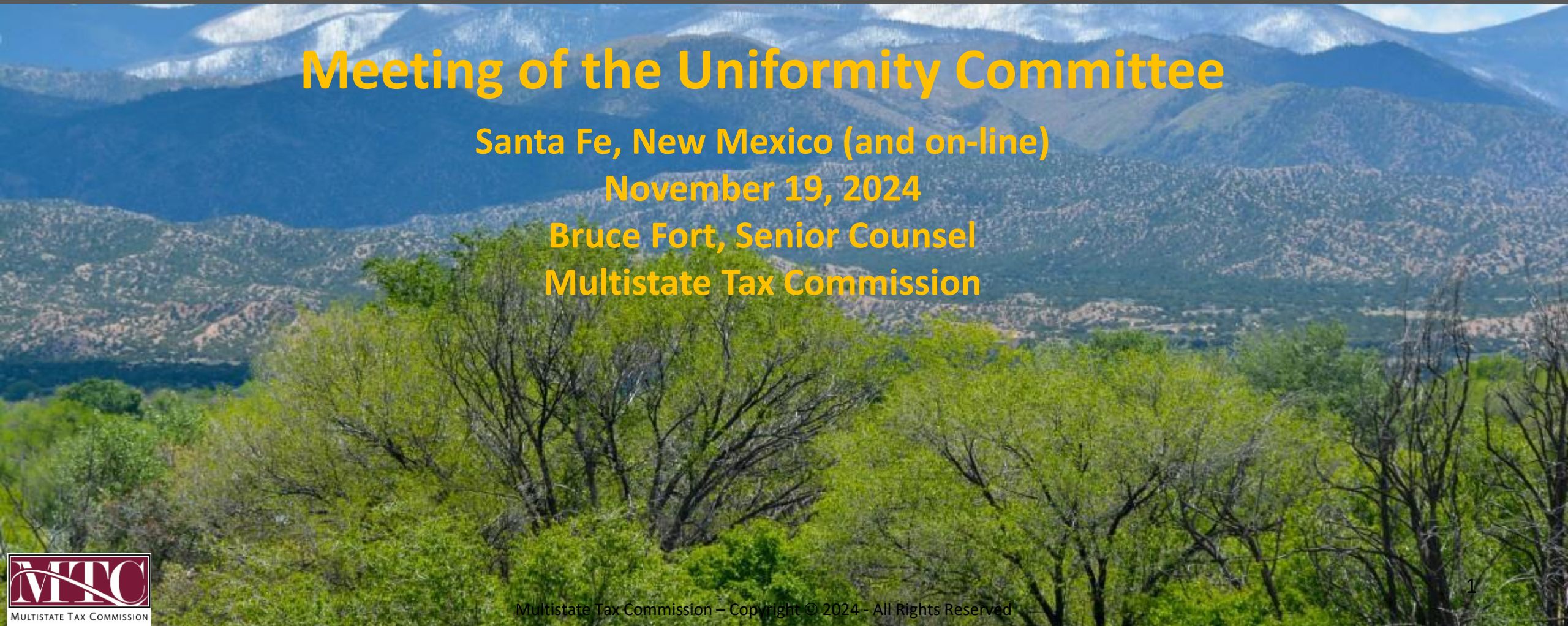
Source-Based Taxation of Intangibles

It's not often easy, and not often kind, but necessary



Meeting of the Uniformity Committee

Santa Fe, New Mexico (and on-line)
November 19, 2024
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Multistate Tax Commission

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MULTISTATE TAX COMMISSION

UDITPA and Intangible Property

- **Formulary apportionment has its roots in the property taxation of businesses with intangible property values:**
- **An on-going business may be more valuable than the sum of its parts; we call that goodwill.**
- **Taxing railroads by dividing the capitalized value by in-state track miles (the "units" in "unitary taxation") allowed every state to reach that goodwill value.**
- ***Adams Express Co. v. Ohio*, 165 U.S. 194 (1897): A businesses' "intangible property [goodwill] is distributed wherever its tangible property is located and its work is done."**
- **Formulary apportionment continues to be used for determining the value of interstate utilities subject to centralized assessment, while other businesses are valued using replacement costs, etc. Some businesses claim it is an equal protection violation. Compare: *Pacificare v. Oregon DOR; Delta Airlines v. Oregon DOR* (2024) TC 5409 (Control); TC 5418; TC 5433; TC 5452.**

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UDITPA and Intangible Property

The business situs doctrine is a recognized exception to the *mobilia sequuntur personam* (intangibles follow the person) doctrine allowing taxation in the state of residence or commercial domicile.

What is the business situs doctrine?

"'When we speak of a "business situs' of intangible property in the taxing State we are indulging in a metaphor. We express the idea of localization by virtue of the attributes of the intangible right in relation to the conduct of affairs at a particular place. The right may grow out of the actual transactions of a localized business or the right may be identified with a particular place because the exercise of the right is fixed exclusively or dominantly at that place. In the latter case the localization for the purpose of transacting business may constitute a business situs quite as clearly as the conduct of the business itself."

***Whitney v. Graves*, 299 U.S. 366, 372 (1937)(New York could tax capital gain of Massachusetts resident selling seat on NYSE.)**

UDITPA and Intangible Property

UDITPA's goals include full taxation of multistate business activity. This is achieved primarily through apportionment.

Note that UDITPA's property factor does not include intangible property.

This makes sense under holding of *Adams Express*: a business' IP is located "wherever its tangible property is located and its work is done."

UDITPA and Intangible Property in the Sales Factor

- **UDITPA's sales factor for "sales other than sales of TPP" (Section 17) was never intended for sales of IP. Never mentioned in official comments or Pierce article.**
- **The "income producing activity" is the exploitation of the IP by the customer, not the taxpayer. The "costs of performance" are the activities of the business as a whole.**
- **1973 MTC model regulation IV.18(c): "if the income producing activity for intangible property is "readily identified" it is included in the sale factor. Examples: sales or licenses to use intangible property; interest on installment sales. No guidance on numerator sourcing. By contrast, I.P.A. for dividends, royalties and interest cannot be "readily identified" and should be excluded.**
- ***Coca-Cola v. Oregon* (Or. T.C. 1978): rejects notion that Coca-Cola should have a fourth factor for intangible property, presumably the recipe sourced to the location of a mythical vault somewhere. IP already represented in sales factor.**

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UDITPA and the Business Situs Doctrine

UDITPA sources non-business income to the state(s) with the clearest constitutional right to tax it, to promote goal of full taxation of multistate businesses.

- **Net rents and royalties from real property and TPP: to location of property; apportioned if TPP is mobile, with throwback to commercial domicile;**
- **Interest and dividends: to commercial domicile;**
- **Royalties on intangible property: where employed by customer; if taxpayer not subject to tax there, throwback to commercial domicile;**
- **Capital gains and losses on sales of real property and TPP: to location of property (for TPP, location at time of sale; throwback to commercial domicile if taxpayer not subject to tax there);**
- **IV.6(c): Capital gains and losses on sales of intangible property: to commercial domicile**

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UDITPA and the Business Situs Doctrine

Implications of IV.6(c): allocation of capital gains from the sales of intangible property to commercial domicile.

- UDITPA's definition of business income is an ambiguous mess, especially when applied to capital gains.
- Capital gains are now a substantial component of many business' taxable income, but there are no associated apportionment factors for non-business (or business) gains;
- As a result, stakes in contesting apportionment v. allocation for capital gains are very high: 60 years of inconclusive litigation over definition of business income and constitutional ability to apportion gains on sale of out of state business enterprise.

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UDITPA and the Business Situs Doctrine

Were the drafters of UDITPA compelled to assign non-business capital gains to commercial domicile?

- *Whitney v. Graves* (1937); *International Harvester v. Wisconsin* (1944); *Wisconsin v. J.C. Penny Co*. (1940) suggest otherwise. But the Supreme Court doesn't think it has ever addressed the question, as it noted in *MeadWestvaco v. Illinois* (2007).

- Source-based allocation of capital gains (based on the location where a business operates) from the sale of partnership interests has been upheld recently in *VAS Holdings Inv., LLC. v. Commissioner of Revenue,* 86 N.E.3d 1240 (Mass. S.J.Ct. 2022)(dicta) and *J.P. Morgan Trust Co. of Delaware (AKA, The 2009 Metropoulos Family Trust) v. Franchise Tax Board, 79 Cal. App. 5th 245 (Cal. Ct. App. 2022).* The latter case held (as an alternative ground) that goodwill can have a business situs within the taxing jurisdiction. (The business also had a regional headquarters in the state.)

UDITPA and the Business Situs Doctrine

Vermont's Alternative Intangible Sourcing Rule:

If the intangible property has acquired a business situs in a state, the taxpayer's non-business gain should be sourced to that state; if not, source the capital gain to the taxpayer's business domicile. See *Vermont National Telephone Co. v. Department of Taxes*, 250 A.3d 567 (Vt. 2000)(never used radio broadcast license had not acquired a business situs in state).

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On the Not so distant Horizon

- **The word "partnership" is nowhere found in UDITPA. The drafters left no instruction for allocating non-business partnership distributive share income, or capital gains and losses from the sale of partnership interests. The drafters may not have even considered partnership interests to be "intangible property." (Partnerships are included in the term "taxpayer" under Art. II of the Compact.)**

- **As more business is conducted through partnerships and other PTE's, where management agreements supplant the need for majority ownership of stock, disputes over whether capital gains from the sale of those interests are apportionable are sure to become more frequent.**

- **Source-based allocation of such gains and losses may be a better alternative than allocation to the taxpayer's commercial domicile.**