Brief Overview of State Corporate Issues

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Scope of Corporate Taxation

- Forty-four states have corporate taxation
- Four states have gross receipts taxes: Nevada, Ohio, Washington, Texas (margin tax—a hybrid as it allows alternative deductions)
- Only South Dakota and Wyoming have neither.

Brief History of State Corporate Taxation

- State corporate income taxes were introduced at the same time as personal income taxation in most states—joined at the hip. In Louisiana both personal and corporate income taxes were enacted in 1934.
- To try to get uniformity and avoid double taxation and "no-where" income, in 1957 a national uniform law body drafted UDITPA (Uniform Division of Income for Tax Purposes Act)
- This developed the idea of business vs. non-business income (allocating the latter) and a three-factor apportionment formula, equally weighted payroll, property, and sales.
- Not much interest at first, but after Supreme. Court *Northwestern Cement v. Minn. (1959)*, business pushed for limiting nexus (Public Law 86-72) and for their own uniformity solutions through the Willis commission and Congressional legislation.
- States desire to keep sovereignty led to Multistate Compact formed in 1967 and the Multistate Tax Commission (MTC) was created to promote uniformity, which headed off federal legislation.

Legal Perspectives

- Constitutional issues were settled in *Complete Auto Transit (1977)*.
- To meet constitutional muster, a tax on interstate business must be:
  - (1) on activities connected to the state (substantial nexus),
  - (2) fairly apportioned
  - (3) nondiscriminatory, and
  - (4) related to state services provided

NOTES:

1) Unlike sales tax, the Supreme Court has not required physical presence for income tax nexus

2) Prong #4 no longer has real meaning

Allocation vs Apportionment

- All state allocate some income (typically non-business) but this varies by state
  - LA allocable income discussed in Kevin Richard May 26th memo (rents and royalties from certain types of property, royalties from use of intangibles etc.)

- Remainder is apportioned by formulas:
  - Originally, 3 factor formula
    - Property (original cost)
    - Payroll
    - Sales
  - There has been an historic shift to over-weighting sales, including single sales factor
  - LA has single sales factor for manufacturers and merchandisers with three-factors for most others (but some special rules)

Economic Effects of Apportionment

- One way to think of apportionment is a tax on using that factor in the state.
- Given the total income of the corporation and the tax rate in a state, the additional use of payroll or property or a sale into the state creates an additional tax obligation.
- To shift the burden of the tax to out-of-state taxpayers, states have relied less on the payroll and property factors and more on the sales factor.
- Limiting case is a single sales factor.   MTC now recommends double-weighted sales but states are not really listening to them on this issue.

Single Entity vs Combined Reporting

- LA apportions income for each separate entity or company. Total of 20 states now follow this method.
- Twenty four states plus District of Columbia use combined reporting.
- Under combined reporting, the related corporations that are part of a "unitary group" are generally treated as one entity for tax purposes. Intercompany transactions are netted out. Then the total income of the combined corporations is apportioned by formula.
- Unitary group usually means common ownership and corporations are in the same line of business.

Why Does This Matter? Passive Income

- Toys R Us example.   Operating company pays a royalty to a separate holding company in Delaware (which does not tax it) for use of a trademark. This reduces apportionable income of operating company.
- How to solve this problem?
  - Assert economic nexus through court decisions. LA current practice. Depends on vagaries of court decisions.
  - Add-back statute (LA starting in 2017). If payments to a holding company not taxed, add them back to base of operating company. Need to define precisely what is added back.
  - Combined reporting—automatically handles this as holding company and operating company are combined in a unitary group. Intercompany payments net out.

Pros/Cons Combined Reporting

- Pros
  - Most robust method of handling passive income flows
  - More accurately captures actual business operations.
  - Does not require a new statute for each state corporate tax planning innovation, unlike add-back statutes.
  - Can rely on years of experience in other states for administrative tips.
- Con
- Need to define a unitary business—issues can get complex
- Need new training for audit staff
- In South, most states use separate entity (except Texas margin tax uses combined reporting)

Sales Factor and Services

- Originally in UDITPA, the sales factor was treated differently for tangible personal property (TPP) and everything else (including services).
- For TPP, it was sourced to the state of <u>destination</u> where the TPP was delivered.
- For everything else, it was based on where the highest fraction of the cost of producing the service occurred (<u>cost of performance</u>).
- There now is a strong trend towards market sourcing to destination state and away from cost of performance for the sales factor for services and intangibles. Over 20 states and growing
- The MTC has adopted a market sourcing statute and Alabama and Massachusetts have similar statutes and also regulations. California uses a slightly different method.

Why This Shift Now?

- Re-capture the original market state rationale for the sales factor.
- With increased reliance on sales factor, states don't want to use cost of performance which is an origin concept (where produced)
- States believe they can work out the complexities and when in doubt, allow companies to use reasonable methods. To make this work does require detailed regulations particularly for business transactions.
- The service sector is growing over time and states want a larger share of it.

An Example of Market Sourcing

- Consider a credit card company with all payroll and property located in South Dakota and credit cards circulate in another state G.
- Under cost of performance, state G would not be able to tax the income of the credit card company (no sales into the state)
- With market sourcing state G could say:
  - We have nexus as our market is being exploited (recall, no physical presence required)
  - We can use the ratio of credit cards outstanding in our state to all credit cards outstanding everywhere as the sales factor and apportion the income of the credit card company.

Corporate Tax Rates

- In LA, corporate tax rates start at 4% but rise to 8% over 200K.
- Nationally, in top 1/3 in terms of <u>statutory</u> rate.
- <u>Highest</u> in South among those with corporate taxes
  - 5.0% MS and SC
  - 5.5% FL
  - 6.0% GA and KY
  - 6.5% AL, AR, and TEN
- One major reason: deductibility of federal taxes—headline rate much higher than effective rate
- By eliminating deductibility one could bring rates down to Southern levels—between 6.5 and 6%. Also create more stable tax environment for LA.

Decisions for Louisiana

Single Sales Factor for All Business?

Market Sourcing for Sales Factor?

Combined Reporting?

Eliminate Federal Deductibility and Lower Rate?