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MULTISTATE TAX REPORT

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Procedure

Recently, the Oregon Tax Court denied a motion for partial summary judgment in *Oracle v. Oregon Dept. of Rev.*, a case involving a taxpayer's inconsistency in classifying income as business or nonbusiness income in two different states. In *Oracle*, the court ruled that the goal of uniformity under the Uniform Division of Income for Tax Purposes Act does not equate to law. At a time when states themselves impose widely varying requirements for disclosing inconsistencies, the ruling is particularly significant. In this article, authors Giles Sutton, Jamie Yesnowitz, and Chuck Jones, of Grant Thornton LLP, discuss the differences among state disclosure requirements and the impact that *Oracle* may have for taxpayers taking nonuniform positions from state to state.

Lessons of *Oracle*: Inconsistencies and Changes in Reporting Inevitable in State Taxation, But When Must They Be Disclosed?

By Giles Sutton, Jamie C. Yesnowitz
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INTRODUCTION

In many states, taxpayers are required to disclose inconsistencies or changes in reporting income. These requirements stem from the goal of uniformity that is advanced by the Uniform Division of Income for Tax Purposes Act (UDITPA)[1] and the Multistate Tax Com-

[1] UDITPA is a set of model apportionment laws initially promulgated in 1957. These laws were designed for the purpose of enactment by states that impose an income tax. Many states originally adopted the UDITPA model laws, but a number of states have moved away from UDITPA and adopted their own provisions. For example, UDITPA uses a three-factor equally weighted apportionment formula. States have tended to put more weight on the sales factor, especially in recent years.

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mission (MTC).[2] In an effort to promote uniformity and consistency in reporting, the MTC has adopted a series of model apportionment regulations. A number of states have adopted at least some of the MTC's model regulations that require disclosure of changes, but other states have adopted their own regulations. Despite the model regulations, numerous states do not require taxpayers to disclose inconsistencies in reporting.

Accordingly, states have adopted a variety of approaches for taxpayers to disclose changes and inconsistencies, and little judicial or administrative guidance in this area currently exists. Taxpayers are often unaware of these rules, and in many cases, such disclosure requirements are forgotten or ignored in the rush to file original corporation income tax returns before filing deadlines, or amended corporation income tax returns pursuant to federal revenue agent reports.

UNIFORM DISCLOSURE REQUIREMENTS

Many states have regulatory disclosure requirements that are based on provisions in the model allocation and apportionment regulations promulgated by the MTC. The MTC regulations require consistency in classifying an item of income as business or nonbusiness income, and disclosure if changes are made to a taxpayer's apportionment of an item of income that impairs year-to-year consistency or state-to-state consistency.

Classification of Income

The MTC model regulation requiring year-to-year consistency provides that ''[i]f the taxpayer departs from or modifies the manner in which income has been classified as business income or nonbusiness income in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.''[3]

The corresponding state-to-state consistency regulation states that: ''[i]f the returns or reports are filed by a taxpayer for all states to which the taxpayer reports under Article IV of this Compact or the Uniform Division of Income for Tax Purposes Act are not uniform in the classification of income as business or nonbusiness income, the taxpayer shall disclose in its return to this state the nature and extent of the variance.''[4]

Apportionment Factors

Consistency requirements also are included in the MTC model regulations for the property and sales apportionment factors. Under the property factor regulation requiring year-to-year consistency, ''if the taxpayer departs from or modifies the manner of valuing property or of excluding property from or including property in the property factor used in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.''[5]

The property factor state-to-state consistency model regulation provides that ''[i]f the returns or reports filed by the taxpayer with all states to which the taxpayer reports under Article IV of this Compact or the Uniform Division of Income for Tax Purposes Act are not uniform in the valuation of property and in the exclusion of property from or the inclusion of property in the property factor, the taxpayer shall disclose in its return to this state the nature and extent of the variance.''[6] The sales factor regulation contains similar disclosure requirements if the taxpayer is not consistent in excluding or including gross receipts.[7]

STATE DISCLOSURE REQUIREMENTS

States, ironically, have not followed a consistent approach in addressing the issue of disclosing inconsistencies in business/nonbusiness income classifications and apportionment factor positions. While many states have adopted all or selected MTC model disclosure regulations, some states have promulgated disclosure regulations that differ from the MTC's regulations, and others have no disclosure regulations at all. Michigan, New Jersey, New York, Pennsylvania, Texas, and Virginia are among those states that do not require disclosure of inconsistencies in income classification or apportionment factors.

States have adopted a variety of approaches for taxpayers to disclose changes and inconsistencies, and little judicial or administrative guidance in this area currently exists.

States Adopting Uniform Requirements

California has adopted the MTC's model disclosure requirements, incorporating the MTC's income classification, property factor, and sales factor disclosure regulations into its regulations.[8] Also, California has adopted disclosure requirements for the payroll factor that are similar to the requirements for the other two apportionment factors.[9] Arizona and Missouri also have

[2] The MTC is organized to promote interstate commerce through uniform state tax requirements. The Multistate Tax Compact is the MTC's governing document. A total of 19 states and the District of Columbia have enacted the compact into their state laws, according to the MTC. These states govern the commission and participate in a wide range of projects and programs. In addition to these compact members, six states are classified as sovereignty members, which support the compact through regular participation in, and financial support for, the general activities of the commission. Furthermore, 22 states are classified as associate members, which participate in certain MTC meetings and projects. Only Delaware, Nevada, and Virginia do not participate in MTC activities. *See* www.mtc.gov. Also, the MTC has approved model regulations that states may adopt.

[3] MTC Reg. IV.2.(c)(1). Note that similar disclosure requirements apply to prorating deductions. MTC Regs. IV.1.(d).

[4] MTC Reg. IV.2.(c)(2).

[5] MTC Reg. IV.10.(c)(1).

[6] MTC Reg. IV.10.(c)(2).

[7] MTC Reg. IV.15.(a)(3), (4). The MTC payroll regulation does not have consistency requirements.

[8] Cal. Code Regs. tit. 18, §§25121(e), 25129(c), and 25134(a)(3).

[9] Cal. Code Regs. tit. 18, §25132(a)(5). The payroll factor year-to-year consistency regulation provides: ''In filing returns with this state, if the taxpayer departs from or modifies the treatment of compensation paid used in returns for prior years,

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adopted disclosure regulations that are very similar to California's regulations.[10] It should be noted that the MTC model regulation, and the disclosure regulations adopted by the states that mirror the MTC regulation, do not explicitly provide for a penalty in the event that disclosure is not made. Rather, penalties may be imposed by each state under general statutory provisions.[11]

Other states have adopted some, but not all, of the uniform disclosure requirements. A Florida regulation combines the MTC's year-to-year consistency requirements for the property and sales factors.[12] In addition, Florida's regulation adopts a year-to-year consistency requirement for the payroll factor that is similar to California's regulation, but does not include income classification or state-to-state consistency requirements.[13] Hawaii and Kansas have adopted the uniform year-to-year and state-to-state consistency requirements for income classification and the property factor, but have not adopted other consistency requirements.[14] Oregon, which is a single-sales factor apportionment state, has not adopted consistency requirements for the sales factor, but it has adopted the MTC's model regulation concerning consistency in income classification.[15]

States Adopting Different Requirements

Among the states that have adopted consistency disclosure regulations different from the MTC's model regulations is North Carolina. For example, North Carolina's sales factor regulation provides ''[i]n including or excluding gross receipts, the taxpayer shall be consistent in the treatment of such gross receipts in filing returns with this state.''[16] The regulation requires that ''[i]n the event the taxpayer is not consistent in its reporting, it shall disclose in its return to this state the nature and extent of the inconsistency.'' North Carolina has similar regulations for the property factor, payroll factor, and the classification of income as apportionable or nonapportionable income.[17] The regulations appear to combine the year-to-year consistency and state-to-state consistency tests. Other states, including Indiana[18] and Maine,[19] also have unique regulations requiring consistency in reporting. Again, none of these states' regulations specifically imposes a penalty on the failure to follow the consistency disclosure regulations, though general statutory penalties could be imposed.

To date, Massachusetts has been the boldest in requiring disclosure of inconsistent filing positions beyond the MTC's model regulations.[20] The statute, enacted in late 2005, defines the term ''inconsistent position'' as a situation in which: ''(i) the governing law in another state in which the taxpayer files a return is the same in all material respects as the law in Massachusetts; and (ii) if the taxpayer had interpreted Massachusetts law as it interpreted the law of the other state in filing its return in such state, the taxable income attributed to Massachusetts would have been greater.''[21] The penalty for failure to disclose an inconsistency is equal to the amount of tax attributable to the inconsistency, in

the taxpayer shall disclose in the return for the current year the nature and extent of the modification.'' The payroll factor state-to-state consistency regulation provides: ''If the returns or reports filed by the taxpayer with all states to which the taxpayer reports under the Uniform Division of Income for Tax Purposes Act are not uniform in the treatment of compensation paid, the taxpayer shall disclose in its return to this state the nature and extent of the variance.''

[10] Ariz. Admin. Code r. 15-2D-508, 15-2D-607, 15-2D-705 and 15-2D-807; Mo. Code Regs. Ann. tit. 12, §10-2.075(13), (22), (38) and (44).

[11] For example, a state tax authority may consider the failure to submit required information to result in the failure to file a complete return. California imposes penalties for a taxpayer's failure or refusal to furnish information to the Franchise Tax Board, as well as the failure to file a tax return. Cal. Rev. & Tax. Code §§19133, 19701.

[12] Fla. Admin. Code Ann. r. 12C-1.015(6).

[13] *Id*.

[14] Haw. Admin. Rule §§18-235-22-05, 18-235-30-03; Kan. Admin. Regs. §92-12-79, 92-12-86.

[15] Or. Admin. R. 150-314.615-(A).

[16] N.C. Admin. Code tit. 17, r. 05C.1002.

[17] N.C. Admin. Code tit. 17, r. 05C.0701, 05C.0803 and 05C.0902.

[18] In Indiana, a property factor regulation provides: ''[i]n filing returns with this state, the taxpayer's valuation and treatment of property as business or nonbusiness property must be consistent from year to year. It must also be consistent with the taxpayer's treatment of such property for purposes of returns filed with other states having apportionment statutes and regulations substantially similar to Indiana's. If the taxpayer's Indiana returns are not consistent in these respects, the returns should disclose the nature and extent of the inconsistency.'' Ind. Admin. Code tit. 45, r. 3.1-1-42. The payroll and sales factor regulations require that these factors be consistent in the manner described in the property factor regulation. Ind. Admin. Code tit. 45, r. 3.1-1-47, 3.1-1-50.

[19] In Maine, where taxpayers use a single sales apportionment factor, ''[t]he taxpayer must disclose in its Maine return the nature and extent of any inconsistency between that return and its Maine returns for prior years with respect to the composition of its unitary business, the classification of income, the prorating of deductions to business and constitutionally exempt income, and the determination of the sales apportionment factor.'' Code Me. R. §801(05)(A). Also, ''[i]f the returns filed by a taxpayer for all states to which the taxpayer reports are not uniform in the composition of its unitary business, the classification of income, the prorating of deductions to business and constitutionally exempt income, and the determination of the sales apportionment factor, the taxpayer must disclose in its Maine return the nature and extent of the variance.'' Code Me. R. §801(05)(B).

[20] It should be noted that the MTC considered adopting a Model Compilation of State Tax Return Data Statute, under which taxpayers would have been required to report certain data as it was filed in the other states in which the taxpayer does business. This ''51-state spreadsheet'' would have included reporting on filings, business income, nonbusiness income, apportionment factors, and the composition of the combined group. The taxpayer could elect to file copies of all state tax returns in each state in lieu of the above spreadsheet. The MTC ultimately did not adopt the model statute. Montana also attempted to impose broad disclosure requirements, under which for tax years ending after Dec. 31, 2004, all Montana taxpayers with multistate activity satisfying a $2 million net worth (individual) or $10 million gross receipts (corporate) requirement would have been required to disclose ''the filing position taken in the income tax return of each state with respect to business income, nonbusiness income, apportionment and allocation of income, and combined reporting.'' 2005 Mont. H.B. 973, §5(2)(a). Likewise, this provision, which was accompanied by significant penalties for noncompliance, was not enacted.

[21] Mass. Gen. Laws ch. 62C, §35D(a), (b).

addition to any other penalties that may be imposed (subject to abatement for reasonable cause).[22]

OREGON TAX COURT: CONSISTENCY IN REPORTING

While many states have pursued the goal of consistency and uniformity in corporate income tax reporting through the enactment of UDITPA, few court opinions actually have addressed the state mandates discussed above. However, the Oregon Tax Court recently provided some valuable insight into these issues. In *Oracle Corp. v. Oregon Dept. of Rev.*, the court issued an interim order denying a motion for partial summary judgment requested by the Oregon Department of Revenue that involved the issue of consistency in reporting the classification of income as business or nonbusiness income in UDITPA states.[23]

In this case, the taxpayer was a large software company that generated significant gains from selling stock and corporate assets. The taxpayer treated these gains as nonbusiness income in Oregon, and business income in California, the taxpayer's state of domicile. The department audited the taxpayer, disputing the nonbusiness income classification, and challenging the presumably inconsistent nature of the taxpayer's reporting in Oregon and California.

Department's Assertion of Duty Of Uniform Reporting

In *Oracle*, the department claimed that a duty of uniform reporting exists in all jurisdictions that use UDITPA, which was created with the goal of uniformity. In asserting the duty of uniform reporting, the department noted that Oregon and California have almost identical definitions of business income,[24] with immaterial differences. The department cited to Oregon Supreme Court precedent[25] and the fact that Oregon joined the Multistate Tax Compact to show that the state was supportive of uniformity efforts. In the department's view, taxpayers that take inconsistent positions in different states on the same income item thwart the goal of uniformity. In contrast, the taxpayer argued that the California and Oregon conceptions of business and nonbusiness income do differ, even though the actual statutes both track UDITPA language. As a result, the position that the taxpayer took in California should not control the position taken in Oregon.

The department argued that Oregon has an administrative rule based on the MTC model regulation that requires a taxpayer to disclose on its Oregon tax return any differences in business or nonbusiness reporting in UDITPA states.[26] Because the taxpayer did not comply with the disclosure rule, the taxpayer violated the duty of consistency by reporting that the income from the sale of the stock and assets was business income in California and nonbusiness income in Oregon. The department did not cite any authority regarding application of the administrative rule. The taxpayer responded by challenging the rule as not relevant or valid when the taxpayer properly followed the laws in other states, and the taxpayer also claimed that while being audited, it informed a department employee of the business income position taken in California.

As a result of the taxpayer's violation of the duty of consistency, the department stated that under the doctrine of estoppel, the taxpayer could not claim that the gains from the sale of stock and assets were classifiable as nonbusiness income in Oregon. The department based its estoppel argument on a series of federal income tax cases that require a taxpayer to treat a tax item in a consistent manner as the taxpayer treated such item in a year barred by the statute of limitations when the treatment of such item is not in doubt.[27] The department requested that the court apply a duty of uniform reporting in UDITPA cases, similar to the federal income tax duty of consistency. The taxpayer argued that the duty of consistency was limited to specific federal tax matters and did not deal with positions taken in different states.

Oregon Tax Court's Analysis

The Oregon Tax Court rejected the department's request for an equitable doctrine that would achieve the goal of uniformity. While UDITPA was created with the goal of uniformity, the court stated, this is an aspirational goal that does not equate to law. The court refused to determine whether California and Oregon truly have the same or similar definitions of business income, and cited several practical reasons for rejecting the department's request. The court said that approving the request would require the court to become expert in the laws of all the other states with respect to the definition and treatment of business and nonbusiness income. In addition, granting the department's request would compromise the notion of federalism and states' rights. A judicially fashioned doctrine of equitable estoppel would, in the court's view, ''produce illogical and unworkable results.''

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[22] Mass. Gen. Laws ch. 62C, §35D(c).

[23] *Oracle v. Oregon Dept. of Rev.*, TC-MD 070762C (Or. Tax Ct., Magistrate Division, Feb. 11, 2010).

[24] California's definition of business income is at Cal. Rev. & Tax. Code §25120(a). Oregon's definition of business income is at Or. Rev. Stat. §314.610(1).

[25] *Twentieth Century-Fox Film v. Oregon Dept. of Rev.*, 700 P.2d 1035 (Or. 1985).

[26] Or. Admin. R. 150-314.615-(A).

[27] Oregon courts have stated that the equitable doctrine of estoppel generally requires the satisfaction of the following elements: (1) there must be a false representation; (2) it must be made with knowledge of the facts; (3) the other party must have been ignorant of the truth; (4) it must have been made with the intention that it should be acted upon by the other party; and (5) the other party must have been induced to act upon it. See *Donahoe v. Eugene Planing Mill*, 450 P.2d 762 (Or. 1969), citing *Earls et ux. v. Clarke et al.*, 355 P.2d 213 (Or. 1960). Oregon courts have recognized the potential application of estoppel in tax cases, particularly where consistency in stated positions are involved. Historically, Oregon courts proclaimed that a taxpayer ''generally has been required to be consistent in his theories.'' *Industrial Air Products Co. v. Oregon Tax Comn.*, Multnomah County Court, Nov. 21, 1962, citing Atlas, ''The Doctrine of Estoppel in Tax Cases,'' 3 Tax L. Rev. 71. The doctrine has been applied by courts against tax authorities in limited circumstances. *Johnson v. Oregon Tax Comn.*, 435 P.2d 302 (Or. 1967). In noting the federal tax case law requiring consistency in reporting, the department cited a treatise to support this proposition. 15 *Mertens Law of Federal Income Taxation* §60:05.

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While UDITPA was created with the goal of uniformity, the court stated, this is an aspirational goal that does not equate to law.

The tax court noted that if pure uniformity and consistency were required, there would be conflicts between states over whether both states should treat the income as business or nonbusiness income. The court observed that this issue needed to be determined by each state, not by a judicial doctrine that would require a state to treat the issue in a manner inconsistent with its own laws. The court also noted that situations could arise under which a taxpayer took a controversial position in Oregon that complied with uniformity and consistency in other UDITPA states, and the department could be prevented from recharacterizing the taxpayer's position in Oregon, unless it resorted to its powers of equitable apportionment.[28]

In declining to grant partial summary judgment to the department, the court noted that even though the taxpayer did not disclose the differential treatment of the income in California and Oregon (until its disclosure of the information to a department employee), there are no legal sanctions for failing to timely make such disclosure. Further, the court agreed with the taxpayer that the department's estoppel argument based on a violation of a duty of consistent reporting has only been used in certain federal contexts, and should not be extended to state tax cases involving the same tax year.

CONCLUSION

Taxpayers should consider the potential risk of not properly disclosing inconsistencies in income classification or apportionment factors in states that have a disclosure requirement. The MTC model regulations require disclosure, but they do not specify any particular course of action if the disclosure requirements are not satisfied. Similarly, states do not provide a particular course of action if a taxpayer fails to disclose any inconsistencies in its income classification or apportionment factors. However, state tax authorities have the ability to impose statutory civil penalties on taxpayers that do not follow filing requirements, or otherwise challenge the taxpayer's change in income classification or apportionment, particularly if a taxpayer's change results in an overall reduction in tax liability.

Equally puzzling is that there is very little guidance on how to disclose state-to-state or year-to-year inconsistencies or changes in the reporting of income characterization or of apportionment methodologies. It is unclear as to whether a statement attached to the return would suffice, and if so, what information would need to be included in such statement. Further, if different states require a taxpayer to characterize income or compute apportionment factors differently (by statute, regulation or other administrative or common law guidance), is the taxpayer really making an inconsistent filing, or is the taxpayer properly complying with inconsistent laws?

The Oregon Tax Court's take on these issues in its intriguing ruling is noteworthy on a number of fronts. The order addresses the UDITPA goal of uniformity as just that, a goal, not an ironclad common law equitable requirement. The court also declined the invitation to determine whether the rules of Oregon and California (or any other state for that matter) were sufficiently similar to require disclosure, showing the hesitancy inherent in the judiciary to become experts in subjects beyond their jurisdiction. Finally, the court gave short shrift to a provision contained in regulatory guidance requiring that a taxpayer disclose inconsistent filing positions in different states, by emphasizing that there is no penalty attached to the failure of a taxpayer to timely comply with the disclosure requirement. It should be noted that with the states' inclination towards penalties, this may change.

Is the taxpayer really making an inconsistent filing, or is the taxpayer properly complying with inconsistent laws?

The interim order gives interesting guidance to similarly situated taxpayers who are concerned about taking nonuniform positions from state to state in the areas of business/nonbusiness income, addition and subtraction modifications, filing methods and apportionment factor inclusions, exclusions and sourcing methods, even when the laws of different states warrant such conclusions. While the interim order issued by the Oregon Tax Court cannot be appealed at this time, the issues that were decided in the order ultimately could be the subject of an appeal by the department if the tax court ultimately finds for the taxpayer in this case.

[28] *See* Or. Rev. Stat. § 314.670. The court also stated that the validity of the equitable apportionment statute itself could be called into question under a pure uniformity and consistency requirement.

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