Corporate Income Tax Issues and Trends

Barb Dickerson
Deloitte Tax LLP

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Determination of Tax Base

Federal Taxable Income
+/- State Modifications
Adjusted Income

Business Income
X Apportionment Ratio
State Business Income

Nonbusiness Income
(Allocated to specific state using criteria such as commercial domicile, location of property, etc.)

State Taxable Income
X Tax Rate
Tax
<Credits>
Net Tax Liability

Compliance Environment

- Arizona adopted the Uniform Division of Income for Tax Purposes Act (UDITPA) effective 1/1/84.
- 18 other states and the District of Columbia have also adopted UDITPA.
- Administration of UDITPA is <u>not</u> uniform, with legislatures, state tax agencies and courts applying modifications and different interpretations.
- Many other states have adopted similar provisions with even more deviations from "uniformity."

Issue: Determination of Business vs. Nonbusiness Income

A.R.S. § 43 – 1131 (and Section 1(a) of UDITPA)

"Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business <u>and</u> includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business.

"Nonbusiness income" means all income other than business income.

Determination of Business vs. Nonbusiness Income, cont'd

Problem:

- Is there one test or two in the business income definition?
- States and courts differ – either one transactional test or a transactional and a functional test
- ADOR interprets definition as comprising two tests
- Under AZ rules of statutory construction would courts agree, since "and" is used rather than "or"?

Issue: Variations in the Apportionment Ratio

- Business income is apportioned among the states in which taxpayer does business using an apportionment ratio
- The apportionment ratio is generally comprised of property, payroll and sales, but treatments of factors vary
- Double – weighted sales factor: 22 states
- Super – weighted sales factor (60 – 95% or phasing in): 5 states
- Single sales factor (now or phasing in): 8 states
- Colorado has both 3-factor and two-factor apportionment
- Super-weighted or single sales factors are sometimes available only to certain industries or taxpayers

Note: Numbers based on 2005 data

Variations in the Apportionment Ratio, cont'd

Problems:

- Super-weighting of the sales factor or single sales factor approaches are typically done for economic development purposes to attract and grow capital intensive industry
- Late adopter states will likely not see same benefit
- Variation in apportionment ratios can result in apportionment of more than 100% of income to the states

Variations in Apportionment Ratio, cont'd

Arizona Sales Factor

- Currently double-weighted
- Laws 2005, Chapter 289 provided for a conditional enactment of a super-weighted sales factor based on capital investment in the state of at least $1 billion
- Conditions have been met
- Beginning with 2007 tax year, Arizona will allow annual election to use either a double-weighted sales factor or for

  tax year 2007 = 60% sales factor
  tax year 2008 = 70% sales factor
  tax year 2009 and after = 80% sales factor

Variations in Apportionment Ratio, cont'd

- Reporting requirements in session law to evaluate benefits
- Arizona's election provision ensures that companies are not disadvantaged by super-weighting the sales factor

Deviations from Standard Apportionment

<u>Issue: Taxpayer/Tax Agency Ability to Deviate from Standard Apportionment</u>

- Generally, taxpayers must secure permission to deviate from tax agency
- Tax agency can alter apportionment ratio upon audit based on:
  - Constitutional distortion
    - No bright line test
    - US Supreme Court in *Hans Rees,* 250% change was distortion but, in *Container*, 14% change was not

Deviation from Standard Apportionment

Equitable relief provisions of UDITPA

- No bright line test
- California Supreme Court in *Microsoft*, in interpreting UDITPA provision similar to A.R.S. § 43-1148, distinguished it from constitutional distortion, but put burden of proof on tax agency invoking relief
- Arizona Court of Appeals in *Walgreen* case did not focus on burden of proof in identical situation as the *Microsoft* case
- In interpreting virtually identical definitions of “sales” in the UDITPA sales factor provisions as adopted by both states, the California and Arizona Courts derived different interpretations as to the application of the law, as have other courts around the country

Deviation from Standard Apportionment, cont'd

Problem

- Taxpayers have no definitive guidance on key issues in determining how to apportion income to the states even when language is "uniform"

Multistate Tax Commission (MTC) Uniform Statute on Compilation of State Tax Return Data

- Adopted by MTC 9/7/06 for adoption by states

- Requires 51-state spreadsheet be filed within 180 days of filing original federal return or amended state return

MTC 51-State Spreadsheet, cont'd

Required Information includes:

- Whether the taxpayer filed in that state
- Business income of the taxpayer, or of the taxpayer's combined reporting group, reported to that state
- Total nonbusiness income of the taxpayer, or the total nonbusiness income of each member of the taxpayer's combined reporting group
- Total nonbusiness income of the taxpayer, or the total nonbusiness income of each member of the taxpayer's combined reporting group, allocable to that state
- For each of the apportionment factors used to determine the apportionment percentage, the dollar amount of the numerator and the denominator of the ratio used in that factor

MTC 51-State Spreadsheet, cont'd

Required Information, cont'd

- Apportionment percentage used to apportion income subject to taxation in that state
- Dollar amount of business income apportioned to that state
- For combined reporting states, for each combined reporting group of which the taxpayer is a member, a list of all corporations whose business income was included in business income of the combined reporting group

MTC 51-State Spreadsheet, cont'd

Problems with MTC Reporting Requirement

- States do not have uniform laws – information cannot be compared and is worthless
- Creates significant additional and unnecessary reporting burden on multistate businesses
- Most companies do not have automation that will capture this data
- Legitimate differences between states (business/nonbusiness income interpretations, different unitary standards, different apportionment factor interpretations, etc.) will generate unnecessary state inquiries
- Option to file copies of all state tax returns in each state is burdensome and expensive for taxpayers and a waste of space for states

Trend: Un-Income Taxes

- **Ohio Commercial Activities Tax (CAT)**
  - Phasing out income/franchise and personal property taxes over 5 years
  - Gross receipts tax (.26% of gross receipts in excess or $1 million)
  - 5 year phase in
- **Texas Margin Tax**
  - Effective for tax years ending in 2007
  - Total revenue less cost of goods sold or compensation not to exceed 70% of total revenue
  - 1% rate except retailers/wholesalers at .5% rate

Un-Income Taxes, cont'd

Reasons for Adoption:

- Broad-based
- Few deductions
- Nexus determinations unrestricted by P.L. 86-272 (but would be under H.R. 1956, the "Business Activity Tax Simplification Act of 2006," if it passes Congress)
- Generally unaffected by operating losses because they are gross receipts/revenue based

But . . .

Michigan is eliminating the Single Business Tax (SBT), an un-income tax, as of 12/31/07 and possibly replacing it with an income tax

Contact Information

Barb Dickerson
Director
Multistate Tax Services

Deloitte Tax LLP
2901 North Central Avenue – Suite 1200
Phoenix, AZ 85012-2799

Phone: 602-234-5246
E-mail: bdickerson@deloitte.com

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