[2] Container Corporation of America v. Franchise Tax Board, 463 U.S. 159, 170 (1983).

[3] Bloomberg Tax Research; Corporate Tax Chart Builder. Other states may use the formula for particular businesses or industries.

[4] 868 S.E.2d 429 (Va. 2022).

[5] seal of the Virginia colony - Bing images.

[6] R.J. Reynolds, 868 S.E.2d at 430.

[7] Corporate Executive Board Company v. Virginia Department of Revenue, 822 S.E.2d 918, 921 (Va. 2019).

[8] "The property factor is a fraction, the numerator of which is the average value of the corporation's real and tangible personal property owned and used or rented and used in the Commonwealth during the taxable year and the denominator of which is the average value of all the corporation's real and tangible personal property owned and used or rented and used during the taxable year and located everywhere, to the extent that such property is used to produce Virginia taxable income and is effectively connected with the conduct of a trade or business within the United States and income therefrom is includable in federal taxable income."

[9] www.mtc.gov.

[10] 23 VAC 10-120-160(A)(4).

[11] R.J. Reynolds, supra, at 434.

[12] Id.

[13] Id.

[14] Black Law Dictionary, 10th Ed., p. 97.

[15] 676 P.2d 595 (Ak. 1984).

[16] Commissioner of Revenue v. Exxon Corporation, 551 N.E.2d 36 (Ma. 1990).

[17] Id. at 39.

[18] Commissioner of Revenue v. New England Power Company, 582 N.E.2d 543 (Ma. 1991). The court noted that Massachusetts had not adopted the MTC's model regulation excluding property under construction from the property factor. Id. at 546.

[19] Uniform Laws Commission, Division of Income for Tax Purposes - Uniform Law Commission (uniformlaws.org) (last accessed February 2023).

[20] See, e.g., Allied-Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768, 788 (1992)(purchase of futures contracts).

[21] https://www.mtc.gov/wp-content/uploads/2023/02/AllocaitonandApportionmentReg.pdf. The model regulation was not modified by the Commission until 1988; the property factor provisions were modified in 2003.

[22] Atlantic Richfield Corporation v. Department of Revenue, 717 P.2d 613 (Or. 1986).

[23] Foodways National, Inc. v. Commissioner of Revenue Services, 654 A.2d 1228 (Conn. 1995).

[24] International Mines and Chemical Corp. v. Heitcamp, 417 N.W.2d 791 (N.D. 1987).

[25] Matter of Meridith Corp. v. Tax Appeals Tribunal of Dept. of Tax & Fin., 956 N.Y.S.2d. 585 (N.Y. App. Div., 3rd. Dept. 2012)

[26] Illinois Tool Works, Inc. v. Lindley, 436 N.E.2d 220 (Oh. 1987).

[27] Harvard Law School, The Antonin Scalia Lecture Series: A Dialogue with Justice Elena Kagan on the Reading of Statutes, YOUTUBE (Nov. 25, 2015) https://www.youtube.com/watch?v=dpEtszFT0Tg.

[28] Federal Tax Laws and Regulations are Now Over 10 Million Words Long | Tax Foundation (last accessed February 2023.).

[29] See, e.g., Ex Parte Uniroyal Tire Co., 779 So.2d 227, 231 (Al. 2000)("We consider this case within the context of two well-settled rules. First, '[t]axing statutes must be construed most strictly against the taxing authority and most favorably for the taxpayer.'").

[30] The Connecticut Supreme Court has described a more nuanced approach to applying the axiom that tax statutes should be construed against the tax collector. In United Illum. Co. v. City of New Haven, 692 A.2d 742, 760 (Conn. 1997) the court explained that:

this long-standing axiom of statutory construction applied to taxing statutes is an important guideline to legislative meaning, but it cannot displace the result of careful and thoughtful interpretation.

Second, taken literally, the axiom proves too much, because there are few, if any, tax or

other statutes that are free from "any ambiguity." It may well be that the axiom's proper application is to cases in which, after the court has engaged in the interpretive process and the arguments are essentially in equipoise--that is, the legislative meaning is nonetheless in doubt--the axiom applies to resolve the case in favor of the taxpayer. In this sense, it would operate as a kind of interpretive tiebreaker.

[31] 893 N.E.2d 811 (Oh. 2008).

[32] Id. at 817.

[33] https://quoteinvestigator.com/2016/09/18/every-word/.

[34] "(a) 'Business income' means 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."

[35] 446 P.2d 781 (Ks. 1968).

[36] Ex Parte Uniroyal Tire Co., 779 So.2d 227 (Al. 2000); Phillips Petroleum Co. v. Iowa Dep't of Revenue & Fin., 511 N.W.2d 608 (Iowa 1993).

[37] Lenox, Inc. v. Tolson, 548 S.E.2d 513 (N.C. 2001).

[38] 22 P.3d 324 (Ca. 2001).

[39] Appeal of Houghton Mifflin Co., 3 SBE 344 (3/28/46); Appeal of International Business Machines Corp., 6 SBE 5 (10/7/54).

[40] Hoechst-Celanese, 22 P.3d at 336.

[41] Jim Beam Brands Inc. v. Franchise Tax Board, 34 Cal. Rept. 3d 874 (Ca. App., 1st Dist. 2005).

[42] UDITPA, Art. 19.