

Chapter 23

Multistate Corporate Taxation

**Eugene Willis, William H. Hoffman, Jr.,
David M. Maloney and William A. Raabe**

Copyright ©2004 South-Western/Thomson Learning

Overview

- 46 states and District of Columbia impose a tax based on corp's taxable income
 - Majority of states “piggyback” onto Federal income tax base
 - Essentially, they have adopted part or all of the Federal tax provisions

Computing Corporate State Income Tax Liability (slide 1 of 2)

Starting point in computing taxable income**

± State modification items

State tax base

± Total net allocable income/(loss) (nonbusiness income)

Total apportionable income/(loss) (business income)

x State's apportionment percentage

Income apportioned to the state

**Most states use either line 28 or line 30 of the Federal corp tax return (Form 1120). In other states, the corp must identify and report each element of income and deduction on the state return.

Computing Corporate State Income Tax Liability (slide 2 of 2)

Income apportioned to the state

± Income/(loss) allocated to the state

State taxable income/(loss)

x State tax rate

Gross income tax liability for state

- State's tax credits

Net income tax liability for the state

Common State Additions (slide 1 of 3)

- Interest income on state/municipal obligations and other interest income exempt from Federal income tax
 - May exclude interest income on obligations within that state to encourage investment in in-state bonds

Common State Additions (slide 2 of 3)

- State income taxes deducted on Federal return
 - Includes franchise taxes based on income
- Federal depreciation in excess of amount allowed by state (if depreciation systems differ)

Common State Additions (slide 3 of 3)

- State gain in excess of Federal gain on assets; Federal loss in excess of state loss on assets
- Adjustments to amounts under Federal elections
- Federal Net Operating Loss Deduction

Common State Subtractions

(slide 1 of 3)

- Interest on U.S. obligations to extent included in Federal taxable income
 - States cannot impose income tax on income from U.S. obligations, but may assess income-based franchise tax
- State depreciation in excess of Federal (if depreciation systems differ)

Common State Subtractions

(slide 2 of 3)

- Federal gain in excess of state gain on assets; State loss in excess of Federal loss of assets
- Adjustments to amounts under Federal elections

Common State Subtractions

(slide 3 of 3)

- State Net Operating Loss Deduction
- Dividends received from certain out-of-state corps to extent included in Federal return
- Federal income taxes paid

UDITPA And The Multistate Tax Commission

- Uniform Division of Income for Tax Purposes Act (UDITPA) is a model law relating to assignment of income among states for multistate corps
- Many states have adopted UDITPA either by joining the Multistate Tax Compact or modeling their laws after UDITPA

Nexus for Income Tax Purposes (slide 1 of 2)

- Nexus is the degree of business activity which must be present before a state can impose tax on an out-of-state entity's income
- Sufficient nexus typically exists if:
 - Income is derived from within state
 - Property is owned or leased in state
 - Persons are employed in state
 - Physical or financial capital is located in state

Nexus for Income Tax Purposes (slide 2 of 2)

- No nexus if only “connection” to state is solicitation for sale of tangible personal property, with orders sent outside state for approval and shipping to customer (Public Law 86-272)
- Sales tax can still apply

Independent Contractors

- May generally engage in the following activities without establishing nexus by company:
 - Solicit sales
 - Make sales
 - Maintain sales office
- Source: Public law 86-272

Allocation And Apportionment Of Income (slide 1 of 3)

- Apportionment is the means by which business income is divided among states in which it conducts business
 - Corp determines net income for the company as a whole and then apportions some to a given state, according to an approved formula

Allocation And Apportionment Of Income (slide 2 of 3)

- Allocation is a method used to directly assign specific components of a corp's income, net of related expenses, to a specific state
- Allocable income generally includes:
 - Income or loss from sale of nonbusiness property
 - Income or losses from rents or royalties from nonbusiness real or tangible personal property

Allocation And Apportionment Of Income (slide 3 of 3)

- Typically, allocable income (loss) is removed from corporate net income before the state's apportionment formula is applied
 - Nonapportionable income (loss) assigned to a state is then combined with income apportionable to the state to arrive at total income subject to tax in the state

Apportionment Procedure

- Business income is assigned to states using an apportionment formula
 - Business income arises from the regular course of business
 - Integral part of taxpayer's regular business
- Nonbusiness income is apportioned or allocated to the state in which the income-producing asset is located

Apportionment Factors

- Apportionment formulas vary among states
 - Traditionally, states use a three-factor formula that equally weights sales, property, and payroll
 - Many states use a modified formula where sales factor receives a larger weight
 - Tends to pull larger amount of out-of state corporation's income into the state
 - May provide tax relief to corps domiciled in the state

Sales Factor (slide 1 of 3)

- Sales factor is a fraction
 - Numerator is corp's sales in the state
 - Denominator is corp's total sales everywhere
- Most states follow UDITPA's "ultimate destination concept"
 - Tangible asset sales are assumed to take place at point of delivery, not where shipping originates

Sales Factor (slide 2 of 3)

- Dock sales occur when delivery is taken at seller's shipping dock
 - Most states apply the destination test to dock sales
 - If purchaser has out-of-state location to which it returns with the product, sale is assigned to purchaser's state

Sales Factor (slide 3 of 3)

– Throwback rule

- If adopted by state, requires that out-of-state sales not subject to tax in destination state be pulled back into origination state
- Treats such sales as in-state sales of the origination state
- Also applies if purchaser is U.S. government

Payroll Factor (slide 1 of 4)

- Payroll factor is a fraction
 - Numerator is compensation paid within a state
 - Denominator is total compensation paid by the corporation

Payroll Factor (slide 2 of 4)

- Compensation includes wages, salaries, commissions, etc
 - Amounts paid to independent contractors are excluded
 - Some states exclude amounts paid to corporate officers
 - Some states require that deferred compensation amounts be included in the payroll factor (e.g., 401(k) plans)

Payroll Factor (slide 3 of 4)

- Compensation of an employee is usually not split between states (unless employee is transferred or changes positions)
 - Usually allocated to state in which services are primarily performed
 - If more than one state, attribute to:
 - Employee's base of operations, or, if none,
 - Place where work is directed or controlled, or, if none,
 - Employee's state of residency

Payroll Factor (slide 4 of 4)

- Only compensation related to production of apportionable income is included in payroll factor
 - In states that distinguish between business and nonbusiness income, compensation related to nonbusiness income is not included
 - Compensation related to both business and nonbusiness income is prorated between the two

Property Factor (slide 1 of 3)

- Property factor generally includes average value of real and tangible personal property owned or rented
 - Numerator is amount used in the state
 - Denominator is all of corp's property owned or rented

Property Factor (slide 2 of 3)

- Property includes:
 - Land, buildings, machinery, inventory, etc
 - May include construction in progress, offshore property, outer space property (satellites), and partnership property
- Property in transit is included in numerator of destination state

Property Factor (slide 3 of 3)

- Property is typically valued at average historical cost plus additions and improvements
 - Some states allow net book value or adjusted basis to be used
- Leased property, when included in the property factor, is valued at eight times its annual rental payments

Allocation, Apportionment Example

Total allocable income (State A)	\$100,000
Apportionable income (States A and B)	<u>800,000</u>
Total income	\$900,000

All sales, payroll, and property is divided equally between states A and B. Both states use identical apportionment formulas.

Taxable income:	<u>State A</u>	<u>State B</u>
1/2 Apportionable income	\$400,000	\$400,000
Allocable income	<u>100,000</u>	<u>-0-</u>
Total state taxable income	\$500,000	\$400,000

Apportionment Example

(slide 1 of 2)

Americo, Inc. operates in three states with the following apportionment systems:

W's factors: average of four factors, sales double-weighted

X's factors: average of three factors, equally weighted

Y's factors: sales factor only

State:	<u>W</u>	<u>X</u>	<u>Y</u>	<u>Total</u>
Sales:	\$400,000	\$100,000	\$500,000	\$1,000,000
Factor	40%	10%	50%	
Payroll:	90,000	150,000	60,000	300,000
Factor	30%	50%	20%	
Property:	120,000	240,000	40,000	400,000
Factor	30%	60%	10%	

Apportionment Example

(slide 2 of 2)

Taxable income for year (all states)	\$100,000		
State:	<u>W</u>	<u>X</u>	<u>Y</u>
Sales	40%	10%	50%
Sales	40%	N/A	N/A
Payroll	30%	50%	N/A
Property	30%	60%	N/A
Total	140%	120%	50%
Average	35%	40%	50%
Taxable income to each state	\$35,000	\$40,000	\$50,000
Total taxed in all states:	\$125,000		
N/A=not applicable			

Apportionment Example

Revisited_(slide 1 of 2)

Americo, Inc. moves most personnel and property to state Y.

State:	<u>W</u>	<u>X</u>	<u>Y</u>	<u>Total</u>
Sales:	\$400,000	\$100,000	\$500,000	\$1,000,000
Factor	40%	10%	50%	
Payroll:	30,000	30,000	240,000	300,000
Factor	10%	10%	80%	
Property:	40,000	40,000	320,000	400,000
Factor	10%	10%	80%	

W's factors: average of four factors, sales double-weighted

X's factors: average of three factors, equally weighted

Y's factors: sales factor only

Apportionment Example

Revisited_(slide 2 of 2)

Taxable income for year (all states)	\$100,000		
State:	<u>W</u>	<u>X</u>	<u>Y</u>
Sales:	40%	10%	50%
Sales	40%	N/A	N/A
Payroll:	10%	10%	N/A
Property:	<u>10%</u>	<u>10%</u>	<u>N/A</u>
Total	100%	30%	50%
Average	25%	10%	50%
Taxable income			
to each state	\$25,000	\$10,000	\$50,000
Total taxed in all states:	\$85,000		
N/A = not applicable			

Unitary Taxation (slide 1 of 2)

- Theory: operating divisions are interdependent so cannot be segregated into separate units
 - Each unit deemed to contribute to overall profits
 - Unitary theory ignores separate legal existence of companies: all combined for apportionment

Unitary Taxation (slide 2 of 2)

- For multistate apportionment, all divisions or entities are treated as single unitary base:
 - Larger apportionment base (all companies' activities)
 - Smaller apportionment factors (each state's %)

Other Multi-Entity Considerations_(slide 1 of 2)

- Multinational operations: If state uses Unitary system, it may require inclusion of worldwide activities in determining apportionment
- Most unitary states allow Water's Edge election so only U.S. operations are included
 - Cost of election may include:
 - Specified number of years before revocation
 - Additional tax for privilege of excluding foreign entities

Other Multi-Entity Considerations (slide 2 of 2)

- Combined reporting
 - Used in every unitary state in which one or more unitary members have nexus
- Consolidated returns
 - Some states allow consolidated return if filed for Federal

Taxation Of S Corporations

(slide 1 of 2)

- Majority of states with corporate income tax have special provisions that govern S corporations
 - Only a few states do not provide special treatment for S corps
 - In non-S election states, S corps are taxed the same as C corps
 - Must have valid S corp election at federal level to get S corp treatment in states
 - May have other eligibility requirements

Taxation Of S Corporations

(slide 2 of 2)

- Multistate S corps must apportion and allocate income in same manner as regular corp
 - Must file a state tax return in each state with nexus
 - Must inform shareholders of their share of income for each state so their tax returns can be prepared
- S corp may be allowed to file a single return and pay tax for all shareholders

Sales and Use Taxes

(slide 1 of 2)

- Sales tax: Consumers' tax on tangible personal property acquired for use or consumption
 - Vendor acts as collection agent
 - Not assessed on goods purchased for shipment out-of-state
- Use tax complements sales tax
 - Consumers bringing purchased goods into state pay consumption tax to state in which property used
 - States have difficulty enforcing use tax

Sales and Use Taxes

(slide 2 of 2)

- Solicitation by independent brokers is sufficient nexus for sales tax purposes
 - Turns “use” tax into “sales” tax for that state
 - Seller required to collect tax
 - Facilitates collection by state

If you have any comments or suggestions concerning this PowerPoint Presentation for West's Federal Taxation, please contact:

**Dr. Donald R. Trippeer, CPA
donald.trippeer@colostate-pueblo.edu
Colorado State University-Pueblo**