

Multistate Income Taxation

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Describe the major types of taxes imposed by state and local governments.
2. Distinguish between the types of in-state activities that create nexus for an out-of-state company, and those in-state activities that do not establish nexus.
3. Explain the differences between group reporting requirements for financial reporting, federal income tax, and state income tax purposes.
4. Describe the formula for calculating a corporation's state income tax, including the common adjustments to federal taxable income in computing state taxable income.
5. Compute state apportionment percentages, including the calculation of the sales, property, and payroll factors.
6. Distinguish between the allocation of nonbusiness income and the apportionment of business income.
7. Understand the tax treatment of resident and nonresident owners of multistate partnerships, S corporations, and limited liability companies.
8. Recognize basic multistate tax planning issues.

INTRODUCTION TO STATE TAXATION

Overview

This chapter focuses on how states tax the income of business enterprises, including regular corporations, S corporations, partnerships, and limited liability companies. Individual and corporate income taxes are by no means the only sources of state and local tax revenues, however. As Table 1 indicates, the federal government relies primarily on the individual income tax and Social Security taxes, whereas state and local governments rely on a more diverse set of tax revenues. States rely primarily on the sales tax and individual income tax, while counties, cities, and other local governments rely mainly on the property tax.

OBJECTIVE 1:

Describe the major types of taxes imposed by state and local governments.

Table 1: Tax Collections by Type, 2017¹
(billions of dollars)

	Federal	State and Local
Individual income taxes	\$1,481	\$405
Social Security taxes	\$1,120	
Corporate income taxes	\$294	\$53
Property taxes		\$573
General sales taxes		\$386

Sources: 2017 IRS Data Book and U.S. Census Bureau

Sales and Use Taxes

Forty-five states impose sales taxes. The exceptions are Alaska, Delaware, Montana, New Hampshire, and Oregon. State sales tax rates generally range from 4 to 7 percent (see Table 2). Counties and cities also impose add-on sales taxes, increasing the overall sales tax rates on transactions occurring within the local jurisdiction. A sales tax generally is imposed on the gross receipts from retail sales or leases of tangible personal property. A desirable feature of a sales tax is that consumers need not file an annual return in order to pay the tax. Instead, retailers are responsible for collecting and remitting the tax to the state and local tax authorities.

¹ Detailed state-by-state tax data can be found at www.census.gov/programs-surveys/ntax.html.

A variety of items are usually exempt from sales tax, including sales of real property, intangible property, and most services. Each state taxes selected services, however, such as lodging, telecommunications, printing, landscaping, data processing, and repairs of tangible personal property (e.g., auto repairs). States also exempt a “sale for resale” of tangible personal property, for example, when a manufacturer makes an inventory sale to a distributor, which then resells the goods to the end-consumer. The sale for resale exemption prevents multiple taxation of the same item of inventory as it works its way through the distribution chain from the manufacturer to the end-consumer. Many states also provide exemptions for certain purchases of tangible personal property by manufacturers. These manufacturing exemptions usually apply to machinery and equipment, raw materials, and component parts that are purchased by manufacturers for use in the manufacturing process. Finally, for social policy reasons, many states also exempt sales of groceries, prescription drugs, and medical devices, as well as purchases made by tax-exempt organizations or government agencies.

Every state that imposes a sales tax also imposes a corresponding use tax. Whereas the sales tax is imposed on the retail sale of tangible personal property within the state’s borders, the use tax is imposed on the consumption, use, or storage of property within the state’s borders. A use tax is an essential complement to a sales tax because without a use tax, consumers could avoid the sales tax by purchasing items from out-of-state vendors. This would put in-state retailers at a competitive disadvantage and threaten the integrity of the state’s sales tax base.

Example 1: Jill resides in a state that imposes a 5 percent sales and use tax. Jill plans to purchase a new \$1,000 laptop computer for use in her home. If Jill were to purchase the computer from a local brick-and-mortar retail store, the vendor would collect \$50 of sales tax ($5\% \times \$1,000$). On the other hand, if Jill purchases the computer from an out-of-state online vendor, it is possible that no sales tax will be collected. Nevertheless, Jill is legally obligated to self-assess and remit a \$50 use tax on the purchase because the computer will be used within the state’s borders.

Although states are able to enforce use taxes on items such as automobiles that residents must register with the state, use tax compliance is a major problem with respect to mail-order and online purchases of consumer goods.

Table 2: State Tax Rates, 2019

State	Corporate income tax	Individual income tax	Sales tax	State	Corporate income tax	Individual income tax	Sales tax
Alabama	6.5%	5%	4%	Montana	6.75%	6.9%	n.a.
Alaska	9.4%	n.a.	n.a.	Nebraska	7.81%	6.84%	5.5%
Arizona	4.9%	4.54%	5.6%	Nevada	Gross receipts tax	n.a.	6.85%
Arkansas	6.5%	6.9%	6.5%	New Hampshire	7.9%	5% (dividends & interest only)	n.a.
California	8.84%	13.3%	7.25%	New Jersey	9%	10.75%	6.625%
Colorado	4.63%	4.63%	2.9%	New Mexico	5.9%	4.9%	5.125%
Connecticut	7.5%	6.99%	6.35%	New York	6.5%	8.82%	4%
Delaware	8.7%	6.6%	n.a.	North Carolina	2.5%	5.25%	4.75%
District of Columbia	8.25%	8.95%	6%	North Dakota	4.31%	2.9%	5%
Florida	5.5%	n.a.	6%	Ohio	Gross receipts tax	4.997%	5.75%
Georgia	5.75%	5.75%	4%	Oklahoma	6%	5%	4.5%
Hawaii	6.4%	11%	4%	Oregon	7.6%	9.9%	n.a.
Idaho	6.925%	6.925%	6%	Pennsylvania	9.99%	3.07%	6%
Illinois	9.5%	4.95%	6.25%	Rhode Island	7%	5.99%	7%
Indiana	5.75%, 5.5%	3.23%	7%	South Carolina	5%	7%	6%
Iowa	12%	8.53%	6%	South Dakota	n.a.	n.a.	4.5%
Kansas	7%	5.7%	6.5%	Tennessee	6.5%	2% (dividends & interest only)	7%
Kentucky	5%	5%	6%	Texas	0.375% or 0.75% margin tax	n.a.	6.25%
Louisiana	8%	6%	4.45%	Utah	4.95%	4.95%	4.7%
Maine	8.93%	7.15%	5.5%	Vermont	8.5%	8.75%	6%
Maryland	8.25%	5.75%	6%	Virginia	6%	5.75%	4.3%
Massachusetts	8%	5.05%	6.25%	Washington	Gross receipts tax	n.a.	6.5%
Michigan	6%	4.25%	6%	West Virginia	6.5%	6.5%	6%
Minnesota	9.8%	9.85%	6.875%	Wisconsin	7.9%	7.65%	5%
Mississippi	5%	5%	7%	Wyoming	n.a.	n.a.	4%
Missouri	6.25%	5.9%	4.225%				

Note: The reported sales tax rate is the state rate before any county, city, or other local government add-ons. Income tax rates are top marginal rates.

Property Taxes

The property tax is often the most important source of tax revenues for local governments such as counties, cities, and school districts. All types of real property, including raw land, personal residences, apartment buildings, offices, factories, and other business facilities, are generally taxable. Some jurisdictions also tax selected types of tangible personal property used in a trade or business, such as machinery and equipment, furniture and fixtures, or inventory. Property tax exemptions are often provided for property owned by religious, educational, and charitable organizations, as well as property owned by government agencies.

The tax base is the assessed value of taxable property as of a fixed date (e.g., January 31). The basis for assessing property is market value, not historical cost. Market value is usually defined as the price at which a willing seller would sell the property to a willing buyer. Assessed value is determined by an assessor, who is a government official appointed or elected to perform this function. There are three basic methods that an assessor can use to estimate a property's market value: (i) actual sales prices from recent sales of similar properties (market method), (ii) cost to reproduce or replace the property (cost method), and (iii) capitalization of the expected future net cash flows derived from the property (income method). Because market values are often uncertain, valuation is a source of controversy, particularly in the case of one-of-a-kind properties or single-purpose commercial facilities for which it is difficult to obtain the information needed to apply the market method. Another common issue is the proper classification of property as real or personal. This distinction is important because many jurisdictions tax real property but do not tax personal property. Common law tests for determining whether an asset is properly classified as real or personal property include whether the asset is permanently and physically affixed to the land, whether the use or function of the asset is tied to the use or function of the land, and whether the owners of the land intended that the asset become part of the realty.

Payroll Taxes

Payroll taxes are a significant component of the total cost of hiring employees. Payroll taxes include Federal Insurance Contributions Act (FICA) taxes, Federal Unemployment Insurance Act (FUTA) taxes, and state unemployment taxes. The FICA tax includes a 12.4 percent Social Security tax applied to the first \$132,900 of an employee's wages (2019), as well as a 2.9 percent Medicare tax applied to all of an employee's wages. Employers pay half of the FICA tax and employees pay the other half through withholding. In addition to withholding the employee's share of the Medicare tax (1.45 percent), employers must withhold a 0.9 percent Medicare surtax from an employee's annual wages in excess of \$200,000 (\$250,000 if filing

status is married filing jointly). The 0.9 percent surtax is imposed only on the employee; there is no employer match.

The FUTA tax is designed to provide workers with income during temporary periods of involuntary unemployment, and is jointly administered by federal and state officials. The federal tax equals 6.0 percent of the first \$7,000 of wages paid to each employee each year. The federal tax is integrated with state unemployment tax systems through a credit mechanism. An employer may claim a credit against its federal tax for the amount paid in state unemployment taxes. The credit is limited to 5.4 percent of taxable wages. If an employer is entitled to the maximum credit, the federal tax rate after the credit is 0.6 percent. An employer's state unemployment tax is determined by the amount of payroll in a state and the applicable tax rate. The tax rate varies with the taxpayer's employment history. In other words, the tax rate is lower for employers that provide employees with steady employment, and higher for employers that have a history of layoffs.

Employers must pay FICA, FUTA, and state unemployment taxes with respect to employees, but not with respect to independent contractors. Therefore, the distinction between employees and independent contractors has significant federal and state payroll tax consequences. Under common law principles, an agent is an employee if the payer controls what work is done and how the work is done. The key fact is that the payer controls the details of how the work is performed. On the other hand, an agent is an independent contractor if the payer controls the results of the work but not the means of accomplishing the result. Examples of factors suggesting that an agent is an independent contractor, rather than an employee, include working for more than one principal, bearing entrepreneurial risk (that is, the risk of a net loss), and making a significant personal investment in the equipment used to perform the job.

Income Taxes

Forty-five states impose corporate income taxes, with rates generally ranging from 4 to 10 percent (see Table 2). The five states that do not have corporate income taxes are Nevada, Ohio, South Dakota, Washington, and Wyoming. However, Nevada, Ohio, and Washington impose gross receipts taxes. The corporate income taxes of numerous states are formally "franchise taxes" imposed on the privilege of doing business within the state. Nevertheless, because the value of the franchise is measured by the income earned in a given state, the tax is computed in essentially the same manner as a direct income tax. Not all corporate franchise taxes operate in this manner, however. For example, some states (e.g., Tennessee) impose a corporate franchise tax on capital in addition to a tax on income.

The computation of state taxable income generally begins with the amount of federal taxable income reported on the corporation's federal Form 1120, which eases the administrative burden of computing state taxable income. Each state requires certain addition and subtraction modifications to convert federal income to state taxable income. A corporation is subject to income tax in the state in which it is organized as well as any other state in which the corporation conducts activities of the type that create a taxable presence, or nexus. It is common for large corporations to have nexus in a number of states. To prevent double taxation, states allow corporations that are taxable in two or more states to apportion their business income among the nexus states. In such cases, the taxpayer computes an apportionment percentage for each nexus state using a prescribed formula. These formulae typically take into account the relative amounts of property, payroll, and sales that the corporation has in each taxing state.

States generally conform to the federal pass-through treatment of partnerships, S corporations, and limited liability companies. Therefore, most states do not impose an entity-level tax on the income of such businesses, but instead tax the income at the partner, shareholder, or member level. If the partner, shareholder, or member is an individual, the income of the pass-through entity is potentially subject to individual income tax in the state in which the individual resides, as well as any other state in which the pass-through entity has facilities or otherwise conducts business.

Forty-three states impose individual income taxes, with rates generally ranging from 3 to 10 percent (see Table 2). The seven states that do not impose an individual income tax are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. In addition, New Hampshire and Tennessee tax only selected types of income, not including salaries or wages.

For administrative ease, the computation of taxable income usually begins with the amount of federal adjusted gross income reported on the individual's federal Form 1040. Each state then requires its own unique combination of addition and subtraction modifications to convert federal income to state taxable income. An individual is subject to income taxation in the state of residence (or domicile), which is the state in which the individual's fixed and permanent home is located. It is also possible for an individual to be subject to income tax in another state, but only with respect to certain types of income derived from sources within that state. Examples include profits from business activities conducted in another state, compensation for personal services performed in another state, and income from real or tangible property located in another state. If the same item of income is taxable in more than one state, the state of residence generally allows the individual to claim a credit for income taxes paid to other states as a mechanism for mitigating double-taxation.

Unusual State Business Taxes

Most states closely link their corporate tax structures to the federal income tax. Some states, however, impose corporate taxes that are based on entirely different models. For example, the State of Washington imposes a gross receipts tax called the “business and occupation tax.” Unlike a retail sales tax, where the vendor acts as a collection agent for taxes imposed on the ultimate consumer, the business and occupation tax is borne by the seller. The business and occupation tax is imposed on the gross receipts that a corporation or other business entity derives from business activities conducted in Washington. The tax rate varies with the type of business activity. The primary tax rates are 0.484 percent for manufacturing and wholesaling activities, 0.471 percent for retailing activities, and 1.5 percent for service activities. There are also numerous specialized tax rates for selected business activities.

Ohio imposes a gross receipts tax called the “commercial activity tax.” The commercial activity tax applies to corporations and other business entities, and is imposed on the business gross receipts attributed to Ohio. In addition to a minimum tax on the first \$1 million of taxable gross receipts, a tax rate of 0.26 percent applies to gross receipts in excess of \$1 million.

Nevada also imposes a gross receipts tax called the “commerce tax,” which applies to entities that are engaged in business in Nevada and have Nevada gross revenue that exceeds \$4 million in the fiscal year. The commerce tax rates vary, ranging from 0.051 percent to 0.331 percent, depending on the industry in which the business entity is primarily engaged.

Texas imposes a corporate franchise tax based on a taxpayer’s margin. Taxable entities include not only corporations, but also partnerships and limited liability companies. On the other hand, sole proprietorships or general partnerships owned entirely by individuals are not subject to the margin tax. A taxable entity’s margin is the lowest of four amounts: (1) total revenue less \$1 million, (2) 70 percent of total revenue, (3) total revenue minus cost of goods sold, or (4) total revenue minus compensation. The tax rate is 0.375 percent for taxpayers primarily engaged in retail or wholesale trade, and 0.75 percent for all other businesses.

THE NEXUS ISSUE

A threshold issue for a business enterprise with operations nationwide is determining the states in which it must file returns and pay income tax. One basis upon which a state can impose a tax obligation is that the person in question is a resident of the state. For example, in the case of partnerships and S corporations where the ultimate taxpayer is an individual partner or shareholder, the state in which the individual resides may tax that resident's pro-rata share of the pass-through entity's income, even if the underlying business assets and activities are located in other states. For example, if an S corporation shareholder resides in New Mexico, New Mexico may tax that resident's distributive share of S corporation income, even if the S corporation conducts business only in the neighboring state of Arizona. In a similar fashion, the state in which a corporation is organized may impose a corporate income tax on that corporation, irrespective of the location of the corporation's assets or activities.

OBJECTIVE 2:

Distinguish between the types of in-state activities that create nexus for an out-of-state company, and those in-state activities that do not establish nexus.

A second basis upon which a state can impose a tax obligation is if the business enterprise derives income from assets or activities located within the state's borders. For example, if a corporation owns a production facility located in Maine, Maine may tax the income that the corporation derives from that production facility, even if the business is incorporated in some other state. Likewise, partners and S corporation shareholders are potentially subject to state taxation in any state in which the partnership or S corporation does business, regardless of whether the partners or shareholders reside in the state.

In state tax parlance, the types of contacts between a business enterprise and a state that are necessary to establish the state's right to impose a tax obligation are referred to as "nexus." For many smaller businesses, such as a locally-owned restaurant, convenience store, or hair salon, nexus may be a moot issue. These businesses are typically organized under the laws of the state in which they are located, do business only in that state, and have owners who reside in that state. Therefore, the profits of such businesses are taxable only in one state. In contrast, determining the nexus states for a large corporation can be a major challenge. Such corporations clearly have nexus in a state in which the company has offices, production facilities, and other significant investments in tangible property accompanied by local employees. A more difficult issue is whether the company has nexus in states in which it has no facilities, but does have a significant customer base.

Example 2: ABC, Inc. manufactures office equipment for sale nationwide. ABC's headquarters office and production facilities are located in California. ABC also has regional sales offices located in Illinois, New York, and Texas. In addition to its regional sales offices, ABC also sells office equipment directly to customers in all fifty states through the company's website. ABC clearly has income tax nexus in California, Illinois, New York, and Texas, due to the regular presence of company property and employees in those states. The nexus determination is less obvious, however, in the other forty-six states. For example, consider some other populous states, such as Florida, Georgia, Ohio, or Pennsylvania, where ABC may make millions of dollars of online sales, but where ABC does not have any property or employees. The issue in these states is whether an economic presence in the form of a significant volume of in-state sales is sufficient to create income tax nexus.

Income tax nexus is not the only type of nexus that multistate businesses must be wary of. Sales and use tax nexus is also a concern. Sales and use taxes are theoretically imposed on consumers. Nevertheless, vendors are generally responsible for collecting the tax, including out-of-state vendors that have nexus in the state in which the customer is located. For example, a New York retailer must collect New York sales tax on taxable sales made at its stores located in New York. Likewise, a California-based online vendor that makes sales to New York customers must also collect New York use tax on such sales if the online vendor has nexus in New York for sales and use tax collection purposes.

Multistate businesses generally prefer to file returns and pay tax in as few states as possible. Fortunately for these companies, the U.S. Constitution and Public Law 86-272 (a federal statute) provide important protections against state taxation. These federal protections also provide an important degree of uniformity in state tax laws because they govern nexus determinations in all fifty states.

Constitutional Restrictions

Historically, states have asserted that virtually any type of in-state business activity creates nexus for an out-of-state company. Such behavior reflects the reality that it is more politically palatable to collect taxes from out-of-state companies than to raise taxes on in-state business interests. The desire of state officials to export the local tax burden has been counterbalanced by the U.S. Constitution, which limits the ability of states to tax out-of-state businesses.

The Fourteenth Amendment to the Constitution (the Due Process Clause) states that no state shall deprive any person of life, liberty, or property without due process of law. The Supreme Court has interpreted this clause as prohibiting a state from taxing a company unless there is a “minimal connection” between the company’s interstate activities and the taxing state.² In addition, Article 1 of the Constitution (the Commerce Clause) states that Congress has the authority to regulate commerce among the states. The Court has interpreted the Commerce Clause as prohibiting states from enacting laws that unduly burden or inhibit the free flow of trade among the states. These constitutional restrictions include prohibiting a state from taxing a company unless that company has a “substantial nexus” with the state.³

As a practical matter, the critical question in the nexus arena is: what does substantial nexus mean? In 1967, the Supreme Court ruled that constitutional nexus requires an in-state physical presence, at least with respect to sales and use taxes. Specifically, the Court ruled that the State of Illinois could not require a mail-order vendor based in Missouri to collect use tax on sales to Illinois residents because the vendor had no offices, employees, or any other type of physical presence in Illinois.⁴ In 1992, the Supreme Court reaffirmed the physical presence test for substantial nexus in another sales and use tax case involving an out-of-state mail-order vendor.⁵ In neither case did the Supreme Court address the issue of whether the physical presence test also applied to income tax nexus.

Due to the dramatic growth of online sales since the Supreme Court’s 1992 decision in *Quill*, it was only a matter of time before the physical presence test for substantial nexus gave way to the realities of the modern marketplace. In *South Dakota v. Wayfair, Inc.* [585 U.S. ____ (2018)], the Supreme Court overturned the physical presence test and ruled that an out-of-state vendor’s “economic and virtual contacts” with a state can be sufficient to satisfy the substantial nexus requirement.⁶ In *Wayfair*, an out-of-state internet vendor challenged the constitutionality of a South Dakota law that required a seller to collect South Dakota sales tax if, on an annual

² *Mobil Oil Corporation v. Commissioner of Taxes*, 445 U.S. 425 (1980). The Due Process Clause also requires a rational relationship between the income taxed by a state and the taxpayer’s in-state activities.

³ *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). The Commerce Clause also requires that a state tax be fairly apportioned, not discriminate against interstate commerce and be fairly related to the services provided by the state.

⁴ *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967).

⁵ *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

⁶ *South Dakota v. Wayfair, Inc.* (585 U.S. ____, 2018), which can be found at <https://www.law.cornell.edu/supremecourt/text/17-494>.

basis, the seller delivered more than \$100,000 of goods or services in the state or engaged in 200 or more separate transactions for the delivery of goods and services into the state. The Supreme Court concluded that this level of activity could not have been achieved unless the seller “availed itself of the substantial privilege of carrying on business in South Dakota.” Moreover, several aspects of the South Dakota law were designed to prevent an undue burden on interstate commerce, including a safe harbor provision for sellers with only limited business in the state, the state’s adoption of the Streamlined Sales and Use Tax Agreement, and the state’s prospective application of the law.⁷

Example 3: Reconsider the fact pattern in Example 2, where ABC, Inc. sells office equipment nationwide. Because ABC has facilities located in California, Illinois, New York, and Texas, it clearly has constitutional nexus in those states. Likewise, under the Supreme Court’s decision in *Wayfair*, the other states in which ABC has a significant customer base can craft laws requiring ABC to collect and remit sales taxes on in-state sales or file corporate income tax returns.

What Would You Do in This Situation?

Sparrow, Inc. is an engineering consulting firm based in Colorado. Most of Sparrow’s clients are located in Colorado, but Sparrow does have a few clients located in Salt Lake City, Utah. In fact, Sparrow employees spend several weeks each year in Salt Lake City working on the Utah accounts. Nevertheless, Sparrow files corporate income tax returns only in its home state of Colorado. Sparrow’s controller realizes that Sparrow may also have income tax nexus in Utah, but believes that because Sparrow is a small business, it is justified in not filing an income tax return in Utah. “After all,” Sparrow’s controller says, “even if we did file a Utah return, we would probably end up owing less than a thousand dollars per year in Utah tax. It does not seem worth the effort.” What would you advise Sparrow to do in this situation?

Economic and Factor Presence Nexus for Income Tax Purposes

In its 1992 ruling in *Quill Corporation v. North Dakota*, the Supreme Court did not address the issue of whether the physical presence test for constitutional nexus applies to nexus for income tax purposes. As a consequence, the precise meaning of constitutional nexus in the

⁷ The purpose of the Streamlined Sales and Use Tax Agreement (www.streamlinedsalestax.org) is to reduce the sale and use tax compliance burden through state-level collection of local taxes, uniformity in the state and local tax bases, and the simplification of state and local tax rates, tax returns, and tax payment procedures.

income tax arena remained a grey area of the law. Consequently, numerous states enacted statutes establishing an economic nexus standard for income taxes, and the highest courts in some states have ruled that an economic presence is sufficient to create income tax nexus. Common situations in which states assert the principle of economic nexus include out-of-state trademark holding companies that derive royalty income from licensing intangibles in the state, and out-of-state credit card banks that derive income from transactions involving state residents and merchants. As discussed above, in *Wayfair* the Supreme Court held that “economic and virtual contacts” can be sufficient to satisfy the Commerce Clause’s “substantial nexus” requirement. The Court’s repudiation in *Wayfair* of the prior physical presence standard opens the door for states that have previously adopted a physical presence test for income tax nexus to adopt an economic nexus standard.

In addition to the concept of economic nexus, some states have adopted a factor presence nexus standard, under which an out-of-state corporation has nexus in a state if the apportionment factors of the corporation in the state (that is, property, payroll, or sales) exceed a specified threshold. For example, a corporation is subject to the New York corporate franchise tax if its New York sales exceed \$1 million.⁸ Likewise, a corporation is subject to the California corporate franchise tax if: (1) its sales in California exceed the lesser of \$561,951 or 25 percent of its total sales, (2) its real and tangible personal property in California exceed the lesser of \$56,195 or 25 percent of its total real and tangible personal property, or (3) its payroll in California exceeds the lesser of \$56,195 or 25 percent of its total payroll. The protections of Public Law 86-272 still apply to a corporation selling tangible personal property.⁹

Public Law 86-272: Income Tax Safe Harbor for Sellers of Goods

The Commerce Clause gives Congress the authority to regulate interstate commerce, including regulating how states tax the income that businesses derive from interstate commerce. Congress exercised this authority in 1959 when it enacted Public Law 86-272, which protects multistate businesses from income tax nexus in certain limited circumstances.¹⁰ Congress enacted Public Law 86-272 in response to political pressure from the business community, which was concerned that the states were becoming overly aggressive in their attempts to tax out-of-state companies. Public Law 86-272 prohibits a state from imposing a net income tax on an out-

⁸ N.Y. Tax Law § 209.1.

⁹ Cal. Rev. and Tax Code § 23101. These dollar thresholds are for 2017, and are adjusted annually for inflation.

¹⁰ The designation “86-272” is a reference to the 272nd law enacted during the 86th Session of Congress. Officially, the federal statute is Section 381 of Title 15 of the U.S. Code, but the popular name is Public Law 86-272. It can be found at www.law.cornell.edu/uscode/15/381.html.

of-state company if that company's only in-state activity is the presence of representatives who limit their activity to the solicitation of orders for tangible personal property, where such orders are sent outside the state for approval, and, if approved, are shipped or delivered from a point outside the state.

Example 4: Grey Corporation manufactures back-up electric generators at its plant in Missouri for sale to commercial customers nationwide. Grey has no property or employees located in Illinois, with the exception of sales personnel who regularly travel to Illinois to solicit sales. As long as Grey sales personnel limit their Illinois activities to the solicitation of orders that are sent to the Missouri home office for approval, and if approved, are shipped from the factory in Missouri, Public Law 86-272 prohibits Illinois from imposing a net income tax on Grey, despite the regular physical presence of Grey employees within Illinois's borders.

Although Public Law 86-272 can provide important protections for a multistate business, it has several significant limitations. First, it applies only to a "net income tax" and provides no protection against an obligation to collect sales and use tax on sales to in-state customers. Public Law 86-272 also does not apply to gross receipts taxes, such as the Washington business and occupation tax, Ohio commercial activity tax, or Nevada commerce tax. Second, Public Law 86-272 provides no protection to businesses that sell services, real estate, or intangible property. Third, for businesses that do sell tangible personal property, their representatives must strictly limit their in-state activities to the "solicitation of orders." For this purpose, solicitation of orders generally is defined as requests for purchases and any other activity that is entirely ancillary to requests for purchases; that is, the activities serve no independent business function apart from their connection to requests for purchases.¹¹

Example 5: The facts are the same as in Example 4 except that the employees of Grey Corporation who travel to Illinois to make requests for purchases also help train those Illinois customers to use Grey's generators. Because customer training serves an independent business function, Public Law 86-272 probably no longer protects Grey from Illinois income taxation.

¹¹ *Wisconsin Department of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214 (1992).

Examples of in-state activities that are generally considered protected by Public Law 86-272 include the following:¹²

- Carrying samples and promotional materials for display or distribution without charge.
- Furnishing and setting up display racks of the company's products without charge.
- Providing automobiles, computers, and other personal property to sales personnel for use in soliciting orders.
- Maintaining a display room for 14 days or less at a location within the state.

Examples of in-state activities that generally are not protected by Public Law 86-272 include:

- Investigating credit worthiness.
- Installation or supervision of installation at or after shipment or delivery.
- Making repairs or providing maintenance to property sold.
- Conducting training courses, seminars, or lectures for personnel other than personnel involved only in solicitation.

¹² Excerpts from the *Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States Under Public Law 86-272*, which can be found at www.mtc.gov.

Stop and Think

Issue: Blue Jay Corporation specializes in producing custom glass bottles for microbreweries. Blue Jay's main offices and production facilities are located in Georgia. During the past few years, Blue Jay's sales have expanded rapidly from its initial customer base in Georgia to customers in over two dozen states. Blue Jay files an income tax return only in the state of Georgia. Blue Jay's controller, Gwen, is concerned that Blue Jay may have unwittingly established nexus in other states, such as Alabama, which Blue Jay employee-salespersons regularly visit to make sales calls. Gwen has asked you to brief her as to what types of activities may create income tax nexus in states other than Georgia.

Solution: Income tax nexus is a concern primarily in those states in which Blue Jay has both customers and some sort of physical presence, such as a sales office or the regular presence of Blue Jay employees. A major exception to the physical presence test is Public Law 86-272. Under Public Law 86-272, Blue Jay is protected from establishing income tax nexus if its employees limit their in-state activities to the solicitation of orders that are sent back to the Georgia home office for approval, and if approved, are shipped from Georgia. Therefore, as long as Blue Jay salespeople strictly limit their activities in other states to the solicitation of orders, Blue Jay should be able to avoid income tax nexus.

State Versus Federal Nexus Standards for Foreign (Non-U.S.) Corporations

As discussed above, state tax nexus generally arises when an out-of-state corporation, including a corporation organized in another country, has a physical presence within the state. A different nexus standard applies with respect to federal taxation of a foreign (non-U.S.) corporation. The United States has bilateral income tax treaties with about 60 countries.¹³ These treaties generally contain a "permanent establishment" provision, under which the business profits of a foreign corporation that is a resident of a treaty country are exempt from U.S. federal income tax, unless the foreign corporation conducts business through a permanent establishment situated in the United States.¹⁴ A U.S. permanent establishment generally requires the existence

¹³ A listing of these income tax treaties can be found at www.irs.gov/businesses/international-businesses/united-states-income-tax-treaties-a-to-z.

¹⁴ Article 7 of the United States Model Income Tax Convention of February 17, 2016.

of a fixed place of business, such as a U.S. sales office. In addition, certain activities are specifically excluded from the definition of a permanent establishment, such as maintaining a stock of goods or merchandise in the United States solely for the purpose of storage or delivery, or maintaining a U.S. office solely for the purpose of purchasing goods or collecting information for the taxpayer.¹⁵ Treaty permanent establishment provisions generally are not binding for state nexus purposes, however, because income tax treaties generally apply only to selected types of federal taxes.¹⁶ Therefore it is possible for a foreign corporation to have nexus for state tax purposes but not for federal income tax purposes. As an example, if a foreign corporation stores inventory in a state in which it has some U.S. customers, the physical presence of company-owned inventory may create state income tax nexus, but not federal income tax nexus, because the mere storage of inventory generally does not constitute a permanent establishment.

¹⁵ Article 5 of the United States Model Income Tax Convention of February 17, 2016.

¹⁶ Article 2 of the United States Model Income Tax Convention of February 17, 2016.

CORPORATE GROUP FILING OPTIONS

Financial Reporting and Federal Tax Law

Larger business enterprises, such as a publicly-traded corporation, tend to have legal structures that include a parent corporation with one or more chains of subsidiary corporations. Such multi-corporate structures allow companies to organize operations by product lines or geographic markets, isolate different business risks in different legal entities, and establish a local corporate presence in foreign countries. For purposes of preparing a corporation's financial statements, generally accepted accounting principles require that all majority-owned subsidiaries be consolidated with the parent corporation.¹⁷ The purpose of consolidated financial statements is to report the results of operations and the financial position of the parent company and its subsidiaries as if the group were a single economic entity. Therefore, a consolidated income statement reflects only those items of income and expense arising from transactions involving unrelated third parties.

OBJECTIVE 3:

Explain the differences between group reporting requirements for financial reporting, federal income tax, and state income tax purposes.

For federal income tax purposes, every regular corporation must compute and report its tax separately, with the exception of members of an "affiliated group" of corporations, which can elect to file a federal consolidated income tax return.¹⁸ An "affiliated group" is one or more chains of includible corporations connected through stock ownership with a common parent that is an includible corporation, provided that the common parent directly owns 80 percent or more of at least one of the other corporations, and stock meeting the 80 percent test in each corporation other than the common parent is owned directly by one or more of the other corporations.¹⁹

As with consolidated financial statements, federal consolidated taxable income is computed as if the group members were a single economic entity. Therefore, an affiliated group's consolidated taxable income reflects only those items of income and expense derived from transactions with unrelated third parties. Affiliated groups often elect to file a federal consolidated return, in part because it allows the consolidated group to offset losses of one affiliate against the profits of other affiliates. Whereas generally accepted accounting principles

¹⁷ FASB ASC 810, *Consolidation*.

¹⁸ IRC Sec. 1501.

¹⁹ IRC Sec. 1504(a).

require a worldwide consolidation that includes both U.S. and foreign country subsidiaries, only a corporation organized in the United States is includible in a federal consolidated income tax return.

State Reporting Options

The states that impose corporate income taxes have not reached a consensus regarding how members of a commonly controlled group of corporations should file their state income tax returns. Instead, state reporting requirements for multi-corporate groups vary significantly from one state to another.²⁰ Roughly speaking, state filing options fall into one of the following three categories:

- **Separate company returns.** Under this approach, each member of a commonly controlled group of corporations computes its income and files a return as if it were a separate and distinct economic entity. Delaware, Maryland, and Pennsylvania are the only states that require separate company reporting. These states neither permit nor require consolidated returns or combined unitary reporting under any circumstances.
- **Consolidated returns.** Roughly twenty states, including Florida and Georgia, generally allow affiliated corporations to file separate company returns but also permit or require the filing of state consolidated returns if certain conditions are met. The qualification requirements for filing consolidated returns vary from state to state. One common requirement is that the corporations are members of a federal affiliated group that has elected to file a federal consolidated return.
- **Combined unitary reporting.** Roughly twenty-five states, including California, Illinois, New York, and Texas, require corporations that are engaged in a unitary business to compute their taxable income on a combined basis. Combined unitary reporting differs from a federal consolidated return in several respects. For example, the minimum stock ownership requirement for combined reporting generally is more than 50 percent ownership, as opposed to 80 percent in the case of a federal consolidated return. Furthermore, combined reporting is limited to those group members engaged in the same trade or business, that is, a “unitary business,” as indicated by such factors as functional integration, centralized management, and economies of scale. In addition to those states that require combined reporting, some

²⁰ For a state-by-state summary, see Healy and Schadeewald, *2019 Multistate Corporate Tax Guide* (Chicago: CCH Incorporated, 2019).

states generally allow members of a unitary group to file separate returns, but also permit or require combined reporting under certain conditions, such as the need to clearly reflect the amount of the group's income that is taxable in the state. Finally, some mandatory combined reporting states (e.g., New York) provide taxpayers with the option of electing to file a combined report that includes all unitary and non-unitary corporations that meet the common ownership test. This election helps companies avoid the uncertainties associated with determining which affiliates are engaged in a unitary business.

In sum, states employ a variety of reporting options for commonly controlled corporations. At one end of the spectrum are a handful of states that do not allow combined or consolidated reporting under any circumstances. At the other end of the spectrum are roughly twenty-five states that require the use of combined unitary reporting. Mandatory combined reporting is based on the principle that the only effective way to tax the income of two or more corporations engaged in a single trade or business is to tax them on a combined basis. Other states take a middle-ground approach, allowing some taxpayers to file separate company returns while simultaneously permitting or requiring other taxpayers to file on a consolidated or combined basis. Because of the lack of uniformity, it is necessary to carefully review the laws of each state in which the taxpayer has a filing obligation.

Example 6: Robin, Inc. is a State X corporation that manufactures office furniture at its production facility located in X. Robin has nexus only in X. Robin has two wholly-owned subsidiaries, Yco and Xco. Yco is a State Y corporation that sells furniture manufactured by Robin at a factory outlet store located in Y. Yco has nexus only in Y. Xco is a State X corporation that operates a cattle ranch in X. Xco has nexus only in X. The operations of Xco are unrelated to those of Robin and Yco. Xco also has its own executive force and administrative staff. Both Robin and Yco are profitable, but Xco operates at a loss. For financial reporting purposes, Robin, Yco and Xco must issue consolidated financial statements. In a similar fashion, Robin, Yco and Xco may elect to file a federal consolidated income tax return. The group's State X filing requirements will depend on X's filing options for commonly controlled corporations. For example, if X requires separate company returns, Robin and Xco (but not Yco) will each file its own separate X returns. On the other hand, if X permits affiliates that file a federal consolidated return and have nexus in X to file on a consolidated basis, Robin and Xco could file a consolidated X return. One benefit of a consolidated return is that the losses of Xco would offset the profits of Robin. If X is a mandatory combined unitary reporting state, the business income and

apportionment factors of Yco would be included in the computation of Robin's State X income tax, even though Yco does not have nexus in X. Xco would also file an X return, but would probably do so on a separate company basis because its operations do not appear to be unitary with those of Robin and Yco.

Definition of a Unitary Business

Combined unitary reporting requires a taxpayer to determine which commonly controlled corporations are engaged in a "unitary business." The Multistate Tax Commission, which is an agency of state governments established in 1967 to promote fairness and uniformity in state tax laws, describes the essential concept of a unitary business, as follows:

"A unitary business is a single economic enterprise that is made up either of separate parts of a single business entity or of a commonly controlled group of business entities that are sufficiently interdependent, integrated and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts."²¹

Examples of a unitary business include a vertically-integrated petroleum company and a horizontally-integrated chain of retail stores.

Over the years, the courts have developed several different judicial interpretations of what constitutes a unitary business, including:

- **Three unities test.** Two or more corporations are engaged in a unitary business if they exhibit unity of ownership, unity of operation, and unity of use.²²
- **Contribution and dependency test.** A group of commonly-controlled corporations is engaged in a unitary business if they are dependent upon or contribute to one another.²³

²¹ MTC Reg. IV.1.(b).(1), which can be found at www.mtc.gov.

²² *Butler Bros. v. McColgan*, 315 U.S. 501 (1942).

²³ *Edison California Stores, Inc. v. McColgan*, 30 Cal. 2d 472 (1947).

- **Flow of value test.** A group of commonly-controlled corporations is engaged in a unitary business if they share or exchange some value beyond the mere flow of funds arising out of a passive investment.²⁴
- **Factors of profitability test.** A group of commonly-controlled corporations is engaged in a unitary business if they exhibit functional integration, centralized management, and economies of scale.²⁵

Statutory and administrative definitions of a unitary business vary from state to state. An approach taken by some states is to presume that a group of commonly-controlled corporations is engaged in a unitary business if one or more of the following conditions are met:

- **Same type of business.** For example, a taxpayer that operates a chain of retail grocery stores is likely to be engaged in a unitary business.
- **Steps in a vertical process.** For example, a taxpayer engaged in the exploration, development, extraction, and processing of a natural resource and the subsequent sale of a product based upon the extracted natural resource, is engaged in a single unitary business.
- **Strong centralized management.** A taxpayer that might otherwise be considered as engaged in more than one business, such as a conglomerate, may properly be considered as engaged in a unitary business when there is strong central management, coupled with the existence of centralized departments for such functions as financing, advertising, research, or purchasing.²⁶

A particularly controversial issue has been whether a state can require the inclusion of foreign (non-U.S.) corporations in a combined unitary report. In the case of a U.S. multinational corporation, the issue is whether to include foreign country subsidiaries in the combined report. In the case of a multinational corporation that is based in a foreign country but has subsidiaries in the United States, the issue is whether to include the foreign parent and foreign affiliates in the combined report. States generally take one of the following two approaches:

²⁴ *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983).

²⁵ *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992).

²⁶ MTC Reg. IV.1.(b).(3), which can be found at www.mtc.gov.

- **Worldwide combination.** The combined report includes all unitary affiliates, regardless of the country in which the affiliate is incorporated or the country in which the affiliate conducts business.
- **Water's-edge combination.** The combined report includes all unitary affiliates, except for any affiliates that are incorporated in a foreign country or conduct most of their business abroad. A common approach is to exclude so-called "80/20 corporations," which is a corporation whose business activity outside the United States, as measured by some combination of apportionment factors, is 80 percent or more of that corporation's total business activity.

The U.S. Supreme Court has ruled that states can require worldwide combined reporting.²⁷ However, because a worldwide combination creates a significant administrative burden for both taxpayers and state tax authorities, most mandatory combined reporting states require a water's-edge combination, and do not permit a worldwide combination under any circumstances. Some states permit a worldwide combination (most notably California), but generally provide taxpayers with the option of using the more limited, water's-edge method of reporting.

²⁷ *Barclays Bank PLC v. Franchise Tax Board*, 512 U.S. 298 (1994); and *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983).

CORPORATE INCOME TAX BASE

State Income Tax Formula

Once a corporation has determined the states in which it has to file an income tax return, and has identified the appropriate filing option (separate company returns, consolidated return, or combined unitary reporting), the next step is to compute the taxable entity's state income tax.

Figure 1 outlines the formula for computing a corporation's state income tax liability.

OBJECTIVE 4:

Describe the formula for calculating a corporation's state income tax, including the common adjustments to federal taxable income in computing state taxable income.

Figure 1: Corporate Income Tax Formula

	Federal taxable income (Form 1120, line 28 or 30)
+/-	<u>Addition and subtraction modifications</u>
	Income subject to allocation and apportionment
-	<u>Allocable nonbusiness income</u>
	Apportionable business income
×	<u>Apportionment percentage</u>
	Business income apportioned to state
+	<u>Nonbusiness income allocated to state</u>
	State taxable income
×	<u>State tax rate</u>
	Tax before credits
-	<u>Credits</u>
	<u>State tax liability</u>

Example 7: Big Corporation operates a nationwide chain of office supply stores. Big has several stores located in State Z which taxes corporate income at a 5% rate. Big's operations are structured as a single corporate entity. Big's federal taxable income is \$95 million. Under State Z tax law, Big has \$6 million of addition modifications and no subtraction modifications. Big has \$1 million of nonbusiness income, none of which is allocable to Z. Big's State Z apportionment percentage is 10%. Finally, Big is entitled to \$50,000 of tax credits in Z. Based on this information, Big's State Z income tax liability is \$450,000, computed as follows:

• Federal taxable income.....	\$ 95,000,000
• Addition modification.....	+ <u>6,000,000</u>
• Income subject to allocation and apportionment....	101,000,000
• Nonbusiness income.....	- <u>1,000,000</u>
• Business income.....	100,000,000
• Apportionment percentage.....	× <u>10%</u>
• Business income apportioned to Z.....	10,000,000
• Nonbusiness income specifically allocated to Z....	+ <u>None</u>
• Taxable income.....	10,000,000
• Tax rate.....	× <u>5%</u>
• Tax before credits.....	500,000
• Credits.....	- <u>50,000</u>
• Tax liability.....	<u>\$450,000</u>

As Figure 1 illustrates, there are three principal steps involved in computing a corporation's state taxable income. The first step is to compute the amount of income subject to allocation and apportionment. This is usually accomplished by starting with the corporation's federal taxable income (i.e., federal Form 1120, line 28 or 30) and making addition and subtraction modifications that are specific to each state. For example, a corporation that has received interest from a municipal bond and has excluded that interest from federal taxable income may be required to add back that interest in computing state taxable income. The second step in computing state taxable income is to remove any nonbusiness income from the apportionable business income tax base, and then specifically allocate the entire amount to a single state. For example, nonbusiness interest or dividend income is generally allocated to the state in which the corporation's headquarters office is located, the so-called state of "commercial domicile." Roughly speaking, nonbusiness income is any income that has no relationship to the trade or business that the corporation conducts in the taxing state. The third step is to apportion the corporation's business income among all of the states in which the corporation has nexus, based on an apportionment percentage that is calculated for each state. Each of these steps is discussed in detail in the following sections, starting with the computation of a corporation's income subject to allocation and apportionment.

Most states allow corporate taxpayers to claim tax credits for expenditures related to selected activities, such as new investments in machinery and equipment, employee training, research and development, or locating new facilities within a state-designated enterprise zone.

Conformity to Federal Taxable Income

Virtually all of the states that have corporate income taxes piggyback on the federal system by adopting federal taxable income as the starting place for computing state taxable income. Depending on the state, the calculation of state taxable income begins with either federal

Form 1120, line 28 (federal taxable income before the federal dividends received and net operating loss deductions), or line 30 (federal taxable income). Therefore, once the federal tax return is completed, much of the work has been done in terms of computing state taxable income. It is generally not necessary to apply state-specific rules for calculating such items as inventory and cost of goods sold. This broad conformity to the federal tax base eases the compliance burden and creates a degree of uniformity in state tax systems.

A major disadvantage of piggybacking on the federal tax base is that if Congress amends the Internal Revenue Code in a way that reduces federal tax revenues (e.g., the enactment of more accelerated depreciation methods), the effects of the change can spill over and reduce state tax collections. This is an important consideration for state legislatures that are required by their state constitutions to balance the state budget each year.

Example 8: Assume that in response to an economic recession, Congress attempts to stimulate the economy by amending the Internal Revenue Code to allow for the immediate expensing of investments in new machinery and equipment. In states that mechanically conform to any changes in federal law, this change in federal law will automatically apply for state tax purposes, thereby causing a reduction in state income tax collections without any vote by the state legislature.

To guard against any unwanted changes to their tax base, some states have adopted a static federal tax base whereby state taxable income is defined in terms of the Internal Revenue Code in effect as of a specific date (e.g., December 31 of the prior year). Under this wait-and-see approach, any amendments to the Internal Revenue Code have no effect on the state tax base until the state legislature affirmatively votes to adopt these changes. In such states, the legislature often ends up adopting most federal changes, albeit belatedly. Nevertheless, tax practitioners must be careful not to assume that all federal tax law changes will automatically be adopted by the states.

Other states adopt a moving federal tax base, whereby the computation of state taxable income is based on the Internal Revenue Code currently in effect. In other words, any amendments to the Internal Revenue Code are automatically adopted for state purposes. Even with a moving federal tax base, however, a state legislature has the authority to amend state law to exclude specific federal changes which, in retrospect, the legislature chooses not to adopt.

Addition and Subtraction Modifications

Despite the broad conformity to the federal tax base, each state requires taxpayers to make a number of addition and subtraction modifications to arrive at state taxable income. Therefore, a principal task in computing state taxable income is identifying and calculating the pertinent adjustments. Each state has its own unique set of adjustments, which adds to the compliance burden. Nevertheless, as outlined in Figure 2, there are some common adjustments that are required by a number of states.²⁸

Figure 2: Common Addition and Subtraction Modifications

- Net operating loss deduction
- Dividends received deduction
- State and local income taxes
- Interest earned on debt obligations of the federal government
- Interest earned on debt obligations of state and local governments
- Expenses related to federal or state tax credits
- Royalties and interest paid to related parties
- Federal Section 168(k) bonus depreciation
- Federal Section 179 asset expensing
- Federal Section 250 foreign-derived intangible income deduction
- Federal Section 951 Subpart F inclusions and Section 951A GILTI inclusions related to a foreign (non-U.S.) subsidiary

These addition and subtraction modifications are described in more detail below.

- **Dividends received deduction.** In computing federal taxable income, corporate taxpayers can claim a dividends received deduction equal to 50 percent, 65 percent or 100 percent of dividends received from domestic corporations. Prior to 2018, the deduction percentages were 70 percent, 80 percent and 100 percent. Starting in 2018, a domestic corporation may claim a 100 percent dividends received deduction for the foreign-source portion of any dividends received from a 10 percent-or-more-owned (non-U.S.) foreign corporation. Most states also allow corporate taxpayers to claim a

²⁸ For a state-by-state summary, see Healy and Schadeewald, *2019 Multistate Corporate Tax Guide* (Chicago: CCH Incorporated, 2019).

dividends received deduction. The requisite ownership percentages and the amount of the deduction vary from state to state. State dividends received deductions generally apply to dividends from both domestic and foreign (non-U.S.) corporations.²⁹

Assuming the computation of state taxable income begins with line 28 of federal Form 1120 (federal taxable income before the federal dividends received and net operating loss deductions), the state dividends received deduction takes the form of a subtraction modification.

- **State and local income taxes.** In computing federal taxable income, corporations can deduct state and local income taxes. States generally require corporations to add these deductions back for state tax purposes.
- **Interest earned on debt obligations of the federal government.** Interest income derived from obligations of the federal government, such as U.S. Treasury notes or bonds, is included in federal taxable income. The treatment of federal interest for state tax purposes depends, in part, on whether the state is imposing a direct income tax or a franchise tax. Federal law prohibits states from imposing a direct income tax on interest income derived from obligations of the U.S. government.³⁰ Therefore, states imposing direct income taxes provide a subtraction modification for federal interest. On the other hand, states that impose corporate franchise taxes often tax federal interest, in which case no subtraction modification is allowed.
- **Interest earned on debt obligations of state and local governments.** Interest income derived from obligations of state and local governments is exempt for federal tax purposes. However, many states tax this income by requiring corporations to make addition modifications for municipal interest. A common approach is to exempt interest received from debt obligations issued by the taxing state, while taxing interest received from debt obligations issued by other states.³¹
- **Expenses related to federal or state tax credits.** Both federal and state governments provide tax credits for certain types of business expenditures, but the specific credits allowed vary for federal and state tax purposes. To prevent a double-

²⁹ In *Kraft General Foods, Inc. v. Department of Revenue* (505 U.S. 71, 1992), the U.S. Supreme Court ruled that a state dividends received deduction cannot discriminate against foreign commerce.

³⁰ 31 USC Sec. 3124.

³¹ In *Kentucky Department of Revenue v. Davis* (553 U.S. 328, 2008), the U.S. Supreme Court ruled that limiting the exemption to in-state bonds does not violate the Commerce Clause.

tax benefit, taxpayers claiming a credit generally cannot also claim a deduction for the same expenditure. As a result, many states require addition modifications with respect to expenditures for which the taxpayer claimed a deduction for federal tax purposes but a credit for state tax purposes. Likewise, states often provide a subtraction modification for expenditures for which the taxpayer claimed a credit for federal tax purposes, but a deduction for state tax purposes.

- **Net operating loss deduction.** The federal treatment of net operating losses varies, depending on whether the net operating loss arises in a tax year beginning after 2017 or before 2018. For pre-2018 net operating losses, the federal carryover period is two years back and twenty years forward. In contrast, post-2017 net operating losses may be carried forward indefinitely, but no carryback is allowed. Furthermore, federal carryforward deductions for post-2017 losses are limited to 80 percent of taxable income in the carryforward year. States also usually allow net operating loss deductions, but the rules for computing these deductions vary from state to state. Common differences between the federal and state treatment of net operating losses include different state carryover periods, as well as different state carryover amounts caused by such factors as state addition and subtraction modifications and the application of state apportionment percentages. Assuming the computation of state taxable income begins with line 28 of federal Form 1120 (federal taxable income before the federal dividends received and net operating loss deductions), the requisite adjustment takes the form of a subtraction modification to federal taxable income.
- **Federal Section 168(k) bonus depreciation.** For federal tax purposes, taxpayers may claim a first-year bonus depreciation deduction equal to a specified percentage of the cost of qualifying property placed in service during the year. The bonus depreciation rate is 100 percent for property acquired and placed in service after September 27, 2017, and before 2023. The rate is phased down starting in 2023. Due to budgetary constraints, many states do not conform to the federal bonus depreciation provisions, and require taxpayers to add back the federal bonus depreciation deduction in computing state taxable income. In subsequent years, taxpayers may claim a subtraction modification for the excess of state depreciation over federal depreciation.
- **Federal Section 179 asset expensing.** For federal tax purposes, taxpayers may elect to immediately expense a portion of the cost of tangible personal property, rather than depreciating the cost over the asset's recovery period. The amount of qualifying Section 179 property that a taxpayer may elect to expense is limited, however, and Congress has increased the maximum Section 179 deduction (\$1,020,000 in 2019)

numerous times over the years. Due to fiscal constraints, many states do not conform to the increases in the maximum Section 179 deduction, and require additional modifications for the excess of the federal Section 179 expensing amount over the state maximum. For example, many states limit the Section 179 deduction to \$25,000.

- **Royalties and interest paid to related parties.** Many states have enacted provisions that generally disallow deductions for certain interest and royalty expenses paid to related parties. These provisions are designed to prevent corporate taxpayers from using intercompany financing and licensing agreements to erode the state income tax base.
- **Federal Section 250 foreign-derived intangible income deduction.** Starting in 2018, a domestic corporation may claim a deduction equal to a statutory percentage of its foreign-derived intangible income (or FDII) and its global intangible low-taxed income (or GILTI). The deduction related to FDII is intended to encourage U.S. companies to hold high-value intangible property, such as trademarks and patents, in the United States rather than offshore.
- **Income from foreign (non-U.S.) subsidiaries.** For federal tax purposes, a U.S. shareholder of a controlled foreign corporation must include in gross income its pro-rata share of the controlled foreign corporation's Subpart F income and any investment of earnings in U.S. property. Many states exempt these items of foreign source income from taxation by providing subtraction modifications. In addition, starting in 2018, a U.S. shareholder of a CFC must include its GILTI in gross income in a manner generally similar to that for Subpart F inclusions.

The *Tax Cuts and Jobs Act of 2017* (P.L. 115-97) enacted numerous changes to the federal corporate income tax base, thereby expanding the list of potential federal-state tax base differences. Examples of new federal provisions that may require state modifications include the Code Sec. 163(j) limitation on business interest expense deductions, the Code Sec. 965 one-time transition tax on deferred foreign income, the Code Sec. 951A inclusion for any GILTI of a controlled foreign corporation, and the Code Sec. 250 deduction based on a domestic corporation's GILTI inclusions and any FDII that a domestic corporation derives directly from export sales.

Example 9: State X defines corporate taxable income as the amount on line 28 of federal Form 1120, with addition modifications for state income tax deductions and interest earned on obligations of state and local governments, and subtraction modifications for interest earned on obligations of the federal government and dividends from 50% or more owned subsidiary corporations. ABC Corporation,

which has nexus in X, reported \$400,000 of income on line 28 of federal Form 1120. ABC included on its federal return \$20,000 of interest from U.S. Treasury notes, \$80,000 of dividends from a wholly-owned domestic corporation, and a \$30,000 state income tax deduction. ABC also received \$10,000 of interest from state and local bonds, which was not included in federal taxable income. ABC computes its State X taxable income, before allocation and apportionment, as follows:

• Federal taxable income (Form 1120, line 28)	\$400,000
• Addition modifications:	
• State income tax deduction	+ \$30,000
• Interest on state and local bonds	+ \$10,000
• Subtraction modifications:	
• Interest on U.S. Treasury notes	– \$20,000
• Dividends received deduction	– <u>\$80,000</u>
• State X taxable income subject to allocation and apportionment	<u>\$340,000</u>

APPORTIONMENT OF BUSINESS INCOME

Double taxation is a concern for any corporation conducting business in two or more states. It is also a concern for federal and state policy makers because an undue tax burden on interstate commerce might hinder economic growth. To illustrate, consider the potential plight of a large retailer with stores in twenty states. Assume the retailer's total profit across all twenty states is \$100 million. If the twenty states in which the retailer does business make no attempt to mitigate double taxation, the same \$100 million profit would be subject to state taxation fully twenty times. Even if the average state tax rate was only 5 percent, the total state tax rate would be 100 percent (5 percent tax rate $\times$ 20 states). The U.S. Constitution protects multistate businesses from this type of double taxation. Specifically, the Supreme Court has ruled that the Commerce Clause gives a corporation the right to have its income fairly apportioned among the states in which it has nexus.

OBJECTIVE 5:

Compute state apportionment percentages, including the calculation of the sales, property, and payroll factors.

In 1957, state tax officials promulgated the original version of the Uniform Division of Income for Tax Purposes Act (UDITPA), which is a model law for allocating and apportioning the income of a corporation that is taxable in two or more states. In 2014, the Multistate Tax Commission amended several provisions of UDITPA, including the apportionment formula, the sourcing rules for sales other than sales of tangible personal property, and the definition of business income.³² The Multistate Tax Commission (MTC), which is an agency of state governments established in 1967 to promote fairness and uniformity in state tax laws, has promulgated model allocation and apportionment regulations that interpret UDITPA.³³ Many states have adopted UDITPA and the MTC regulations in full or in part. As a consequence, along with constitutional restrictions on nexus, Public Law 86-272, and conformity to the federal tax base, UDITPA and the MTC regulations are important sources of uniformity in state income taxation. Because UDITPA is the best available exemplar of state laws for allocating and apportioning income, references are made to UDITPA throughout the discussion of allocation and apportionment.

³² UDITPA can be found at www.mtc.gov.

³³ MTC Regs. IV.1 through IV.18 can be found at www.mtc.gov.

Apportionment Formulas

As required by the U.S. Constitution, each state may tax only an apportioned percentage of a multistate corporation's total business profits. These apportionment percentages are computed using formulae that are based on the relative amounts of property, payroll, and sales that the corporation has in each taxing state. These formulae reflect the intuition that a corporation's business profits are a function of its capital, labor, and customer base. Operationally, capital is defined as the cost of the corporation's real and tangible personal property, labor is defined as payroll costs, and the customer base is defined as sales. 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 within the state to its total property, payroll, or sales everywhere.

The states vary in terms of how they weight the property, payroll, and sales factors. One approach is an equally-weighted three-factor formula, whereby the apportionment percentage equals the simple average of the property factor (in-state property $\div$ total property), payroll factor (in-state payroll $\div$ total payroll), and sales factor (in-state sales $\div$ total sales). With an equally-weighted three-factor formula, each factor is effectively given a weight of 33 percent.

Example 10: Eagle Corporation conducts a business in States L and M. Eagle's property, payroll, and sales are distributed as follows (all amounts in millions):

	<u>State L</u>	<u>State M</u>	<u>Total</u>
Property	\$400	\$100	\$500
Payroll	\$80	\$20	\$100
Sales	\$300	\$300	\$600

Assuming States L and M both use an equally-weighted three-factor formula, the state apportionment percentages are computed as follows:

STATE L

• Property factor ($\$400 \div \500)	80%
• Payroll factor ($\$80 \div \100)	80%
• Sales factor ($\$300 \div \600)	<u>50%</u>
• Sum of factors	<u>210%</u>
• Apportionment percentage ($210\% \div 3$)	<u>70%</u>

STATE M

• Property factor ($\$100 \div \500)	20%
• Payroll factor ($\$20 \div \100)	20%
• Sales factor ($\$300 \div \600)	<u>50%</u>
• Sum of factors	<u>90%</u>
• Apportionment percentage ($90\% \div 3$)	<u>30%</u>

Historically, many states used the equally-weighted three-factor formula, due in part to its inclusion in the original version of UDITPA. In recent decades, however, most states have amended their apportionment formulae to place more weight on the sales factor than on the property or payroll factors. State lawmakers are attracted to such formulae for two reasons. First, such formulae shift a greater portion of the corporate income tax burden from in-state corporations that have large amounts of property and payroll in the state but sales nationwide, to out-of-state corporations that have relatively low proportions of property and payroll but with substantial sales in the state. Second, if a state uses a formula that emphasizes the sales factor, and in turn de-emphasizes the property and payroll factors, locating additional property or payroll in the state has less effect on that state's apportionment percentage, which creates a tax incentive for businesses to locate or expand in the state.

At present, most states use a single-factor sales formula or a modified three-factor formula that super weights the sales factor. Consequently, the sales factor plays a prominent role in computing the state income tax liability of a multistate corporation. Table 3 summarizes the apportionment formulae used by the states.

Example 11: The facts are the same as in Example 10, except that State M now uses a double-weighted sales formula. Therefore, the State L apportionment percentage remains unchanged at 70 percent, but the State M apportionment percentage increases to 35 percent, computed as follows:

• Property factor (\$100 million ÷ \$500 million)	20%
• Payroll factor (\$20 million ÷ \$100 million)	20%
• Sales factor (\$300 million ÷ \$600 million) × (2)	<u>100%</u>
• Sum of factors	<u>140%</u>
• Apportionment percentage (140% ÷ 4)	<u>35%</u>

The State L and M apportionment percentages now sum to 105 percent, indicating that 5 percent of Eagle Corporation's income is subject to double taxation as a result of the use of inconsistent apportionment formulae.

Table 3: Apportionment Formulas, 2019

Alabama	DW sales	Montana	Evenly-weighted
Alaska	Evenly-weighted	Nebraska	Sales-only
Arizona	DW sales or Sales-only	Nevada	n.a.
Arkansas	DW sales	New Hampshire	DW sales
California	Sales only	New Jersey	Sales only
Colorado	Sales only	New Mexico	Evenly-weighted
Connecticut	Sales only	New York	Sales only
Delaware	Sextuple-weighted sales	North Carolina	Sales only
District of Columbia	Sales only	North Dakota	Evenly-weighted or Sales only
Florida	DW sales	Ohio	n.a.
Georgia	Sales only	Oklahoma	Evenly-weighted or DW sales
Hawaii	Evenly-weighted	Oregon	Sales only
Idaho	DW sales	Pennsylvania	Sales only
Illinois	Sales only	Rhode Island	Sales only
Indiana	Sales only	South Carolina	Sales only
Iowa	Sales only	South Dakota	n.a.
Kansas	Evenly-weighted	Tennessee	Triple-weighted sales
Kentucky	Sales only	Texas	Sales only
Louisiana	Sales only	Utah	Varies
Maine	Sales only	Vermont	DW sales
Maryland	Quadruple-weighted sales	Virginia	DW sales
Massachusetts	DW sales	Washington	n.a.
Michigan	Sales only	West Virginia	DW sales
Minnesota	Sales only	Wisconsin	Sales only
Mississippi	Varies	Wyoming	n.a.
Missouri	Evenly-weighted or Sales only		

Note: *Sales only* means a single-factor sales formula. *DW sales* means a three-factor property, payroll and sales formula with a double-weighted sales factor. *Evenly-weighted* means a three-factor formula with equal factor weights.

In addition to the general purpose apportionment formulae discussed above, many states also require the use of specialized apportionment formulae for companies in selected industries such as financial institutions, telecommunications companies, pipeline companies, publishers, television and radio broadcasters, airlines, trucking companies, and railroads. These formulae are

designed to address the unique apportionment issues raised by these respective industries. For example, it is difficult to calculate property and payroll factors for airlines or trucking companies because their property and employees are constantly in motion. To address these issues, many states have created specialized formulae that apportion the income of transportation companies based on more readily measurable factors, such as ton miles, passenger miles, or revenue miles.³⁴

Sales Factor

The sales factor plays a dominant role in apportioning the income of a multistate corporation because most states use either a single-factor sales formula or a double-weighted sales formula. The sales factor is a fraction, the numerator of which is the taxpayer's total sales within the state during the taxable year, and the denominator of which is the taxpayer's total sales everywhere during the taxable year.³⁵ For apportionment purposes, "sales" generally is defined as all gross receipts from transactions and activities in the regular course of the taxpayer's trade or business. Proceeds from the sale of inventory, fees from services, and rents and royalties from leasing or licensing business property are examples of business receipts commonly included in the sales factor.

With respect to sales of tangible personal property, a destination test is used to compute the numerator of the sales factor, whereby the gross receipts are assigned to the state in which the goods are delivered or shipped to the purchaser.³⁶ For example, if a manufacturer ships an item of inventory from its factory in State X to a customer located in State Y, that sale is assigned to the numerator of the State Y sales factor.

An important exception to the destination test is a throwback rule, under which a sale that is delivered or shipped to a purchaser in a state in which the taxpayer is not taxable (i.e., does not have income tax nexus) is thrown back to the state from which the goods were shipped. Continuing with the prior example, under a throwback rule, if the State X manufacturer did not have nexus in State Y, the sale to the customer in Y would no longer be assigned to the numerator of the Y sales factor (because a sales factor is not computed for Y), but instead would

³⁴ The MTC has issued model regulations for a number of industries, including construction contractors, airlines, railroads, trucking companies, television and radio broadcasters, and publishers. The MTC has also promulgated a model statute for apportioning the income of financial institutions. These special apportionment rules can be found at www.mtc.gov.

³⁵ UDITPA Sec. 15.

³⁶ UDITPA Sec. 16.

be thrown back to the numerator of the sales factor of the state from which the goods were shipped (i.e., State X). A sales throwback rule helps to ensure that all of the taxpayer's income is subject to state taxation. Nevertheless, many states do not require throwback, in an attempt to make the state a more attractive location for a manufacturing or distribution facility.

Example 12: Blue, Inc. is a State P corporation that manufactures and sells industrial equipment. Although Blue makes sales to customers nationwide, it has nexus only in States P and Q. All shipments are made from Blue's factory located in P. Both P and Q employ double-weighted sales apportionment formulae. Blue's property, payroll, and sales are distributed as follows (all amounts in millions):

	<u>State P</u>	<u>State Q</u>	<u>Other</u>	<u>Total</u>
Property	\$90	\$10	\$0	\$100
Payroll	\$40	\$10	\$0	\$50
Sales	\$30	\$30	\$140	\$200

As the following computations indicate, if State P does not have a sales throwback rule, 50 percent of Blue's income is taxable in State P, 15 percent is taxable in State Q, and the other 35 percent is not taxable in any state.

STATE P

- Property factor (\$90 million ÷ \$100 million) 90%
- Payroll factor (\$40 million ÷ \$50 million) 80%
- Sales factor (\$30 million ÷ \$200 million) × (2) 30%
- Sum of factors 200%
- Apportionment percentage (200% ÷ 4) 50%

STATE Q

- Property factor (\$10 million ÷ \$100 million) 10%
- Payroll factor (\$10 million ÷ \$50 million) 20%
- Sales factor (\$30 million ÷ \$200 million) × (2) 30%
- Sum of factors 60%
- Apportionment percentage (60% ÷ 4) 15%

On the other hand, if State P has a throwback rule, the State Q apportionment percentage is still 15 percent, but the State P apportionment percentage increases to 85 percent (see computation below). Therefore, 100 percent of Blue's income is now subject to state taxation.

STATE P

• Property factor (\$90 million ÷ \$100 million)	90%
• Payroll factor (\$40 million ÷ \$50 million)	80%
• Sales factor ([(\$30 million destination sales + \$140 million throwback] ÷ \$200 million) × (2)	<u>170%</u>
• Sum of factors	<u>340%</u>
• Apportionment percentage (340% ÷ 4)	<u>85%</u>

Different sourcing rules apply to sales other than sales of tangible personal property. Examples include fees for services, rents, and royalties. At present, roughly half the states employ a cost of performance rule, while the other states employ market-based sourcing rules. Under a cost of performance rule, a business receipt is attributed to the state in which a greater proportion of the income-producing activity is performed, based on costs of performance. For example, fees from the performance of professional services are assigned to the state in which the services are performed. Likewise, income from leases of real or tangible personal property is assigned to the state in which the underlying property is used. With respect to interest and dividends included in the sales factor, one approach is to assign the receipts to the state in which the corporation's headquarters office or commercial domicile is located, based on the assumption that the underlying income-producing activity is the management of the intangibles. Many states assign royalties to the state in which the intangible property is used by the licensee.

In the case of sales of services, the state where the income-producing activity is performed may not be the same state as where the customer or service recipient is located. This would occur, for example, if a data processing facility located in one state provides data processing services to customers located nationwide. As a consequence, to the extent that the service recipients are located in different states than the service provider, the costs of performance rule for sales of services does not measure a company's customer base in the same fashion as the destination test for sales of goods. To address this issue, in recent years many states have adopted market-based sourcing rules for sales of services, which assign the sale to the state in which the service is delivered or received by the customer.³⁷

³⁷ UDITPA Sec. 17. In 2014, the MTC amended UDITPA Section 17 and replaced the cost of performance rule with market-based sourcing rules. For example, sales of services are attributed to the state in which the "service is delivered."

Figure 3 summarizes the most commonly used attribution rules for computing the numerator of the sales factor.

Figure 3: General Rules for Sourcing Gross Receipts

Type of Gross receipt	Attribution rule
Sales of tangible personal property	Destination test, subject to throwback
Rents from tangible personal property	Where property is used
Rents, royalties, and gains from realty	Where property is located
Fees for services	Where services are performed, or where services are delivered or received
Royalties from intangible property	Where intangible is used

Example 13: Acme, Inc. markets its products nationwide but has nexus only in States X and Y. All goods are shipped from Acme’s production facility located in State X, which has a sales throwback rule. Assume States X and Y include income from intangibles in the sales factor, and assign such income to the state of commercial domicile. Acme is commercially domiciled in State X. States X and Y both use the costs of performance rule to source gross receipts other than gross receipts from sales of tangible personal property. Acme’s current year business receipts are as follows (all amounts in millions):

• Sales shipped to X customers	\$ 190
• Sales shipped to Y customers	300
• Sales shipped to customers in other states	400
• Interest income on short-term investments of working capital	15
• Income from renting excess space in warehouse located in X	25
• Fees for services performed by X employees for Y customers	40
• Royalty from industrial patent licensed to Y user	30
	<u>\$1,000</u>

The State X and Y sales factors are computed as follows (all amounts in millions):

	State X	State Y	Total
• Sale shipments (destination test)	\$190	\$300	\$ 490
• Sale shipments (throwback)	400	0	400
• Interest income (commercial domicile)	15	0	15
• Rental income (where used)	25	0	25
• Fees for services (where performed)	40	0	40
• Royalties (commercial domicile)	30	0	30
	<u>\$700</u>	<u>\$300</u>	<u>\$1,000</u>

The State X sales factor is 70 percent ($\$700 \div \$1,000$), and the State Y sales factor is 30 percent ($\$300 \div \$1,000$).

Property and Payroll Factors

The property factor is a fraction, the numerator of which is the taxpayer's total property within the state during the taxable year, and the denominator of which is the taxpayer's total property everywhere during the taxable year. The term "property" is generally defined as real and tangible personal property, owned or rented by the taxpayer and used in the regular course of its trade or business. Common examples include land, buildings, furniture and fixtures, machinery and equipment, and inventories. Certain types of assets are generally excluded from the property factor, including intangible property, nonbusiness property, construction-in-progress, and property that has been permanently withdrawn from service. Property is generally valued at original cost, and is included in the property factor at the average of the beginning and end-of-year cost amounts. In addition, to create parity between taxpayers that lease rather than purchase assets, rentals on real and tangible personal property generally are included in the property factor at an amount equal to eight times the net annual rental rate. The numerator of the property factor includes property that is physically located within the state.³⁸ The value of mobile property, such as construction or transportation equipment, is generally included in the numerator based on the time spent within the state during the tax year.

Example 14: ExCo is a calendar year corporation that manufactures industrial equipment at its production facility located in State J. In addition, ExCo leases a distribution facility located in State K at an annual rental rate of \$10 million. For purposes of computing the property factor, ExCo's January 1 and December 31 account balances are as follows (in millions):

January 1

	<u>State J</u>	<u>State K</u>
• Inventory	\$150	\$340
• Property, plant, and equipment	\$1,000	\$100
• Land	\$500	\$0

December 31

	<u>State J</u>	<u>State K</u>
• Inventory	\$250	\$400
• Property, plant, and equipment	\$1,200	\$100
• Land	\$500	\$0

³⁸ UDITPA Sec. 10 through 12.

The State J and State K property factors are computed as follows:

<u>STATE J</u>	<u>Jan. 1</u>	<u>Dec. 31</u>	<u>Average</u>
• Inventory	\$150	\$250	\$200
• Property, plant, and equipment	\$1,000	\$1,200	\$1,100
• Land	\$500	\$500	<u>\$500</u>
			<u>\$1,800</u>
<u>STATE K</u>	<u>Jan. 1</u>	<u>Dec. 31</u>	<u>Average</u>
• Inventory	\$340	\$400	\$370
• Property, plant, and equipment	\$100	\$100	\$100
• Rentals (\$10 × 8)			<u>\$80</u>
			<u>\$550</u>

The State J property factor equals $[\$1,800 \div (\$1,800 + \$550)]$, or 76.6 percent, and the State K property factor equals $[\$550 \div (\$1,800 + \$550)]$, or 23.4 percent.

The payroll factor is a fraction, the numerator of which is the taxpayer's total compensation paid in the state during the taxable year, and the denominator of which is the taxpayer's total compensation during the taxable year. For this purpose, "compensation" means wages, salaries, commissions, and any other form of remuneration paid to employees for personal services, and which is taxable for federal income tax purposes. Payments to independent contractors are excluded, as are nontaxable fringe benefits such as employer-provided medical insurance. Some states also exclude officer salaries. If an employee performs services exclusively within a state, then that employee's compensation is included in the numerator of that state. If an employee performs services both within and without a state, the entire amount of the employee's compensation is still generally assigned to a single state, based upon a hierarchy of factors, including the employee's base of operations, where the employee is directed from, and the employee's state of residence.³⁹ The rules for computing an employee's compensation, and for assigning that compensation to a particular state, parallel those used for computing an employer's federal and state unemployment taxes. Federal Form 940, Employer's Annual Federal Unemployment Tax Return, summarizes taxable compensation amounts on a state-by-state basis, and therefore is used as the starting point for computing state payroll factors.

³⁹ UDITPA Sec. 13 and 14.

ALLOCATION OF NONBUSINESS INCOME

A corporation's business income is apportioned among the various states in which the taxpayer has nexus, whereas the entire amount of an item of nonbusiness income is specifically allocated to a single state. Classifying income as nonbusiness in nature has historically been an area of significant controversy, because it effectively removes the income from the tax base of one or more nexus states. Therefore, states generally prefer to have income classified as apportionable business income. For example, in a leading case regarding nonbusiness income (*Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 1992), the state of New Jersey was attempting to tax an apportioned percentage of a \$211.5 million capital gain realized by a corporation that was headquartered in Michigan, but was doing business in a number of states, including New Jersey. If the gain was properly classified as nonbusiness income, only the state of commercial domicile (in this case, Michigan) could tax the gain.

OBJECTIVE 6:

Distinguish between the allocation of nonbusiness income and the apportionment of business income.

In distinguishing between business and nonbusiness income, the essential question is whether the item of income is related to the trade or business that the corporation conducts in the state. Under UDITPA, nonbusiness income means all income other than business income, and business income means all income that is apportionable under the U.S. Constitution, including any item of income that meets one of the following two tests:⁴⁰

- **Transactional test:** The item of income is derived from transactions and activity in the regular course of the taxpayer's trade or business.
- **Functional test:** The item of income is derived from tangible and intangible property, the acquisition, management, employment, development or disposition of which is related to the operation of the taxpayer's trade or business.

Under the UDITPA definition of business income, interest, dividends, and royalties are properly treated as apportionable business income if the income either arises from transactions in the regular course of the taxpayer's trade or business or is derived from property that is an integral part of the taxpayer's regular trade or business. For example, if a manufacturer of industrial chemicals acquires patents on its products and then licenses the production of those

⁴⁰ UDITPA Sec. 1(a).

chemicals in foreign countries, the royalties received by the taxpayer are business income. Likewise, interest that a retailer derives with respect to credit sales of its merchandise is business income, as is interest that a manufacturer earns on short-term investments of its working capital. Finally, dividends that a manufacturer receives from a subsidiary that acts as the marketing agent for products manufactured by the taxpayer are business income.⁴¹

Mechanically, the entire amount of any item of nonbusiness income is removed from the tax base of all states in which the corporation has nexus, and is then added back to the tax base of the single state to which the nonbusiness income is allocable. As Figure 4 indicates, nonbusiness income is generally allocated either to the state in which the underlying nonbusiness property is located or used, or to the state in which the corporation is commercially domiciled.⁴² A corporation's commercial domicile is the principal place from which the business is directed or managed. It is not necessarily the same state as the state of incorporation.⁴³

Figure 4: General Rules for Allocating Nonbusiness Income

Type of Nonbusiness Income	Allocation rule
Rents, royalties, and gains from realty	Where realty is located
Rents and gains from tangible personal property	Where property is located, subject to throwback to commercial domicile
Interest and dividends	Commercial domicile
Capital gains from intangible property	Commercial domicile
Royalties from intangible property	Where intangible is used, subject to throwback to commercial domicile

⁴¹ Examples taken from MTC Reg. IV.1.(c)(3) to (c)(5).

⁴² UDITPA Sec. 4 to 8.

⁴³ UDITPA Sec. 1(b).

Stop and Think

Issue: Giant Corporation, which is incorporated and headquartered in State H, is a large multinational corporation. Giant is engaged in the manufacture and distribution of consumer products worldwide. Giant's U.S. operations are structured as a single corporate entity, which has income tax nexus in thirty states. As part of a major business restructuring, Giant plans to sell its interests in a number of foreign subsidiary corporations, resulting in a total of \$1 billion in capital gains. Giant's chief financial officer has asked you to brief her on how state tax authorities might respond if Giant takes the position that the \$1 billion capital gain is nonbusiness income.

Solution: As a general rule, a nonbusiness gain from the sale of intangible property is allocated to the state of commercial domicile. In other words, a single state is entitled to tax the entire amount of the gain, while the other nexus states collect no taxes on the gain. State H tax authorities would be pleased with this result. For example, assuming the State H tax rate is 5 percent, H would collect \$50 million of taxes on the \$1 billion gain. The reaction of the other twenty-nine states in which Giant is taxable is equally predictable. In order to tax an apportioned percentage of the gain, the gain must be classified as business income. Again assuming a 5 percent tax rate, even in a state in which Giant's apportionment percentage is only 2 percent, classifying the gain as business income rather than nonbusiness income generates \$1 million in tax revenues $[5 \text{ percent tax rate} \times (2 \text{ percent apportionment percentage} \times \$1 \text{ billion capital gain})]$. Therefore, if Giant takes the position that the gain is nonbusiness in nature, Giant should expect to have this position challenged by a number of states.

PARTNERSHIPS, S CORPORATIONS, AND LIMITED LIABILITY COMPANIES

For federal income tax purposes, a business enterprise with two or more owners is classified as a regular corporation, S corporation, or partnership. Regular corporations are subject to the federal corporate income tax, whereas S corporations and partnerships generally are not subject to an entity-level federal income tax.

Instead, the income of these pass-through entities is taxed to the business owners. If the business owners are individuals, the applicable federal tax is the federal individual income tax. Therefore, a threshold issue in the taxation of any business is its proper classification for federal tax purposes.

OBJECTIVE 7:

Understand the tax treatment of resident and nonresident owners of multistate partnerships, S corporations, and limited liability companies.

Under the federal check-the-box regulations, a domestic business entity that is considered a corporation under state law is classified as a corporation for federal income tax purposes.⁴⁴ If eligible, the shareholders can make an S corporation election. If an S corporation election is not made, the entity is considered a regular corporation for federal tax purposes. Other types of domestic business entities that have two or more owners, such as general partnerships, limited partnerships, limited liability partnerships, and limited liability companies (LLC), are classified as partnerships for federal tax purposes, unless the partners or members elect to have the entity classified as a regular corporation for federal tax purposes. A single member LLC is treated as a disregarded entity for federal tax purposes (i.e., a sole proprietorship if the member is an individual or a branch if the member is a corporation), unless the member elects to have the entity classified as a corporation.

Although the states generally conform to the federal pass-through entity treatment of S corporations, partnerships, and LLCs, a number of states impose entity-level taxes on pass-through entities. For example, Tennessee taxes S corporations and LLCs in the same manner as regular corporations. In a similar fashion, both S corporations and partnerships are generally subject to the gross receipts taxes imposed by Ohio and Washington. Table 4 provides some more examples of states that impose entity-level taxes on S corporations and partnerships (including LLCs with two or more members that are classified as partnerships).

⁴⁴ Treas. Reg. 301.7701-2 through 4.

Table 4: Examples of States That Impose Entity-Level Taxes on S Corporations and Partnerships

State	S Corporations	Partnerships
California	1.5% income tax (3.5% for financial S corporations)	LLCs: Fee based on gross receipts
Illinois	1.5% income tax	1.5% income tax
Massachusetts	1.93% (2.9%) income tax if receipts ≥ \$6 million (\$9 million)	n.a.
Ohio	Commercial activity tax (gross receipts tax)	Commercial activity tax (gross receipts tax)
Tennessee	6.5% income tax, and 0.25% franchise tax	LP, LLP, or LLC: 6.5% income tax, and 0.25% franchise tax
Texas	0.375% or 0.75% tax on margin	0.375% or 0.75% tax on margin (general partnership is exempt if all partners are natural persons)
Washington	Business and occupation tax (gross receipts tax)	Business and occupation tax (gross receipts tax)

State Individual Income Taxes

Shareholders of an S corporation generally must be individuals. Likewise, partners in a partnership are often individuals. Therefore, to understand how states tax the owners of pass-through entities, it is first necessary to understand the following basic features of state individual income tax systems:

- **Not all states have individual income taxes.** Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not impose individual income taxes. In addition, New Hampshire and Tennessee tax only selected types of income, not including wages.
- **Taxation of residents.** Individuals must file income tax returns in the states in which they reside. For administrative ease, the computation of state taxable income usually begins with the amount of federal adjusted gross income reported on the individual's federal Form 1040. For federal tax purposes, gross income includes

income from whatever source derived.⁴⁵ Therefore, by virtue of piggybacking on the federal tax base, states generally tax the worldwide income of individuals residing within their borders.

- **Taxation of nonresidents.** In contrast to residents, a state can tax nonresidents only on income derived from sources within the state's borders. For example, the state of Oregon generally does not tax the income of a resident of Idaho. If a resident of Idaho commutes daily to a work site located in Oregon, however, Oregon can tax the Idaho resident on the personal services income earned within Oregon. Other types of income of a nonresident that a state may tax include income derived from business activities conducted in the state and income from real and tangible personal property located in the state. On the other hand, interest, dividends, and capital gains derived from portfolio investments in stocks and bonds are generally sourced to the state in which the individual resides. Consequently, such income is generally taxable only in the state in which the taxpayer is a resident.
- **Taxation of part-year resident.** Within a single calendar year, it is possible for an individual to be a resident for part of the tax year and a nonresident for the other part of the year (e.g., in the year he or she moves into or out of the state). The tax treatment of part-year residents varies from state-to-state. One approach is to tax the individual as a resident during the period of residence, and tax the individual as a nonresident during the period of non-residence.
- **Credit is provided to prevent double taxation.** If a resident of one state derives income from sources within another state, double taxation can result. To prevent this, states usually allow residents to claim a credit for income taxes paid to other states, which effectively offsets the out-of-pocket costs associated with those taxes. States generally limit the amount of the credit to the portion of a resident's pre-credit tax which is attributable to the double-taxed income.
- **Reciprocity agreements.** Some states have entered into reciprocity agreements, primarily to ease the compliance burden of cross-border commuters who reside in one state but work for an employer located across the border in another state. Under these agreements, each state agrees not to tax a resident of the other state on compensation the nonresident receives for working in the state. Instead, the compensation is taxable only by the state of residence.

⁴⁵ IRC Sec. 61(a).

- **Definition of “resident.”** The definition of “resident” varies from state to state. Generally, an individual is considered to be a resident if he or she is domiciled in the state or if he or she is a statutory resident. A statutory resident generally means an individual who spends at least 183 days of the tax year in the state and maintains a dwelling in the state. An individual’s “domicile” is his or her permanent home. It is the place where the individual intends to remain indefinitely and to which, whenever absent, the individual intends to return. An individual can be domiciled in only one state, and that domicile does not change unless the individual abandons his or her old domicile, moves to and occupies a new residence, and intends to remain at the new residence indefinitely. Because an individual’s intentions play a central role in determining residency, there is no simple, objective test for determining the domicile of an individual who maintains dwellings in more than one state. Examples of factors that may be taken into account in making this determination include the amount of time spent in the state, where a spouse and dependents live, where dependent children attend school, voter registration, driver’s license, and membership in a church, club, or other social organization located in state.

Taxation of Partners and S Corporation Shareholders

Consistent with the general principle that states tax the worldwide income of resident individuals, the state of residence generally taxes the entire amount of a resident partner’s distributive share of partnership income, regardless of where the income was earned. This principle also applies to members of an LLC that is classified as a partnership for income tax purposes. For example, assume Juan is a resident of State Z and a partner in a national CPA firm that is structured as a partnership and has offices in thirty states, including State Z. State Z can tax the full amount of Juan’s distributive share of partnership income, even if little of the income is derived from sources within State Z.

On the other hand, states generally tax nonresident partners on only that portion of the nonresident partner’s distributive share of partnership income that is derived from sources within the state’s borders. Continuing with the prior example, if Janet is a resident of State Y and a partner in the same national CPA firm as Juan, State Z can tax Janet but only on that portion of her distributive share of partnership income that is derived from sources within State Z. Under the theory that a partnership is merely the aggregation of the partners and each partner is treated as if he or she directly owns a fractional interest in the assets of the partnership, the partnership’s nexus in State Z is imputed to Janet and any other nonresident partners. To determine the percentage of a nonresident partner’s distributive share of partnership income that is taxable, states generally use the same apportionment formula used for corporate income tax purposes.

In sum, the state of residence typically taxes 100 percent of a resident partner's distributive share of partnership income. At the same time, other states in which the partnership has nexus typically tax an apportioned percentage of that same distributive share of income. These competing claims may result in double taxation. However, as discussed earlier, the state of residence generally allows individuals to claim a credit for income taxes paid to other states.

Example 15: Claire (who resides in State X) is a 30 percent partner in the CDT Partnership, Doug (who resides in State Y) is a 20 percent partner, and Tom (who resides in State Z) is a 50 percent partner. CDT has \$1 million of income, and has nexus in three states (X, Y, and Z), with 40 percent of its income derived from business operations in X, 10 percent in Y, and 50 percent in Z.

Allocation of CDT's Income by Partner and State				
	Claire (30%)	Doug (20%)	Tom (50%)	Totals
State X source (40%)	\$120,000	\$80,000	\$200,000	\$ 400,000
State Y source (10%)	30,000	20,000	50,000	100,000
State Z source (50%)	<u>150,000</u>	<u>100,000</u>	<u>250,000</u>	<u>500,000</u>
	<u>\$300,000</u>	<u>\$200,000</u>	<u>\$500,000</u>	<u>\$1,000,000</u>

Based on both the residence of the partners and the source of income, CDT's \$1 million of income is taxed as follows:

Taxation of CDT's Income by Partner and State			
	Claire	Doug	Tom
State X taxable income	\$300,000 *	\$80,000	\$200,000
State Y taxable income	30,000	200,000 *	50,000
State Z taxable income	<u>150,000</u>	<u>100,000</u>	<u>500,000 *</u>
	<u>\$480,000</u>	<u>\$380,000</u>	<u>\$750,000</u>

* State of residence

Note that each partner is subject to double taxation. For example, Claire's actual share of partnership income is \$300,000, but she is taxed on a total of \$480,000 of income, \$300,000 taxed by her state of residence and \$180,000 (\$30,000 + \$150,000) taxed by the other two source states. To mitigate double taxation, the state of residence (in Claire's case, State X) usually allows a resident partner to claim a credit for income taxes paid to other states.

The approach that states take for taxing shareholders of multistate S corporations is similar to that for taxing partners of multistate partnerships (discussed above). In a nutshell, any state in which the S corporation has nexus will ordinarily tax a nonresident shareholder on that portion of the shareholder's pro-rata share of S corporation income that is derived from sources within that state. On the other hand, the state of residence generally taxes the entire amount of a

resident shareholder's pro-rata share of S corporation income, regardless of the source of that income.

Federal Pass-through Entity Deduction

The *Tax Cuts and Jobs Act of 2017* (P.L. 115-97) provides individuals with a new 20 percent deduction for certain qualified business income derived from a partnership, S corporation, or sole proprietorship. Qualified business income is the net business income from a qualified business conducted in the United States. It does not include income earned as an employee or income derived from a specified service business. Examples of specified service businesses include health, law, accounting, consulting, and financial services businesses. The specified service business requirement does not apply to taxpayers with taxable income below a certain threshold. The amount of the pass-through entity deduction is limited, based on the wages paid by the qualified business and the basis of certain property of the qualified business. The pass-through entity deduction is a deduction from adjusted gross income, which is important because most states use federal adjusted gross income as the starting point for computing an individual's state taxable income. These states will not conform to the new federal pass-through entity deduction unless state lawmakers specifically adopt the pass-through entity deduction as a state modification in the computation of an individual's state taxable income.

Compliance Issues

Collecting tax from nonresident owners of a multistate partnership or S corporation is a major compliance issue. Nonresident partners and S corporation shareholders are generally obligated to file returns and pay taxes in every state in which the pass-through entity has income tax nexus. This can create a significant administrative burden. One method of easing this compliance burden is for a state to allow the pass-through entity to file a composite return on behalf of the nonresident partners or nonresident S corporation shareholders. Under this procedure, a single return can be used to satisfy the state filing obligation for the entire group of taxpayers. For example, consider a State X partnership that has ten partners, all of whom are individuals who reside in State X. The partnership has nexus in State Y, which allows nonresident partners to file a composite return. Therefore, rather than each of the ten partners filing separate individual income tax returns in State Y, the partnership can file a single composite State Y return on behalf of the ten partners. Another technique for promoting compliance on the part of out-of-state partners or S corporation shareholders is to require the pass-through entity to withhold and remit any taxes due on the nonresident owners' distributive shares of income. Most states allow the filing of composite returns and/or require withholding.

CORPORATE INCOME TAX PLANNING

Managing Nexus

OBJECTIVE 8:

Recognize basic multistate tax planning issues.

Determining the states in which a corporation has income tax nexus can be a challenge, in part because it is often difficult to gather the pertinent facts. For example, companies may not have systems in place to gather information regarding the precise nature of its employees' activities within a particular state, such as the activities of sales representatives or executives who make business trips to that state. A company clearly has nexus in a state in which the company has an office, manufacturing plant, distribution center or other facility, and is staffed by its own employees. A more difficult issue is whether a company has nexus in one or more of its market states. Even if a company does not have a formal sales office in a state, the activities of its sales force can create nexus. The ability of sales persons to create nexus applies not only to the actions of employee-salespersons, but also to independent commission agents who are regularly present in a state performing activities on behalf of the out-of-state taxpayer.⁴⁶ Key issues include whether the taxpayer is selling tangible personal property (in which case Public Law 86-272 applies), the magnitude of the sales force's in-state activities, and the precise nature of those activities (in particular, whether they are limited to the solicitation of orders). Other activities that might create nexus include the regular in-state presence of other employees, such as service technicians.

After the pertinent facts have been established, the next step is to determine whether a company's activities in a particular state are sufficient to create nexus. This should include a review of the applicable state statutes, administrative rulings, and court cases. For example, some states provide special exemptions for employees who enter the state to attend a trade show. Another key legal authority is federal Public Law 86-272, which provides limited protection to companies that sell goods.

Finally, because numerous states have adopted economic or factor presence nexus standards, a company may need to file income tax returns in states in which it does not have a physical presence. The Supreme Court's decision in *Wayfair* opens the door for more states to adopt or expand their economic or factor presence nexus standards.

⁴⁶ *Scripto, Inc. v. Carson*, 362 US 207 (1960).

Consolidated or Combined Returns

Filing a consolidated or combined return can be beneficial when one member of the affiliated group has losses that can be offset against the profits generated by other affiliates. Other potential benefits of filing a consolidated or combined return include the elimination of intercorporate dividends, deferral of gains on intercompany transactions, and the use of credits that would otherwise be denied due to a lack of income. A major disadvantage of filing a consolidated or combined return is that it can prevent a taxpayer from creating legal structures and intercompany transactions to shift income from affiliates based in high-tax states to affiliates based in low-tax states.

In states that do not permit affiliated corporations to file a consolidated or combined return, structuring a company's in-state activities as a single member LLC (as opposed to a separately incorporated subsidiary) may provide results similar to those of a consolidated or combined return. A single member LLC generally is treated as a disregarded entity for both federal and state income tax purposes. As a consequence, any start-up losses of a newly-formed entity can be used to offset the profits of the parent corporation. If the new operation had been structured as a subsidiary corporation, the losses could not be used by the corporate parent in separate company return states, but instead would have to be carried forward and offset against any future profits of the newly-formed subsidiary.

Location Decisions

Businesses consider a number of factors when deciding where to locate or expand their operations, such as labor costs, transportation costs, and utility costs. To an extent, this is a cost-minimization decision, and therefore differential state tax burdens can play a role in determining where a business chooses to locate or expand. All states offer incentive programs to encourage companies to locate new facilities or expand existing facilities within the state's borders. Examples of nontax incentives include industrial development bonds and assistance with employee training. Examples of tax incentives to attract new businesses include income tax credits (e.g., investment credits and jobs credits), property tax incentives offered by local governments (e.g., tax abatements, reduced tax rates, and tax payment deferrals), and sales tax incentives (e.g., exemptions for machinery and equipment used in manufacturing). To encourage business investment in economically distressed areas, many states offer special tax benefits to companies that establish facilities within defined geographic areas known as "enterprise zones."

A state's apportionment formula can also be an important income tax incentive. By using a formula that includes property and payroll factors, a state effectively imposes a tax penalty on businesses that choose to expand their facilities and add jobs within the state's borders. For this

reason, many states have adopted apportionment formulae that place more weight on the sales factor, and less weight on the property and payroll factors. The lower the weight placed on the property and payroll factors, the less impact that locating additional property and payroll in the state will have on the state income tax. For example, locating additional property and payroll in a state that uses a single-factor sales formula has no effect on the amount of income taxable in that state. The lack of a sales factor throwback rule also makes a state a more attractive place to locate new facilities.