State Income/Franchise Tax Issues

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Combined Reporting Requirement

State	State Has Combined reporting	Required of Unitary Business	Foreign Affiliates Included	Apportionment Formulas
Arizona	Yes	Yes, unless group files AZ consolidated return	No	Three-factor formula with double-weighted sales factor. As long as one or more corporations, beginning June 1, 2005, commits to one or more capital investment projects with expenditures in excess of $1 billion, then effective for taxable years beginning after January 1, 2006, corporations may elect to use an apportionment formula with an enhanced sales factor equal to 60% for 2007, 70% for 2008, and 80% for tax years after 2008.
California	Yes	Yes, if activities both within and without CA	No – if water's edge election made; certain foreign affiliates included if water's edge election made.	Three-factor formula with double-weighted sales factor.
Georgia	No	N/A	N/A	Three-factor formula with double-weighted sales factor (after December 31, 2005, 80-10-10 (sales, property, payroll); after December 31, 2006, 90-5-5 (sales, property, payroll), after December 31, 2007, one-factor sales formula).
Illinois	Yes	Yes	Yes, unless 80% or more of affiliate's business activity is conducted outside U.S.	One-factor sales formula

Combined Reporting Requirement – continued

State	State Has Combined reporting	Required of Unitary Business	Foreign Affiliates Included	Apportionment Formulas
Maryland	**No**	**N/A**	**N/A**	**Three-factor formula with double-weighted sales factor; manufacturers use one-factor sales formula.**
Massachusetts	**No**	**N/A**	**N/A**	**Three-factor formula with double-weighted sales factor.**
Michigan	**Yes**	**No***	**No**	**Three-factor formula 90-5-5 (sales-property-payroll).**
New York	**Yes**	**No***	**No – unless necessary to prevent distortion**	**Three-factor formula 60-20-20 (receipts, property, payroll); after 2006, 80-10-10 (receipts, property, payroll); after 2007, single receipts factor formula. Three-factor formula with a double-weighted receipts factor for tax years prior to 2006.**
North Carolina	**No**	**N/A**	**N/A**	**Three-factor formula with double-weighted sales factor.**
Texas	**No****	**N/A****	**N/A****	**One-factor gross receipts formula.**

*** State has the option to require combined reporting**
**** New law, effective for returns due on or after 1/1/08, requires combined reporting**

Tax Rate

State	Tax Rate	Detailed
Arizona	6.968%	Minimum tax, $50.
California	8.84%	Minimum tax, $800. Banks and financial corporations, excepting financial S Corporation, are subject to a 10.84% tax rate (the general corporation rate, plus 2%). A 3.5% tax rate applies to financial S Corporations, and a 1.5%rate applies to all other S corporations. A 6.65% alternative minimum tax is imposed.
Georgia	6%	N/A
Illinois	4.8%	Additional 2.5% personal property replacement tax imposed, for corporations other than S corporations. 1.5% for S corporations, Partnerships, and trusts.
Maryland	7%	N/A
Massachusetts		Corporations pay an excise equal to the greater of the following: (a) $2.60 (includes surtax) per $1,000 of value of Massachusetts tangible property not taxed locally or net worth allocated to Massachusetts, plus 9.5% (includes surtax) of net income; or (b)$456 (includes surtax), whichever is greater. (A surtax of 14% is imposed.) Special rates apply to security corporations, qualified subchapter S subsidiaries, financial institutions, utilities, and vessels.
Michigan	1.9%	Rate effective Jan. 1 provided the comprehensive annual report for the state shows an ending balance under $250 million. Insurance companies subject to the single business tax pay a surcharge that is the product of 1.26 times the taxpayer's tax liability before the application of any credits.
New York		Corporations are subject to tax on the greatest of 7.5% of entire net income with adjustments, 2.5% AMT base, 1.78 mills per dollar of allocated capital (up to $350K for manufacturers or $1 mill for other taxpayers), or a minimum tax between $100 and $1,500, depending on payroll size. $800 minimum tax if gross payroll, total receipts, and avg. of gross assets are each $1,000 or less. Additional 9/10 mill per dollar of allocated subsidiary capital is imposed. Special rates apply to small business taxpayers. S corporations are subject to the fixed dollar minimum tax.
North Carolina	6.9%	N/A
Texas	4.5%	Current law - The tax is equal to the greater of either 0.25% of its net taxable capital or 4.5% of its net taxable earned surplus. New law, effective for tax returns due on or after 1/1/08, is 0.5%(wholesalers and retailers) or 1% (others) on taxable margin.

Are You Taxable In the State? or Do You Have Nexus in the State?

- Nexus describes the degree of business activity that must be present before a state can tax an out-of-state entity's income
  - Owns or leases property in the state
  - Has capital or property employed in the state
  - Employs personnel in the state
  - Derives income from activities in the state
- Federal Public Law 86-272 limits the states' right to impose an income tax on interstate activities
  - Prohibits a state from taxing a business whose only connection with the state is to solicit orders for sale of tangible personal property that is sent outside the state for approval or rejection.
  - Only sales of tangible personal property are protected.

How Are We Taxed by the State?

Most states:

Federal corporate taxable income
+/- State adjustments

State Tax Base
+/- Allocable (non-business) income

Apportionable Income
x State Apportionment %

Income Apportioned to the State
+/- Allocable (Non-business) income

State Taxable Income
x Tax Rate

State Income Tax
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What’s a Unitary Business?

- A unitary business operates as a unit and cannot be segregated into independently operating divisions
- The unitary theory ignores the separate legal existence of the entities and focuses on practical business realties
- Accordingly, the apportionment formula is applied to the combined income of the unitary business

Unitary Tests – Highly Subjective

- The courts have developed three general tests
- The three-unities test
  - Unity of ownership
  - Unity of operations
  - Unity of use in its centralized executive force and general system of operation
- The contribution and dependency test
- The functional integration test

Worldwide Combined Reporting

- Some states require unitary group to include related non-US corporations in the combined return.
- Some state allow water's-edge election (e.g., California)
- Some states excludes foreign entities that meet 80% foreign business activity test (e.g., Illinois, Texas)

California Water's-Edge Election

- Once made, the election will remain in effect until terminated.
  - An election may be terminated on an original timely return without the consent of California after the election has in effect for at least 84 months.
- Water's-edge group includes:
  - U.S. incorporate entities;
  - DISC, FSCs, and Export Trade Corporations;
  - A controlled foreign corporation with Subpart F income;
  - Any corporation (other than a bank) the average of whose US property, payroll and is 20% or more; and
  - Any entity not described above, to the extent that its income is derived from or attributable to US source

Example: With Water's-Edge Election

		US
Federal taxable income		180,000
Adjustments:		
Depreciation		15,000
State income tax		5,000
California taxable income		200,000
Total within and without California		
	Property	36,000
	Payroll	26,000
	Sales	400,000
Total within California		
	Property	36,000
	Payroll	26,000
	Sales	300,000
Allocation fractions:		
	Property	100.0%
	Payroll	100.0%
	Sales	75.0%
	Sales	75.0%
Total		350.0%
Average		87.5%
Apportioned taxable income		175,000

Example: Without Water's-Edge Election

		No nexus	No nexus	Nexus	
		P	FS	US	Total
Taxable income		2,500,000	(420,000)	200,000	2,280,000
Total within and without California					
	Property	500,000	64,000	36,000	600,000
	Payroll	300,000	74,000	26,000	400,000
	Sales	5,000,000	600,000	400,000	6,000,000
Total within California					
	Property		-	36,000	36,000
	Payroll		-	26,000	26,000
	Sales		-	300,000	300,000
Allocation fractions:					
	Property	0.0%	0.0%	6.0%	6.0%
	Payroll	0.0%	0.0%	6.5%	6.5%
	Sales	0.0%	0.0%	5.0%	5.0%
	Sales	0.0%	0.0%	5.0%	5.0%
	Total	0.0%	0.0%	22.5%	22.5%
	Average	0.0%	0.0%	5.6%	5.6%
Apportioned taxable income		-	-	128,250	128,250

Texas New Tax Law

- Current law:
  - Based on federal taxable income (earned surplus tax) or tax capital
  - No worldwide combined reporting
  - Single apportionment factor (gross receipts)
- New law: effective for tax returns due on or after 1/1/2008
  - Affiliated group engaged in a unitary business files a combined group report.
  - A combined group does not include:
    - Taxable entities that conduct business outside the US if 80% or more of its property and payroll are assigned to locations outside the US;
    - Taxable entities that conduct business outside the US and have no property or payroll if 80% of more of its gross receipts are assigned to locations outside the US; or
    - Insurance companies that pay gross premiums tax

Texas - continued

- The revised tax base is the taxable entity's margin Margin equals the lesser of:
  - Total revenue minus cost of goods sold;
  - Total revenue minus compensation; or
  - Total revenue times 70%

- Tax rate is 0.5% for entities engaged in retail or wholesale trades as well as those business under Major Group 58 of the 1987 SIC code (eating and drinking establishments). The rate is 1% for all other taxable entities

Example: Hub Sales - US sub keeps inventory

	US
Sales - Texas	1,000,000
Sales - Non-Texas	5,000,000
Total revenue	6,000,000
Cost of goods sold - Texas	900,000
Cost of goods sold - Non-Texas	4,000,000
Cost of goods sold	4,900,000
Compensaion	700,000
1. Total revenue x 70%	4,200,000
2. Total revenue minus COGS	1,100,000
3. Total revenue minus compensation	5,300,000
Margin (lowest of the three)	1,100,000
Gross receipts in Texas	1,000,000
Gross receipts everywhere	6,000,000
Apportionment factor	16.6667%
Apportioned margin	183,334
Less: Allowable deductions	-
Taxable margin	183,334
	0.5%
Tax due	917

- US sub has nexus in Texas because it keeps inventory in Texas and makes sales to customers located in Texas

- FP and US cannot file combined return because FP meets the 80% foreign business activity test.

Example: Hub Sale – Foreign parent keeps inventory

	FP
Sales - Texas	1,000,000
Sales - Non-Texas	300,000,000
Total revenue	301,000,000
Cost of goods sold - Texas	700,000
Cost of goods sold - Non-Texas	210,000,000
Cost of goods sold	210,700,000
Compensaion	70,000,000
1. Total revenue x 70%	210,700,000
2. Total revenue minus COGS	90,300,000
3. Total revenue minus compensation	231,000,000
Margin (lowest of the three)	90,300,000
Gross receipts in Texas	1,000,000
Gross receipts everywhere	301,000,000
Apportionment factor	0.3322%
Apportioned margin	299,977
Less: Allowable deductions	-
Taxable margin	299,977
	0.5%
Tax due	1,500

- FP has nexus in Texas because it keeps inventory in Texas.

-FP and US cannot file combined return because FP meets the 80% foreign business activity test

- Is FP subject to federal income tax?

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