CHAPTER 23

MULTISTATE CORPORATE TAXATION

SOLUTIONS TO PROBLEM MATERIALS

Question/ Problem	Topic	Status: Present Edition	Q/P in Prior Edition
1	Issue ID	New	
2	Multistate tax incentives	New	
3	States’ jurisdiction to tax; nexus	New	
4	Immune sales under P.L. 86-272	Unchanged	4
5	P.L. 86-272 solicitation standards	Unchanged	5
6	Apportionment and allocation of income	Unchanged	6
7	Issue ID	Unchanged	7
8	Sales factor	Unchanged	8
9	Throwback rule for sales factor	Unchanged	9
10	Unitary theory	Unchanged	10
11	Sales taxes and corporate restructurings	Unchanged	11
12	Planning with nexus rules	Unchanged	12
13	Multistate tax planning	Unchanged	13
14	Addition and subtraction modifications	Unchanged	14
15	Addition and subtraction modifications	Modified	15
16	Addition and subtraction modifications	Modified	16
17	Apportionment formulas	Unchanged	17
18	Apportionment formulas	Unchanged	18
19	Apportionment formulas	Unchanged	19
20	Apportionment formulas	Modified	20
21	Throwback rule	Unchanged	21
22	Payroll factor	Unchanged	22
23	Property factor	Unchanged	23
24	Property factor	Unchanged	24
25	Property factor	Unchanged	25
26	Unitary business, apportionment factors	Unchanged	26
27	Water’s edge election	Unchanged	27

Question/ Problem	Topic	Status: Present Edition	Q/P in Prior Edition
28	Multistate S corporations, apportionment formula	Unchanged	28
29	Sales tax base	Modified	29
30	Apportionment planning	Unchanged	30

CHECK FIGURES

14.a.	A; $10,000.
14.d.	S; $3,000.
14.e.	N.
14.f.	S; $5,000.
14.i.	N.
14.j.	Varies.
15.	$222,000.
16.a.	$1,360,000.
16.b.	$1,500,000.
16.c.	$1,543,000.
17.	72.39%; 20.00%.
18.	A 80.0%; B 20.5%
19.	A 79.63%; B 23.50%..
20.a.	$232,170.
20.b.	$215,790.
20.c.	$166,680.
21.	A $213,000; B $263,000.
22.	E 73.68%; F 26.32%.
23.	A 63.01%; B 36.99%.
24.	B 34.70%.
25.	Annual method, 38.6% property factor.
26.a	$49,648.
26.b	$110,000.
27.	B 40.00%; Q 77.78%.
28.	$0 Y; $173,167 Z.
30.	Factor drops to 69.7%.

DISCUSSION QUESTIONS

1. Nontax factors dominate most business relocation decisions. However, a combination of some of the following incentives might also force the consideration of a tax-motivated expansion or relocation.

   - Economic development incentives.
   - Sales and use tax exemptions reducing a customer's acquisition price.
   - Use of technology to transfer sales and purchase orders, pricing information, and other data.
   - Ease in complying with multiple jurisdictions' tax rules.
   - "Exporting" of local taxes to visitors and outsiders.
   - Sophistication and effort of jurisdictional enforcement measures.

   pp. 23-2 and 23-3

2. False. The vast majority of states start with Federal taxable income in deriving their own tax base. p. 23-5

3. a. The state in which a business is incorporated has the jurisdiction to tax the income of the corporation, regardless of the volume of its business activities within the state.

   b. If a corporation is to be subject to tax in a state other than that of its incorporation, the former jurisdiction must show that sufficient contact with that state (*nexus*) has been established. Typically, sufficient nexus exists when a corporation derives income from sources within the state, owns or leases property in the state, employs personnel in the state, or has physical or financial capital there.

   c. A state cannot tax the out-of-state activities of an out-of-state corporation.

   p. 23-9

4. No Colorado tax applies. Public Law 86-272 limits the states' right to impose an income tax on interstate activities. This Federal law prohibits a state from taxing a business whose only connection with the state is to solicit orders for sales of tangible personal property, when the orders then are approved or rejected, filled, and shipped from outside the state.

   Only the sale of tangible personal property is immune from taxation under P.L. 86-272, however. Leases, rentals, and other dispositions of tangible personal property are not immune activities. Moreover, dispositions of real estate and intangible assets, as well as sales of services, are not protected activities.

   p. 23-9

5. Now Colorado tax applies. Public Law 86-272 does not define the term *solicitation*, but the Supreme Court in *Wrigley* held that order solicitation includes any explicit verbal request for orders and any speech or conduct that implicitly invites an order. A *de minimis* rule also may allow a transaction to stay immune under the statute.

   Carrying out any of the following (common but substantively) minimal acts within a state, though, in addition to the traditional sales-solicitation tasks of a sales force, could establish nexus through non-immune sales.

   - Collecting delinquent accounts; investigating creditworthiness.
   - Repairing or maintaining company products (even if performed at no charge to the customer).
   - Approving or accepting orders.

   p. 23-9 and Exhibit 23-2

6. A business that carries out transactions in more than one state must divide such resulting income among the states for tax purposes. Generally, this includes *both* an apportionment and an allocation of such income.

   Apportionment is a means by which business income is assigned to specific states by a formula method. The formula usually takes into account the gross receipts, property, and compensation levels generated within each state, although the states vary in the weighting of the factors for this purpose. *Allocation* is a procedure by which nonbusiness income is assigned directly to the state(s) in which it is generated. For instance, a manufacturing firm with some rental income would allocate the net rental profit or loss to the state in which the rental property is located.

   Several states fail to distinguish between business and nonbusiness income, apportioning all of the taxpayer's income among the states.

   pp. 23-10 to 23-12, and Figure 23-1

7. A single-factor apportionment formula consisting solely of a sales factor tends to create greater levels of apportionable income for the state from nonresident (meaning also nonvoting) entities than an apportionment formula that double weights the sales factor. Most states now over-weight the sales factor for this reason. pp. 23-14, 23-15, and Example 9

8. In determining the numerator of the sales factor, most states follow UDITPA's "ultimate destination concept," whereunder sales of tangible personal property are assumed to take place at the point of delivery, as opposed to the location at which the shipment originates. p. 23-17 and Example 10

9. The solution depends upon whether Arizona applies a throwback rule in its sales factor.

   The throwback rule is an exception to the destination concept. It provides that, when a corporation is not subject to tax in the destination state or the purchaser is the U.S. government, the sales are treated as in-state sales of the origination state, and the actual destination of the product is disregarded.

Consequently, when the seller is immune from tax in the destination state, the sales are considered to be in-state sales of the origination state if that state has a throwback provision. The throwback rule was established as an attempt to ensure that none of a corporation's sales escaped taxation. (Arizona has adopted such a throwback rule.)

p. 23-17 and Example 11

10. The unitary approach to state taxation attempts to neutralize taxpayer attempts to place profitable operations in low- or no-tax jurisdictions. Whether the unitary rules apply often turns on subjective assessments as to the structure and operations of the business. This is unlike the application of the controlled and affiliated group rules, discussed in text Chapter 16.

    When the business is found to be unitary, apportionment factors are computed on the basis of the entire unitary entity, not just the subsidiary that is based in the taxing state. This computational convention can work to the taxpayer's benefit when high-taxed income now is subjected to apportionment in a low-tax state.

    pp. 23-22 to 23-25

11. In most states, capital structure changes such as reorganizations constitute taxable transactions with respect to the sales tax. When assets are retitled in these transactions, income tax provisions are irrelevant, and the sales tax applies because assets have changed ownership (from Junior to Parent) for consideration. This rule increases the cost of the reorganization and should result in changes in the attendant purchase price. p. 23-34

12. TAX FILE MEMORANDUM

    November 3, 2004

    From: Daniel S. Lange

    Subject: Multistate tax planning

    Re: Client Ecru's relocation decision

    Because the states employ different definitions of the amount and type of activity necessary to place a tax situs within the state, a company is allowed, to an extent, to select the states with which it desires to establish nexus. When a corporation has only a limited connection with an undesired (high-tax) state, it may abandon that activity by electing an alternative means of accomplishing the same result. For example, when providing a sales representative with a company-owned fax machine in a home office constitutes nexus in a high-tax state, the company could eliminate its connection with that state by reimbursing sales personnel for communication expenses, instead of providing company-owned equipment. These distinctions are more important after *Wrigley*, in which the Supreme Court outlined the terms of nexus under P.L. 86-272.

    Similarly, when nexus is caused by conducting customer training sessions or seminars in the state, the corporation could bypass this connection by sending the customers' personnel to a nearby state in which nexus clearly has been established, or in which the activity would not constitute nexus.

In addition, when sufficient activity originates from the repair and maintenance of the corporation's products or the activities performed by the sales representatives within the state, the organization could incorporate the service or sales divisions. This would invalidate the state's right to tax the parent corporation's income; only the income of the service or sales divisions would be subject to tax. However, this technique is successful only if the incorporated division is a bona fide business operation, and the state in which it operates is not a unitary state. Therefore, the pricing of any sales or services between the new subsidiary and the parent corporation must be at arms' length, and the operations of the new corporation preferably should result in a profit.

Although most planning techniques are employed to disconnect a corporation's activities from an undesirable state, they also can be utilized to create nexus in a desirable state. For example, when the presence of a company-owned copy machine in a home office creates nexus in a desirable state, the corporation could provide its salespersons in that state with company-owned equipment, rather than reimbursing or providing increased compensation for office expenses. Establishing nexus in the state is advantageous, for instance, when that state has a lower tax rate than the state in which the income presently is taxed.

pp. 23-9, 23-29 to 23-31, and Example 24

13.
- Create nexus in a low- or no-tax state, so that, through the apportionment process, a lower effective tax rate can be used.
- Physically move operations to a low- or no-tax state, perhaps on a divisional or other functional basis.
- Move the investment assets into a passive investment subsidiary. This technique alone could reduce the tax liability by $1.6 million (.08 tax rate X $20 million portfolio income) per year.
- Reduce the payroll expense through the use of independent contractors.
- Acquire a subsidiary that offers a presence in a no- or low-tax state, or a research division whose losses will offset Mollusk's income. Then optimize tax liabilities through transfer pricing and management fee structures.
- If State F has not adopted a throwback rule, make new sales in low- or no-tax sates, or into states with which there is no nexus.

pp. 23-29 to 23-34

PROBLEMS

14.
a. A. $10,000.
b. A. $10,000.
c. S. $30,000, although in most states the answer is N.
d. S. $3,000.
e. N.
f. S. $5,000.
g. A. $5,000.

h. S. $3,000.

i. N.

j. Answer varies substantially among the states; however, in most states the answer is N.

Exhibit 23-1

15. Perk's state taxable income is determined as follows.

Federal taxable income	$200,000
A income tax expense	+15,000
A income tax refund	–13,000
Depreciation modification ($200,000 – $180,000)	+20,000
A taxable income	$222,000

Exhibit 23-1 and Example 1

16. a.

Sales	$4,000,000
Cost of sales	–2,250,000
Cost recovery (Federal)	–300,000
Interest income (Federal)	+20,000
X income tax expense	–110,000
Federal taxable income	$1,360,000

b. If interest generated from X obligations is exempt from state tax, state taxable income is $1,500,000.

Federal taxable income	$1,360,000
State income tax expense	+110,000
Depreciation modification ($300,000 – $250,000)	+50,000
Interest on Federal obligations	–20,000
X taxable income	$1,500,000

c. If interest generated from X obligations is subject to state income tax, state taxable income is $1,543,000.

Federal taxable income	$1,360,000
State income tax expense	+110,000
Depreciation modification ($300,000 – $250,000)	+50,000
Interest on Federal obligations	–20,000
Interest on X obligations	+50,000
Expenses related to X obligations	–7,000
X taxable income	$1,543,000

Exhibit 23-1 and Examples 1 and 2

17. Because of the components of the apportionment factors in the two states, less than 100% of Millie's taxable income is subject to state income taxation.

State A Income Apportionment

Sales	$1,200,000/$1,500,000	=	80.00%
Property	$ 280,000/$ 680,000	=	41.18%*
Payroll	$2,400,000/$2,500,000	=	96.00%
Total			217.18%
A Apportionment Factor (217.18%/3)			72.39%

* Owned property is included in the factor at net depreciated basis, and rent payments are included in the factor at 8 times the annual rental expense. Therefore, the numerator of the factor is computed as $280,000 [$500,000 (average cost) less $300,000 (average accumulated depreciation)] plus [8 X $10,000 (annual rental payments)]. The denominator of the factor is computed as $680,000 {[$800,000 (total average cost) less $400,000 (total average accumulated depreciation)] plus [8 X $35,000 (total annual rental payments)]}.

State B Income Apportionment

Sales	$300,000/$1,500,000	=	20.0%
B Apportionment Factor (20%/1)			20.0%

Examples 9, 15, and 16

18. Because of the components of the apportionment factors in the two states, more than 100% of Millie's taxable income is subject to state income taxation.

State A Income Apportionment

Sales	$1,200,000/$1,500,000	=	80.0%
A Apportionment Factor (80%/1)			80.0%

State B Income Apportionment

Sales	$300,000/$1,500,000	=	20.0%
Property	$300,000/$ 800,000	=	37.5%*
Payroll	$100,000/$2,500,000	=	4.0%
Total			61.5%
B Apportionment Factor (61.5%/3)			20.5%

* Property is included in the factor at historical, undepreciated cost, and rent payments are not included in the factor.

p. 23-15 and Examples 9 and 15

19. Because of the components of the apportionment factors in the two states, more than 100% of Millie's taxable income is subject to state income taxation.

State A Income Apportionment

Sales	$1,200,000/$1,500,000 = 80.0% X 2	=	160.0%
Property	$ 500,000/$ 800,000	=	62.5%*
Payroll	$2,400,000/$2,500,000	=	96.0%
Total			318.5%

A Apportionment Factor (318.5%/4) 79.63%

* Property is included in the factor at historical, undepreciated cost, and rent payments are not included in the factor.

State B Income Apportionment

Sales	$300,000/$1,500,000 = 20.0% X 2	=	40.0%
Property	$200,000/$ 400,000	=	50.0%*
Payroll	$100,000/$2,500,000	=	4.0%
Total			94.0%

B Apportionment Factor (94%/4) 23.50%

* Property is included in the factor at net depreciated basis, and rent payments are not included in the factor.

Examples 8, 9, and 15

20. a.

Sales ($500,000/$900,000)	=	55.56%
Property ($300,000/$350,000)	=	85.71
Payroll ($100,000/$110,000)	=	90.91
Sum of Apportionment Factors		232.18
Average		÷ 3
State A apportionment factor		77.39%
Apportionable income		$300,000
Income apportioned to State A		$232,170

b.

Sales ($500,000/$900,000) X 2	=	111.11%
Property ($300,000/$350,000)	=	85.71
Payroll ($100,000/$110,000)	=	90.91
Sum of Apportionment Factors		287.73
Average		÷ 4
State A apportionment factor		71.93%
Apportionable income		$300,000
Income apportioned to State A		$215,790

c.

Sales ($500,000/$900,000)	=	55.56%
State A apportionment factor		55.56%
Apportionable income		$300,000
Income apportioned to State A		$166,680

Examples 8 and 9

21. The E throwback rule places in the E sales factor any sales to customers in G and to the U.S. government.

E sales factor = $112 million/$152 million	=	73.68%*
F sales factor = $40 million/$152 million	=	26.32%
Total of sales factors		100.00%

* $64 million (E) + $30 million (G) + $18 million (all 50 states) = $112 million.

This arrangement calls for better tax planning by Orange, in that shipping from E keeps the total of the sales factors at 100%. Shipments should be made from a non-throwback state, like F.

p. 23-17 and Example 11

22.

G payroll factor	$200,000/$950,000	=	21.05%
H payroll factor	$400,000/$700,000	=	57.14%
I payroll factor	$350,000/$950,000	=	36.84%
Total of payroll factors			115.03%

This arrangement calls for better planning by Aqua, in that placing the officers' salaries in I increases the total of the payroll factors far above 100%. The salaries for the executives should be sourced to H.

p. 23-18 and Example 12

23. Under the statutes of States A and B, accumulated depreciation and nonbusiness property (i.e., rental property) are not taken into consideration in computing the property factor.

Average Property in A

	Beg. of yr	End of yr	Total	Average
Inventory	$ 300,000	$ 400,000	$ 700,000	$ 350,000
Plant and equipment	2,500,000	2,500,000	5,000,000	2,500,000
Land	600,000	600,000	1,200,000	600,000
Total				$3,450,000

Average Property in B

	Beg. of yr	End of yr	Total	Average
Inventory	$ 200,000	$ 150,000	$ 350,000	$ 175,000
Plant and equipment	1,500,000	1,200,000	2,700,000	1,350,000
Land	600,000	400,000	1,000,000	500,000
Total				$2,025,000

Property Factor for A

$$\frac{\$3{,}450{,}000 \text{ (In-state property)}}{\$5{,}475{,}000 \text{ (Total property } \$3{,}450{,}000 + \$2{,}025{,}000)} = 63.01\%$$

Property Factor for B

$$\frac{\$2{,}025{,}000 \text{ (In-state property)}}{\$5{,}475{,}000 \text{ (Total property } \$3{,}450{,}000 + \$2{,}025{,}000)} = 36.99\%$$

pp. 23-20 to 23-22 and Example 15

24. Under the statutes of A and B, accumulated depreciation is not taken into consideration in computing the property factor. Nonbusiness property (i.e., rental property) is excluded from the property factor of A, but is included in determining the property factor for B.

HISTORICAL COST - EXCLUDING NONBUSINESS PROPERTY

Property factor for A, as in problem 31 63.01%

HISTORICAL COST - INCLUDING NONBUSINESS ASSETS

Average property in A

	Beg. of yr	End of yr	Total	Average
Inventory	$ 300,000	$ 400,000	$ 700,000	$ 350,000
Plant and equipment	2,500,000	2,500,000	5,000,000	2,500,000
Land	600,000	600,000	1,200,000	600,000
Rental property	900,000	950,000	1,850,000	925,000
Total				$4,375,000

Average property in B

	Beg. of yr	End of yr	Total	Average
Inventory	$ 200,000	$ 150,000	$ 350,000	$ 175,000
Plant and equipment	1,500,000	1,200,000	2,700,000	1,350,000
Land	600,000	400,000	1,000,000	500,000
Rental property	300,000	300,000	600,000	300,000
Total				$2,325,000

Property factor for B

$$\frac{\$2{,}325{,}000 \text{ (In-state property)}}{\$6{,}700{,}000 \text{ (Total property } \$4{,}375{,}000 + \$2{,}325{,}000)} = 34.70\%$$

pp. 23-20 to 23-22 and Example 15

25.

Annual Method
$$\frac{\frac{\$1.5 \text{ million}}{\$3.0 \text{ million}} + \frac{\$0.6 \text{ million}}{\$2.2 \text{ million}}}{2} = 0.386 \text{ property factor}$$

Monthly Method

$$\frac{11\left[\frac{\$1.5 \text{ million}}{\$3.0 \text{ million}}\right] + \frac{\$0.6 \text{ million}}{\$2.2 \text{ million}}}{12} = 0.481 \text{ property factor}$$

The late disposal of the X facility is reflected more favorably in that state's property factor when the annual method is used.

p. 23-20

26. a. **State A Income Tax**

Total apportionable income ($1,000,000 – $500,000)		$500,000

Apportionment formula

Sales	$2,500,000/$6,500,000 =	38.46%
Property	$1,000,000/$3,500,000 =	28.57%
Payroll	$ 800,000/$2,000,000 =	40.00%
Total		107.03%

State A apportionment factor (107.03%/3)	X 35.68%
Taxable income apportioned to State A	$178,400
State A tax rate	X 8.00%
State A tax liability, if unitary	$ 14,272

State B Income Tax

Total apportionable income ($1,000,000 – $500,000)	$500,000

Apportionment formula

Sales	$4,000,000/$6,500,000	=	61.54%
Property	$2,500,000/$3,500,000	=	71.43%
Payroll	$1,200,000/$2,000,000	=	60.00%
Total			192.97%

State B Apportionment Factor (192.97%/3)	X 64.32%
Taxable income apportioned to State B	$321,600
	X 11.00%
State B tax liability	$ 35,376

State A tax liability	$ 14,272
State B tax liability	35,376
Overall state tax liability, if unitary	$ 49,648

b.

True Corporation, State A ($500,000 X 8%)	$ 0
Trumaine Corporation, State B ($1,000,000 X 11%)	110,000
Aggregate state income tax, if nonunitary	$110,000

c. OFFICIAL CORRESPONDENCE

November 3, 2004

To: Board of Directors
Trumaine Corporation
1234 Mulberry Lane
Chartown, AL 35298

From: Alison Brown, CPA, MST

Re: Unitary treatment of operations of the True and Trumaine Corporations

Some states apply a so-called unitary approach in computing the income tax liabilities of corporations doing business within its borders. When the unitary theory is in effect, operating income and losses, and indicators of the level of in-state business activities are computed taking into account all of the other entities related to the corporation.

Unitary computations are favorable to a taxpayer when related corporations generate operating losses, or generally are less profitable than the taxpayer. When more-profitable entities enter the mix, state tax liabilities tend to increase. Similarly, if a unitary group can shift taxable income into low- and no-tax states, the overall tax liability of the group will decline.

Related corporations generally are found to constitute a unitary group where their ownership, operations, and corporate decision-making are interrelated.

I have determined that, if True and Trumaine are found to be a unitary group, the combined A and B income tax liability for the group will be cut by more than half (i.e., from $110,000 to about $50,000). This happens essentially because of our ability to shift more taxable income into A, a lower tax rate state.

I recommend that we undertake to establish and document our position that True and Trumaine constitute a unitary group and to inform the A and B revenue departments of that fact, as soon as possible.

pp. 23-22 to 23-25 and Examples 20 and 21

27. Because of the water's edge election, the sales to the Despina customers are not included in either state's sales factor.

State	*Entity*	*Sales Factor*
B	Gerald	$10 million/$25 million = 40.00%
Q	Unitary group	$35 million/$45 million = 77.78%

pp. 23-23, 23-24, Concept Summary 23-1, and *Global Tax Issues* on p. 23-26

28. MEMORANDUM

November 3, 2004

To: Shareholders of Hernandez Corporation
5678 Alabaster Circle
Koopville, KY 47697

From: Dustin Greene, CPA, MST

Re: Tax liability of the corporation this year

We elected so-called S corporation status at the Federal level long ago. This election eliminates the exposure of corporate income to double taxation—the corporate level tax is zero, but all of the taxable income for the year passes through to the shareholders proportionately and is taxed to them immediately.

Not all of the states recognize the S election in computing corporate and individual income taxes. In our case, one of the states in which we do business (Z) taxes Hernandez as a regular or "C" corporation, while our other state (Y) applies the S election for its purposes. This makes our tax computation more complicated—corporate taxable income must be computed in the aggregate and then "apportioned" between the states, based on our sales, property, and payroll activities in each. Here is a summary of my determinations of Hernandez's tax liabilities for this year.

State Y

Since Y recognizes S corporation status, Hernandez is not subject to tax on any of its income in that state. The income of the corporation is passed through to the shareholders; such income then is subject to tax at the shareholder level.

State Z

Since Z does not recognize S corporation status, Hernandez is subject to tax in the same manner as a C corporation. Hernandez's taxable income before apportionment, determined as though it were a regular corporation, is $518,000. By applying the Z apportionment formula to this amount, Hernandez is subject to a corporate level tax on $173,167.

Income determined as though it were a C corporation

Ordinary business income	$500,000
Taxable interest income	10,000
Capital loss	-0- *
Dividend income	40,000
Income before dividends received deduction	$550,000
Dividends received deduction ($40,000 X 80%)	(32,000)
Taxable income	$518,000

* Corporations are permitted to offset capital losses only against capital gains.

Z Taxable Income

Sales	$800,000/$1,800,000	=	44.44%
Property	$200,000/$700,000	=	28.57%
Payroll	$300,000/$1,100,000	=	27.27%
Total			100.28%

Average (100.28%/3) 33.43%

Taxable income	$518,000
Z apportionment percentage	X 33.43%
Z taxable income	$173,167

pp. 23-25 to 23-27 and Example 22

29. Businesses are merely the collection agents for the states with regard to the sales tax. Thus, Grande must collect and remit, to the state, tax on the $700,000 general sales transactions. Medical devices and out-of-state sales are exempt from this collection requirement, although *use* tax might be due on the mail-order sales. On the goods Grande purchased from its supplier, neither party need collect and remit the tax. A resale exemption applies in virtually all states, so that only the ultimate consumers of the goods—here, Grande's customers—pay tax on the transaction. pp. 23-27 and 23-28

30. The home state payroll factor drops from .750 ($1,500,000/$2,000,000) to .697 ($1,150,000/$1,650,000). p. 23-34 and Example 28