Multistate Corporate Tax Course

2009 EDITION

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MODULE 1: STATE CORPORATE INCOME TAXES — CHAPTER 1

Basic Principles of Multistate Corporate Income Taxation

This chapter discusses the basic principles involved in multistate corporate income taxation, including nexus, apportionment, combined and consolidated reporting, and tax-planning strategies.

LEARNING OBJECTIVES

Upon completing this chapter, the student will:

- Understand which activities of a multistate corporation can create nexus
- Understand how state taxable income is generally calculated
- Be familiar with apportionment formulas and how they vary by states
- Be able to contrast the difference between consolidated returns and unitary reporting
- Understand how the states stand on the issue of consolidated returns and unitary reporting
- Be familiar with multistate tax-planning strategies

INTRODUCTION

Forty-six states and the District of Columbia impose some type of income-based tax on corporations. Nevada, South Dakota, Washington, and Wyoming do *not* levy a corporate income tax.

The corporate income taxes of California, Florida, New York, and a number of other states are formally franchise taxes imposed on, for example, the privilege of doing business in the state. Because the value of the franchise tax is measured by the income derived from that privilege, the tax is computed in essentially the same manner as a direct income tax.

Although many states closely link their corporate tax to the federal income tax, some states impose other types of corporate taxes in lieu of a net income tax.

EXAMPLE

The State of Washington does not have a corporate income tax, but it does impose a gross receipts tax called the *business and occupations tax*.

From 2005 to 2009, Ohio is phasing in a gross receipts tax, called the *commercial activity tax*, as a replacement for its corporate franchise tax on income or net worth.

In 2007, Texas replaced its corporate franchise tax on capital and earned surplus with a tax on gross margin, called the *margin tax*.

Likewise, Michigan recently repealed its *single business tax* (a type of value-added tax), and replaced it with a net income tax and a modified gross receipts tax which takes effect in 2008.

NEXUS

Constitutional Nexus

A threshold issue for any corporation operating in more than one state is determining the states in which it must file returns and pay income tax. A state has jurisdiction to tax a corporation organized in another state *only* if the out-of-state corporation's contacts with the state are sufficient to create nexus.

Historically, states have asserted that virtually any type of in-state business activity creates nexus for an out-of-state corporation. This approach reflects the reality that it is politically more appealing to collect taxes from out-of-state corporations than to raise taxes on in-state business interests. The desire of state lawmakers and tax officials to, in effect, export the local tax burden is counterbalanced by the Due Process Clause and Commerce Clause of the U.S. Constitution, both of which limit a state's ability to impose a tax obligation on an out-of-state corporation.

The most recent landmark case regarding constitutional nexus is ***Quill Corp. v. North Dakota*** [504 US 298 (1992)]. Quill was a mail-order vendor of office supplies that solicited sales through catalogs mailed to potential customers in North Dakota and that made deliveries through common carriers. Quill was incorporated in Delaware and had facilities in California, Georgia, and Illinois.

Quill did not have an office, warehouse, retail outlet, or other facility in North Dakota, nor were any of its employees or representatives physically present in North Dakota. During the years in question, Quill made sales to roughly 3,000 North Dakota customers and was the sixth largest office supply vendor in the state. Under North Dakota law, Quill was required to collect North Dakota sales tax on its mail-order sales to North Dakota residents. Quill challenged the constitutionality of this tax obligation.

The Supreme Court held that Quill's economic presence in North Dakota was sufficient to satisfy the Due Process Clause's "minimal connection" requirement. On the other hand, the Court ruled that an economic presence was not, by itself, sufficient to satisfy the Commerce Clause's "substantial nexus" requirement.

Consistent with its ruling 25 years earlier in ***National Bellas Hess, Inc. v. Department of Revenue*** [386 US 753 (1967)], the Court ruled that a substantial nexus exists *only* if a corporation has a nontrivial physical presence in a state. In other words, the Court ruled that a physical presence is an essential prerequisite to establishing constitutional nexus, at least for sales tax purposes.

The Court did not address the issue of whether the physical presence test also applied for income tax purposes. Many states assert that a physical presence is not a requirement for income tax nexus, and that a significant economic presence is sufficient to create income tax nexus. This "economic nexus" issue has been the subject of extensive litigation, and state courts have issued conflicting rulings.

The highest courts in several states have ruled that the ***Bellas Hess*** physical presence test does *not* apply to income taxes [e.g., ***Geoffrey, Inc. v. South Carolina Tax Commission***, 437 S.E.2d 13 (S.C. 1993); and ***Lanco, Inc. v. Division of Taxation***, 908 A.2d 176 (N.J. 2006)]. However, appellate courts in several other states have come to the opposite conclusion.

Public Law 86-272

Congress enacted Public Law (P.L.) 86-272 in 1959 to provide multistate corporations with a limited safe harbor from the imposition of state income taxes.

Specifically, P.L. 86-272 *prohibits* a state from imposing a "net income tax" on a corporation organized in another state if the corporation's only in-state activity is:

1. Solicitation of orders by company representatives
2. The sale of tangible personal property
3. Orders sent outside the state for approval or rejection, if approved
4. Filled by shipment or delivery from a point outside the state

Although P.L. 86-272 can provide significant protections for a multistate business, it has several important limitations:

1. It applies *only* to a net income tax and, therefore, provides no protection against the imposition of a sales tax collection obligation, gross receipts taxes (e.g., Washington business and occupations tax or Ohio commercial activity tax), or state franchise taxes imposed on a base other than income (e.g., Pennsylvania capital stock tax).
2. It protects only the *sale* of tangible personal property. It does not protect activities such as leasing tangible personal property, selling services, selling or leasing real estate, or selling or licensing intangibles.
3. For businesses that send employees into other states to sell tangible personal property, P.L. 86-272 applies only if those employees limit their in-state activities to the solicitation of orders that are sent outside the state for approval and, if approved, are filled by shipment or delivery from a point outside the state.

EXAMPLE

If a salesperson exercises the authority to approve orders within a state, the company does *not* qualify for protection under P.L. 86-272.

Likewise, P.L. 86-272 does *not* protect the presence of a salesperson who performs non-solicitation activities, such as repairs, customer training or technical assistance, within a state.

Although P.L. 86-272 does not define the phrase "solicitation of orders," the meaning of the phrase was addressed by the Supreme Court in ***Wisconsin Department of Revenue v. William Wrigley, Jr., Co.*** [505 US 214 (1992)].

In this case, the Court defined solicitation of orders as encompassing "requests for purchases" as well as "those activities that are entirely ancillary to requests for purchases—those that serve no independent business function apart from their connection to the soliciting of orders."

Examples of activities that might serve an independent business function, apart from the solicitation of orders, include:

- Installation and start-up
- Customer training
- Engineering and design assistance
- Technical assistance
- Warranty maintenance and repair
- Credit and collection activities

STUDY QUESTIONS

1. Which of the following states do ***not*** impose some type of income-based tax on corporations?

a. Alabama
b. California
c. Florida
d. South Dakota

2. Which of the following is ***not*** a limitation of P.L. 86-272?

a. It applies only to a net income tax.
b. It protects only sales of tangible personal property.
c. For businesses that send employees into other states to sell tangible personal property, P.L. 86-272 applies only if those employees limit their in-state activities to the solicitation of orders that are approved out-of-state and are filled by shipment or delivery from a point outside the state.
d. None of the above.

COMPUTATION OF STATE TAXABLE INCOME

Most states that impose a corporate income tax use either the corporation's federal taxable income before the net operating loss and special deductions (federal Form 1120, Line 28), or the corporation's net federal taxable income (federal Form 1120, Line 30) as the starting place for computing state taxable income.

The states that impose income taxes but do not tie the computation of state taxable income directly to a corporation's federal tax return typically adopt the majority of the federal provisions governing items of gross income and deduction in defining the state tax base.

A corporation's state income tax liability generally is computed using the following steps:

1. Compute the state tax base:

   Federal taxable income (Line 28 or Line 30 of the federal corporate income tax return, Form 1120) +/- State addition/subtraction modifications

2. If applicable, compute the total apportionable income (loss):

   State tax base +/- Net amount of allocable nonbusiness income (loss)

3. Determine the income (loss) apportioned to the state:.

   Total apportionable income (loss) x State's apportionment percentage

4. If applicable, compute the state taxable income (loss):

   Net amount of nonbusiness income (loss) allocated to the state +/- Income apportioned to the state

5. Determine the state tax liability before credits:

   State taxable income x State tax rate

6. Compute the net income tax liability for the state:

   State tax liability - State's tax credits

The use of the federal tax base as the starting point for computing state taxable income is referred to as *piggybacking*. Conformity with federal provisions simplifies tax compliance for multistate corporations, but complete conformity with the federal tax laws would effectively cede control over state tax policy to the federal government. States also must be wary of the effects of federal tax law changes on state tax revenues.

Therefore, although federal taxable income generally is used as the starting point in computing state taxable income, numerous state modifications are required to reflect differences in federal and state policy objectives. The modifications to federal taxable income vary significantly among the states.

Common state modifications include the following:

- Interest income received on state and municipal debt obligations
- State income taxes
- Federal net operating loss carryforward deductions
- Federal dividends-received deductions
- Federal bonus depreciation under Internal Revenue Code ("the Code") Sec. 168(k)
- Royalties and interest expenses paid to related parties
- Expenses related to state tax credits
- Federal domestic production activities deduction under Code Sec. 199
- Expenses related to income that is exempt for state tax purposes

Common subtraction modifications include the following:

- Interest income received on federal debt obligations
- State net operating loss deductions
- State dividends-received deductions
- Expenses related to federal tax credits
- Federal Subpart F and Code Sec. 78 gross-up income with respect to foreign subsidiaries

Distinction Between Business and Nonbusiness Income

In 1957, the National Conference of Commissioners on Uniform State Laws promulgated the Uniform Division of Income for Tax Purposes Act (UDITPA), which is a model law for dividing the income of a multistate corporation among the states for tax purposes. The purpose of UDITPA is to promote uniformity in state allocation and apportionment rules. UDITPA has been adopted, at least in part, by most states.

UDITPA distinguishes between income derived from a corporation's regular trade or business activities (*business income*) and income derived from any activities that are unrelated to that trade or business (*nonbusiness income*). Under the UDITPA approach, a taxpayer apportions a percentage of its business income to each state in which it has nexus, but the taxpayer specifically allocates the *entire* amount of any *non*business income to a single state [UDITPA §§4 and 9].

Therefore, the principal consequence of classifying an item as nonbusiness income is that the income is excluded from the tax base of every nexus state *except* the state in which the nonbusiness income is taxable in full (e.g., the state of commercial domicile). Because the classification of an item as nonbusiness income can effectively remove the income from the tax base of one or more nexus states, the business versus nonbusiness income distinction has historically been an area of significant controversy between taxpayers and state tax authorities.

The distinction between business and nonbusiness income is related to the constitutional restrictions on the ability of a state to tax an out-of-state corporation. Based on these constitutional protections, taxpayers have challenged the ability of nexus states to tax an item of income that, according to the taxpayer, has no relationship to the business activity conducted in the state.

As the Supreme Court stated in ***Allied-Signal, Inc. v. Division of Taxation*** [504 US 768 (1992)], "the principle that a State may not tax value earned outside its borders rests on the fundamental requirement of both the Due Process and Commerce Clauses that there be 'some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.' ***Miller Bros. Co. v. Maryland*** 347 US 340, 344-345 (1954)."

EXAMPLE

The taxpayer in ***Mobil Oil Corp. v. Commissioner of Taxes*** [445 US 425 (1980)] was an integrated petroleum company that was incorporated and commercially domiciled in New York. Mobil challenged Vermont's ability to tax the dividends that it received from its foreign subsidiaries.

The essence of Mobil's argument that Vermont could *not* constitutionally tax the foreign dividends was that the activities of the foreign subsidiaries were unrelated to Mobil's business activities in Vermont, which were limited to marketing petroleum products. Stating that "the linchpin of apportionability in the field of state income taxation is the unitary business principle," the Supreme Court ruled that Vermont could tax an apportioned percentage of the dividends Mobil received from its foreign subsidiaries, because those subsidiaries were part of the same integrated petroleum enterprise as its distribution activities in Vermont. In other words, because they were received from unitary subsidiaries, the dividends were includible in Mobil's apportionable business income.

The Court also indicated that if the business activities of the foreign subsidiaries had "nothing to do with the activities of the recipient in the taxing state, due process considerations might well preclude apportionability, because there would be no underlying unitary business."

In ***Allied-Signal***, a Delaware corporation that had nexus in New Jersey and was commercially domiciled in Michigan realized a $211.5 million capital gain from the sale of 20.6 percent of the stock of ASARCO. During the tax year in question, New Jersey was a so-called "full apportionment" state--that is, New Jersey took the position that all income of a corporation that had nexus in New Jersey was apportionable business income.

Under this approach, New Jersey was entitled to tax an apportioned percentage of the capital gain. The Supreme Court held that New Jersey could not include the gain in apportionable business income, because the taxpayer and ASARCO were "unrelated business enterprises whose activities had nothing to do with the other." Furthermore, the taxpayer's ownership of the ASARCO stock did not serve an "operational rather than an investment function" in the taxpayer's business.

Thus, in ***Allied-Signal***, the Supreme Court reaffirmed the principle that income derived from unitary subsidiaries is business in nature. In addition, the Court appeared to create a second category of business income, that is, income derived from a nonunitary payer where the asset serves an operational rather than investment function.

On April 15, 2008, the U.S. Supreme Court handed down its ruling in ***MeadWestvaco Corporation v. Illinois Department of Revenue*** [U.S. Supreme Court, Dkt. 06-1413, 553 U.S. ___ (2008)]. The issue in this case was whether Illinois could tax an apportioned share of a $1 billion gain realized by an Ohio corporation when it sold its investment in one of its business divisions. An Illinois appeals court ruled that the gain did qualify as apportionable business income because the division served an operational function in the taxpayer's business.

However, the Supreme Court vacated the Illinois appeals court decision on the grounds that it misinterpreted the Court's references to "operational function" in ***Allied-Signal*** as modifying the unitary business principle to add a new basis for apportionment. The Court explained that the operational function concept described in ***Allied-Signal*** merely recognizes the reality that an asset can be part of a taxpayer's unitary business even if there is no unitary relationship between the payee (taxpayer) and payer (asset).

Each state is free to adopt its own definitions of business and nonbusiness income, subject to the constitutional constraints discussed above. Most states have adopted a definition of nonbusiness income that more or less conforms to the UDITPA definition of nonbusiness income, which is "all income other than business income." [UDITPA §1(e)] Thus, the key is the definition of business income.

According to UDITPA §1(a), *business income* is defined as:

> 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.

In determining whether an item of income is business or nonbusiness in nature, state courts have arrived at different conclusions as to whether the UDITPA definition of business income includes both a *transactional test* (i.e., "income arising from transactions and activity in the regular course of the taxpayer's trade or business") and a *functional test* (i.e., "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"), or just a transactional test.

The transactional test looks at the frequency and regularity of the income-producing transaction in relation to the taxpayer's regular trade or business. The critical issue is whether the transaction is frequent in nature, as opposed to a rare and extraordinary event.

In contrast, the *functional test* looks at the relationship between the underlying income-producing asset and the taxpayer's regular trade or business. The critical issue is whether the asset is integral, as opposed to incidental, to the taxpayer's business operations.

The view that the UDITPA definition of business income includes both a transactional test and a functional test, and that an item of income is properly classified as business in nature if either test is met, is supported by state supreme court decisions in California, Illinois, North Carolina, Oregon, and Pennsylvania.

On the other hand, state supreme court decisions in Alabama, Iowa, Kansas, Minnesota and Tennessee support the view that the UDITPA definition contains only a transactional test and that an item of income is nonbusiness income. In each instance, however, the state supreme court decision interpreting the statutory definition of business income to include only a transactional test was followed by a legislative change to broaden the applicable statute to include both a transactional and a functional test. In 2003, the Multistate Tax Commission (MTC) amended MTC Reg. IV.1(a) to provide that business income means income that meets either the transactional test or the functional test.

When an item of income is determined to be nonbusiness income, most states allocate the income to a specific state under guidelines similar to §4 through §8 of UDITPA and the related MTC regulations. The basic thrust of these rules is that nonbusiness income derived from real and tangible personal property is allocable to the state in which the property is physically located, whereas nonbusiness income derived from intangible property is allocable to the state of commercial domicile (except for royalties, which are allocable to the state where the intangible asset is used).

STUDY QUESTIONS

3. Which of the following is an advantage of state conformity to federal tax provisions?

a. It simplifies tax compliance for multistate corporations.
b. Federal tax law changes affect state tax revenues.
c. Complete conformity with federal tax laws would effectively cede control over state tax policy to the federal government.
d. None of the above.

4. Which of the following is ***not*** a true statement regarding UDITPA?

a. UDITPA was promulgated to provide uniformity among the states with respect to the taxation of multistate corporations.
b. Under the UDITPA approach, a taxpayer apportions a percentage of its business income to each state in which it has nexus.
c. UDITPA makes no distinction between business and nonbusiness income.
d. All of the above are true statements.

APPORTIONMENT FORMULAS

A taxpayer's right to apportion its income is neither automatic nor elective; rather, it is a privilege that must be warranted by the corporation's activities. The requirements for establishing the right to apportion income vary from state to state, but they generally include:

- Carrying on business in another state
- Maintaining a regular place of business in another state
- Being taxable in another state

Some states take the restrictive position that permits apportionment only if the corporation is actually filing returns and paying tax in another state.

Once a corporation has established its right to apportion income, the next step is to compute the applicable state apportionment percentages using the formulas provided by each taxing state. These formulas are usually based on the relative amounts of property, payroll, and/or sales that the corporation has in each taxing state. They reflect the notion that a corporation's business activity in a state is properly measured by the amount of property, payroll, and sales in the state. These three components of an apportionment formula are referred to as "factors." For any given state, each factor equals the ratio of the corporation's property, payroll or sales in the state to its property, payroll or sales everywhere.

Factor weights vary from state to state. At present, approximately 10 states use a three-factor apportionment formula that equally weights sales, property, and payroll. Most states use a modified three-factor formula, under which the sales factor is assigned more weight than the property or payroll factors. About 20 states double-weight the sales factor (i.e., 50 percent sales, 25 percent property, and 25 percent payroll).

In the 2008 tax year, 10 states use an apportionment formula that includes only a sales factor. These states include Georgia, Illinois, Iowa, Maine, Michigan, Nebraska, New York, Oregon, Texas, and Wisconsin.

In addition, Indiana and Minnesota have enacted legislation to adopt a *sales-only formula*, effective in 2011 and 2014, respectively. Other states that super-weight the sales factor include Ohio (60 percent weight), and Pennsylvania (70 percent weight).

Assigning more weight to the sales factor than to the property or payroll factor tends to increase the percentage of an out-of-state corporation's income that is subject to tax, because the out-of-state corporation's principal activity in the state—the sale of its products—is weighted more heavily than its payroll and property activities. At the same time, assigning more weight to the sales factor tends to reduce the tax on in-state corporations that have significant amounts of property and payroll in the state (factors that are given relatively less weight in the apportionment formula), but who make sales nationwide.

The standard three-factor formula was designed to apportion the income of multistate manufacturing and mercantile businesses, but it may not fairly apportion the income of businesses in other industries. To address this issue, many states provide special rules for computing apportionment percentages for businesses in certain industries. Typically, these special rules involve the modification or exclusion of the conventional factors or the use of unique, industry-specific factors.

EXAMPLE

Industries for which states provide special apportionment factor rules include airlines, railroads, trucking companies, financial institutions, television and radio broadcasters, publishers, telecommunication services companies, mutual funds, pipelines, ship transportation companies, and professional sports franchises.

In theory, apportionment prevents double taxation of a corporation's income. However, because each state is free to choose its own apportionment formula and its own rules for computing the factors, apportionment does not provide a uniform division of a taxpayer's income among the taxing states. There are significant differences among the states in terms of factor weights, as well as variations in the computation of the factors themselves.

Potentially Adverse Consequences of Apportionment, and Relief

This diversity can result in more than 100 percent of a corporation's income being subject to state taxation. Another potentially adverse consequence of apportionment occurs when a taxpayer's operations in one state result in a loss, but the corporation's overall operations are profitable. In such cases, the apportionment process will assign a percentage of the corporation's overall profit to the state in which the loss was incurred, even though no profit was generated by the taxpayer's operations in that state.

To address these issues, UDITPA §18 and the tax laws of most states allow a corporate taxpayer to petition for relief when the application of the state's apportionment formula does not fairly represent the taxpayer's business activity in the state.

In such situations, UDITPA §18 lists several possible alternatives to the standard formula, including the use of separate accounting, the exclusion of one or more factors, the inclusion of one or more additional factors, or some other method that provides a more equitable apportionment of the taxpayer's income.

Case law indicates that there is a presumption that a state's apportionment method is equitable. As a consequence, to receive relief from distortions caused by the state's standard formula, a corporation must prove by clear and convincing evidence that the apportionment method in question grossly distorts the amount of income actually earned in the state.

Sales Factor

Under UDITPA §15, the sales factor is a fraction whose numerator is the total sales of the taxpayer in the state during the tax period and whose denominator is the total sales of the taxpayer everywhere during the tax period. Because the sales factor is used to apportion a corporation's business income, only sales that generate apportionable business income are includible in the fraction. Nonbusiness sales are excluded from the sales factor.

Under UDITPA §1(g), the term *sales* means all gross receipts of the taxpayer other than receipts related to nonbusiness income. Consistent with this expansive view of the sales factor, MTC Reg. IV.15(b) provides that the sales factor generally includes all gross receipts derived by the taxpayer from transactions and activities in the regular course of its trade or business.

EXAMPLE

Examples of gross receipts that are included in the sales factor are gross receipts from sales of inventory or services, as well as interest, dividends, rentals, and royalties derived from other business assets and activities.