Today it is common for professional and non-professional service providers to service clients in many states. Electronic commerce knows no physical boundaries. For entities taxable in various states, the method of apportionment is of critical tax importance. The recent Court of Appeals decision in Vodafone Americas Holdings1 ("Vodafone") warns taxpayers the standard apportionment formulas which they are otherwise required to use, may be changed retroactively for service enterprises.

For States that have largely adopted the Uniform Division of Income for Tax Purposes Act ("UDIPTA") the sale of services is deemed to take place where the services are rendered on a cost-of-performance basis ("COP"). Tennessee's standard apportionment formulas for franchise and excise taxes are found in TENN. CODE ANN. §67-4-2111 and TENN. CODE ANN. §67-4-2112 respectively. These formulas are substantively identical except for the wording of "net earnings" and "net worth." Basically, for multi-state taxable businesses, Tennessee uses a three factor formula of property, payroll and sales - mathematically taking the Tennessee portion of each factor over the aggregate of each factor, with sales double-weighted and the percentage result divided by four. This percentage is then multiplied by the net profits determined for excise tax purposes or the net worth as determined for franchise tax purposes. However, under T.C.A. §67-4-2014(a) and §67-4-2112(a), a taxpayer may petition for, or the Tennessee Department of Revenue ("TDOR") 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 capital and net earnings for purposes of computing franchise and excise taxes.

§§67-4-911 and 67-4-812 permit a departure from the allocation and apportionment provisions only in limited and specific cases. §§67-1-911 and 67-4-812 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 the Franchise and Excise Tax Laws.

(c) Application for relief must be addressed to the Commissioner of Revenue with the filing of a petition, in writing, setting forth the reasons why application of the statutory allocation and apportionment provisions do not fairly represent the extent of the taxpayer's business activity in this state. It must be shown by clear and cogent evidence that peculiar or unusual circumstances exist which would cause application of the said statutory provisions to work a hardship or injustice. Such application must also include a proposed alternative method of allocation or apportionment to be used by the corporation, and be submitted by the taxpayer on or before the statutory due date of the return. In the event that a variation from the statutory provisions is adopted, then such method shall continue in effect so long as the circumstances justifying the variation remain substantially unchanged. It shall be the duty of the taxpayer to furnish each subsequent year such information with the filing of its return as will establish the fact that the circumstances remain substantially unchanged.

Although the TDOR's administrative regulations speak in terms of a taxpayer initiated request for a variance, the statute (and its predecessor) clearly permits the Commissioner to initiate a variance. In Sherwin-Williams v. Johnson the Tennessee Court of Appeals affirmed the power of the Commissioner to initiate a variance not requested by the taxpayer. This matter arose in a refund case. Up until that time, the variance cases had dealt with variances initiated by taxpayers. Sherwin-Williams involved the addition of the corpus of working capital debt trades by Sherwin-Williams in the denominator of gross sales. While the result of the court is intuitive, only the interest income or gain representing active cash management by companies of their working capital is neither a limited nor unusual fact situation nor nonrecurring. This activity cuts across all industry lines. This holding literally dictated the approach of multi-state businesses of all industries. While the taxpayer's result was abusively favorable to the taxpayer (and in the author's view offensively so), the result of such inclusion would have been equally unfavorable (perhaps equally offensively) for Tennessee-based taxpayers. While the result of Sherwin-Williams appears "right," Sherwin-Williams had the correct technical position under the administrative regulations and perhaps the abuse should have addressed in a technical amendment to the statute. While the Court of Appeals stated it was not following New Jersey and Indiana's "abundant result standard," in the author's opinion actually it did, and it ignored the administrative regulations requirement of "specific cases..."
where unusual fact situations produce incongruous results." Under Sherwin-Williams, the fact situation does not have to be unusual or isolated in a manner to give meaning to "specific case" or "unusual fact situations" if the result to the taxpayer is offensively favorable/abusive.

Ten years after Sherwin-Williams the Court of Appeals in Bellsouth Advertising® (BAPCO) again considered a Commissioner initiated variance.6 This was the first case in which the Commissioner-issued a variance from the COP formula in connection with the sale of advertising and was presumably the first case dealing with a Commissioner initiated variance to the sales apportionment factor for services. In this case, BAPCO sold advertising in the white and yellow pages, charged customers in Tennessee and across the country for such advertising, and was paid when the directories were distributed (by an unrelated party) in Tennessee. The Tennessee sales activities of the affiliated group were conducted by a separate Tennessee corporation which paid Tennessee tax on its earnings.

The services of developing and printing the directories were done outside of Tennessee. Although the TDOR argued that the ultimate distribution of millions of telephone directories throughout the state meant BAPCO was selling tangible property, that argument failed. The directories were not sold, they were given away. Advertising was sold. However, the Commissioner's retroactive variance imposed while the matter was in litigation, succeeded. BAPCO had originally apportioned sales based on the location of the advertising customer. After a study by a national accounting firm, BAPCO filed amended returns requesting refunds based on apportioning its sales on COP vs. the billing address of customers. The COP method of determining the sales of services of a multi-state business to be attributed to Tennessee is required by TENN. CODE ANN. 67-4-2012(i)(2) which states:

"Sales, other than sales of tangible personal property, are in this state, if the earnings-producing activity is performed; (1) In this state; or (2) Both in and outside this state and a greater proportion of the earnings-producing activity is performed in this state than in any other state, based on cost of performance."

The result of BAPCO's use of the mandatory apportionment formula would mean that for 2002, instead of including approximately $200 million of sales to Tennessee by using the billing address of the customer, BAPCO only included $2 million based on COP. The Commissioner's variance required BAPCO to include in the numerator of the sales factor of the apportionment formula its receipts from the sale of advertising as if it were selling tangible property. Per the Court of Appeals, following the administrative regulations, the Commissioner has the burden of proof of showing that a variance is proper and the standard statutory apportionment formula is presumed to be correct.

The Court of Appeals was either swayed by, or used as an excuse to uphold the variance, an article written by Professor William J. Pierce whom the Court referred to as the "father" of UDITPA when discussing the cost of performance for a multi-state business selling national advertising. In this article he stated: "In contract, assume that the sales item involved is advertising revenue received by a national magazine publisher. The state of activity would be difficult, if not impossible to ascertain so it would appear that this type of income may well be apportioned on the same basis as subscription income..."7

BAPCO argued the COP is an all or nothing provision based on where a majority of the costs to provide the service are performed and the Commissioner's issuance of a variance when a particular businesses' sales factor is zero because the greater proportion of its direct costs are outside Tennessee renders TENNESSEE CODE ANN. §67-4-2012(i) meaningless. In addition, BAPCO argued that the Commissioner did not demonstrate there was something unique and nonrecurring about BAPCO's business activity in Tennessee or about the costs of performance to justify the imposition of a variance.

The Court found that the authors of UDITPA and the Tennessee General Assembly were aware that under certain factual scenarios, specifically when the sale of advertising is at issue, the statutory formulas just do not work and the tax collector would need to impose a variance. The Court found that the unusual factual situation was all of the costs of production occurred outside of Tennessee, but the revenue derived from the end product only occurred when the product was distributed in Tennessee which then obligated the purchasers to pay for the sale of the advertising. The Court concluded: "Certainly, the circumstances of this case have a unique quality, and while the process can be recurring, the 'ordinary' qualifier under the rule does not preclude the issuance of a variance in all such cases." The Court at least had the specific provision that the payment was not due until the directories were distributed in the state to cite as a "unique" factor.

With the above background we now move to Vodafone. This case involved Verizon Wireless phone services and whether the revenue from cellular service (the sale of a service, not the sale of tangible personal property) to Tennessee residents would be included in the numerator to determine the sales factor in the apportionment formula to be used in determining the taxpayer's net income apportioned to Tennessee. Vodafone had originally computed the sales factor by allocating to Tennessee revenue from Tennessee billing addresses. Vodafone filed a claim for refund of franchise and excise tax of approximately $13 million. The initial basis for the claim for refund was a lack of nexus by Vodafone to Tennessee.

After a study by a large accounting firm, Vodafone revised its claim for refund on the basis that the majority of the cost of performance occurred outside of Tennessee. Belatedly, over two years after (i) the revised claim for refund that included the COP as the mandatory method for determining the sales factor for apportionment and (ii) the Commissioner's responsive answer to such amended complaint, the Commissioner imposed a variance on the computation of the sales factor. The variance required that the receipts for cell phone services provided to customers with Tennessee billing addresses be included in the provision of cellular services based on the customer's billing address.

The trial court noted that the taxpayer had filed refund claims based upon a nexus theory similar to the one advanced in Tennessee in 12 other states and upon a similar COP theory in 11 other states.
involving a total of 18 states. The trial court ruled against the taxpayer and in favor of the Commissioner on both the nexus and the COP. With respect to the COP, the trial court found the Commissioner did not emphasize his regulations, but rather on the argument that the COP approach did not fairly represent the taxpayer’s business activity in Tennessee. The trial court seemed to accept the testimony of Benjamin F. Miller that there were “two fundamental principles of [the Uniform Division of Income for Tax Purposes Act] which are: (1) no income should be assigned to more than one State; and (2) no income should escape taxation, such income frequently being referred to as ‘nowhere income.’” The trial court found the Commissioner’s authority to issue variances to be both narrow and discretionary. 

While the trial court found BAPCO was not a recompense for the protection of the entity’s local activities and the COP method using only costs attributable to providing services to Tennessee residents would produce a far different result that the taxpayer claimed. Since some of the states in which the taxpayer does business do not employ the COP methodology, the Court of Appeals appears to be offended that COP used by the taxpayer in Tennessee would mean that millions of dollars of income from Tennessee residents go untaxed and overall over a billion dollars of income from various states would go untaxed.

The Court of Appeals seems to fixate on Tennessee receipts from customers with billing addresses in Tennessee not being taxed anywhere, although there is nothing in the record to indicate that the states in which the taxpayer did business that chose not to use the cost of performance UDIPITA formula could not do so and tax the apportioned income. The administrative regulations’ requirement of unusual fact situations was given short shrift. The Court of Appeals found this was an unusual situation because the drafters of UDIPITA likely did not anticipate wireless industry. The Court of Appeals stated that if the variance is precedent for other entities, there would not be many. The Court found that “ordinarily unique and nonrecurring” is not a hard and fast requirement and the fact the administrative regulations state that when another method of tax computation, allocation or apportionment as set out is established, such method will continue as long as circumstances justify the variation remain substantially unchanged demonstrates that the statute contemplated recurrence was envisioned.

At this point it is unknown whether the taxpayer will elect to appeal Vodafone to the Tennessee Supreme Court. The author has been advised, however, that such an appeal is doubtful.

Presently it is unclear whether the additional constraints imposed be the administrative regulations on the Commissioner’s authority to issue a variance are operative for the determination that the mandatory method does not fairly represent the taxpayer’s business activity in the state. In essence, does the Commissioner only have to make a reasonable determination that the use of the standard formulas do not fairly represent the extent of the taxpayer’s business activity in the state? In Sherwin-Williams, the Court of Appeals did not discuss the administrative regulations’ restrictions and does not appear to have applied them. In BAPCO, the Court at least paid lip service to the administrative regulations and found the delivery of millions of directories to
users in Tennessee and their delivery as a condition of payment produced an unusual fact situation and observed that "ordinarily be unique and nonrecurring" did not mean unique and nonrecurring was always required even though the decision impacts the whole advertising industry. Finally, in Vodafone, the Court of Appeals again gave lip service to the self-imposed requirements of the administrative regulations of an unusual fact situation and again indicated that "ordinarily be unique and nonrecurring" was not always required and that the requirement of the continued use of the variance method until the operative facts changed shows recurrence was contemplated. The determination that the situation was "unusual" because the draftsmen of UDIPTA in the 1970s did not foresee cellular service means that many major service industries in the electronic age are unusual and their computation of income subject of variance if, in the Commissioner's discretion, the apportionment does not fairly represent the extent of the taxpayer's business activity in Tennessee.

In the author's opinion, a variance, whether initiated by the taxpayer or by the Commissioner almost always should be prospective. The administrative regulation requires the taxpayer to request the variance prior to the due date of the tax return, conversely the Commissioner should be similarly bound except to a refund claim in which the taxpayer changes its apportionment method. A variance is by definition a change from the otherwise mandatory rules. If a taxpayer is attempting to change its prior methodology or accounting, a retroactive variance that requires the taxpayer to use it's previously chosen method may be an appropriate exception to prospective application. Variances should be granted or imposed in most unusual and almost offensive circumstances to set aside the mandatory provisions of the statute for allocation and apportionment. The apportionment factors are designed to provide rough justice in the aggregate with unfavorable and favorable results canceling each other out and only in "unique" and truly "unusual" circumstances should a variance be exercised. A taxpayer with a variance has a different set of rules than all other taxpayers. That has a fundamental risk of systemic unfairness. Whether another state fully exercises its taxing power should be irrelevant. In Vodafone the "nowhere taxable income" appears to be because other states did not follow UDIPTA's COP methodology. The Commissioner's historic imposition of a self-initiated variance appears to have been fairly rare and at least in the three cases litigated are in situations that the New Jersey or Indiana courts may equate with "absurd results". In the three cases discussed herein, the taxpayers involved were attempting to change their methodology and seeking a refund or had previously clashed with the TDOR on their going forward method. In each case the taxpayer previously took apportionment positions that the Commissioner deemed reasonable and changed them to something that the Commissioner felt unreasonable. If there are significant multi-state business lines such as advertising, cell phone and other electronic services for which the UDIPTA rules are ill suited, a legislative change as opposed to a variance is the appropriate remedy as entire industries are or should be affected. Taxpayers, subject to reasonable anti-abuse provisions, deserve to have the rule of law as opposed to the rule of subjective outcomes. Taxpayers should also have a reasonable and accurate belief that they are playing with the same rules that are applicable to others. It is hoped that the present and future Commissioners will carefully exercise their discretion and apply the administrative regulations.

Endnotes
2 Tenn. Comp. R. & Regs. 1320-06-1-.35(a) and (c) refer to the sections of a prior codification and have not been updated since 2002. The prior relevant sections were substantively the same as the current sections, although numbered differently.
3 Tenn. Comp. R. & Regs. 1320-6-1-.35(a).
6 The Commissioner had audited BABCO for earlier years and challenged a refund based on BABCO's amended returns for 1993-1996. The TDOR apparently settled the case in what BABCO claimed was "highly favorable". For 1997-2001, however, the Commissioner again challenged the taxpayer's position, and this time issued a variance after litigation was well underway.
8 The Court of Appeals noted the administrative regulations require the application for a variance must be in writing and must set forth the reasons why the statutory apportionment provisions do not fairly represent the extent of the taxpayer's business activities in Tennessee. The Commissioner had issued a written variance with such information and the Court seems to imply that is a condition for a variance imposed by the Commissioner.
9 Tenn. Admin. Reg. §1320-6-1-.34(c).
10 "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."
11 The author personally believes the variance in BABCO should have been prospective or better, by legislative action. The Commissioner was aware of the taxpayer's position and had failed to issue a variance at the earlier time.

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