# Revenue and Transportation Interim Committee

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## 59th Montana Legislature

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December 2, 2005

TO: Revenue and Transportation Committee

FROM: Jeff Martin, Legislative Research Analyst

SUBJECT: Corporation Income Taxes

This memorandum discusses some of the concepts, principles, and practices related to corporation income taxes. It provides a brief overview of: the imposition of state corporation income taxes, the rationale for tax corporations, the history of the tax in Montana, and interstate tax comparisons. The purpose is to solicit committee discussion of the type of information and analysis that would be of use to the committee and to the Legislature to better understand business income taxes.

### Introduction

Montana is one of 44 states and the District of Columbia that taxes the net income of corporations. Michigan, Texas, Washington do not tax corporations on the basis of net income. Michigan imposes a modified value-added tax.[1] Texas imposes a franchise tax based on net equity, and Washington imposes a business and occupation tax based on gross receipts (the rate varies by type of business). Nevada, South Dakota, and Wyoming do not impose individual or corporation income taxes. South Dakota taxes only financial institutions on the basis of net income. Ohio recently enacted a commercial activity tax (gross receipts tax) that will replace the current corporation franchise tax (taxes are currently paid on the higher of net income or net worth). The tax is imposed only on commercial activities regardless of business entity form. The tax is phased in over a 5-year period.[2]

Taxes on corporate net income differ significantly among the states in terms of definitions of taxable income, tax rates, the taxable entity, and the apportionment of taxable income of corporations that operate in more than one state.

[1]The tax, enacted in 1975, is scheduled to be phased out by 2009.

[2]For a mind-boggling discussion of Ohio's commercial activity tax see "CAT Got Your Tongue? Navigating the Complexities of Ohio's New Commercial Activity Tax", KPGM, http://www.us.kpmg.com/microsite/tax/salt/perspectives/Fall_2005-02.asp.

**Corporations Taxed Early in the Last Century**

Montana was one of six states (Connecticut, 1915, Missouri, 1917, Montana, 1917, New York 1917, Virginia, 1915, Wisconsin, 1911, and the Territory of Hawaii, 1901) to impose a corporation income tax by 1917.[3] According to David Brunori, the early spread of state taxation of the income of corporations by dint of progressive and populist political leaders with a skeptical view of corporations.[4] "The opportunity to raise revenue from corporations fit naturally with their political philosophies."[5]

By 1930, 10 additional states had adopted the tax, with 15 states joining the ranks in the 1930s. Two states adopted the tax in the late 1940s, one in 1958, and nine between 1963 and 1971. Many states also imposed an individual income tax at the same time as the corporation income tax or the taxes were imposed within a few years of each other.[6]

The tax on corporations was only one component of expanding and diversifying state tax revenue for states that had relied almost exclusively on property and excise taxes. The diversification was particularly evident in the 1930s. During that decade, 24 states first imposed general sales taxes, 17 states (including Montana in 1933) imposed individual income taxes,19 states taxed cigarettes, and 27 states taxed alcoholic beverages.

**Rationale for Taxing the Income of Corporations**

Disenchantment with corporations and the desire to diversify state tax revenue notwithstanding, there are several rationales for taxing the net income of corporations. The first is to protect the individual income tax base by including certain corporate income, such as retained earnings, in the corporation tax base. If corporate income were not taxed, shareholders could hide income within the corporation. However, shareholders are subject to double taxation when dividends are paid.

Another rationale for the taxation of corporations is the benefits-received principle.[7] At the local level, corporations pay property taxes for police and fire protection as well as educational services. At the state level, they pay for such things as transportation infrastructure and the legal system. Shareholders of the corporation benefit from public services, and the corporation tax

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[3]In 1909 Congress imposed a corporate excise tax of 1 percent on income over $5,000. It was considered an indirect tax on the privilege of doing business.

[4]Interestingly, Mike Malone makes no mention of the Montana corporation income tax in his chapter on the progressive era in Montana in Montana, A History of Two Centuries.

[5]Brunori, David, State Tax Policy, A Political Perspective, (The Urban Institute Press, Washington D.C., 2001), p. 105.

[6]Connecticut did not adopt a broad-based individual income tax until 1991.

[7]The benefits-received principle is the equity viewpoint that persons who receive benefits from goods and services provided by government should bear the tax burden in proportion to benefits received. By contrast, the ability-to-pay principle is the equity viewpoint that the amount of tax burden should be related to an person's economic ability to bear the burden.

provides a means of assessing a tax on those beneficiaries.[8] However, a tax on net income may not coincide with the value of the service received. Other taxes, such as a value-added tax or a gross receipts tax, may be better way to tax for benefits received. Under these types of taxes, businesses, whether profitable or unprofitable, would pay the tax for benefits received.

A third rationale is that the corporation tax offsets disparities in the property tax. Businesses that are more capital intensive (e.g., manufacturing) are taxed more heavily under the property tax than are labor-intensive businesses (e.g., high-technology). The corporation income tax mitigates differences in property tax treatment of business inputs.[9]

**The Taxation of Corporations in Montana**

The initial rate imposed on corporations doing business in Montana was 1 percent of net income. Since then, the Montana Legislature increased the tax rate six times. During the second extraordinary session of the 1942 Legislature, the tax rate was temporarily increased from 6.25 percent (the rate was 5.5 percent in 1968) to 6.75 percent (Ch. 7, 2nd Ex. L. 1971). The higher tax rate was effective for tax years 1971 and 1972, after which it would fall to 6.25 percent. The tax rate would have been 6.25 percent in tax year 1972, had the electorate approved Referendum No. 68 (Ch. 9, 2nd Ex. L. 1971) to impose a 2 percent general sales tax and reduce the 40 percent surtax on individual income to 10 percent. The referendum failed by more than a 2-to-1 margin. In 1974, the Legislature made permanent the 6.75 percent tax rate (Ch. 5, L. 1974). The legislation also specifically provided for the apportionment of income of multistate or multinational corporations. Up until that time, the apportionment of income was based on rules adopted by the former state Board of Equalization.

In accordance with the Multistate Compact, multistate or multinational corporations required to file a return whose only activity in the state consists of making sales and that do not own or rent real or personal property in the state and whose gross receipts do not exceed $100,000 may elect to pay a gross receipts tax of 1/2 of 1 percent (15-31-1222, MCA).[10]

In 1987, the Legislature allowed multinational corporations doing business in Montana to elect water's-edge taxation based on income earned in the United States (Ch. 616, L. 1987). Beginning in tax year 2004, the income of a water's-edge taxpayer must include the income of a corporation in a unitary relationship with the taxpayer that is incorporated in a tax haven (Ch. 521, L. 2003). The tax rate for a corporation electing water's-edge is 7 percent.

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[8]Coffey, Sarah Beth, "The Questionable Link Between State Corporate Income Taxes and Economic Development", *State Tax Notes*, Vol. 38, No. 3 (Falls Church, VA: October 10, 2005), p. 213.

[9]Brunori, David, State Tax Policy, A Political Perspective, (The Urban Institute Press, Washington D.C., 2001), p. 106. Based on an interview (Brunori) with Dan Bucks, director, Multistate Tax Commission, *State Tax Notes*, Volume 9, No. 5, July 31, 2000.

[10]The compact provides that the Multistate Tax Commission, not more than once in 5 years, may adjust the $100,000 figure to reflect changes in the real value of the dollar (15-1-601, MCA).

In the 1989 special session, the Legislature required a corporation to make estimated taxes payments if its annual estimated tax is $5,000 or more (Ch. 9, Sp. L. June 1989). One reason for requiring estimated tax payments was to accelerate the collection of corporation taxes to help offset the unfunded liability in workers' compensation.

**Corporation Tax Bases and Rates**

Most states that impose a corporation income tax are tied to the federal tax code. Conformity with federal tax laws simplifies compliance with and the administration of the corporation income tax. The starting point for determining a corporation's state tax liability use federal Form 1120 net federal taxable income (line 30) or federal taxable income before net operating loss and special deductions (line 28) as the starting point for computing state taxable income.[11] Total federal income of a corporation is determined as follows:

- gross receipts (less returns and allowances) - cost of goods sold = gross profit

- gross profit + dividends and interest + gross rents and royalties + capital gain net income + net gain or (loss) from sale of business property + other income = total income (line 11)

Federal taxable income (line 28 of the federal tax return) is determined by subtracting operating expenses and other deductions (e.g., bad debts and charitable contributions) from total income. Federal taxable income may be further reduced by net operating loss deductions and special deductions (line 30 on the federal return). Although states generally conform with federal tax laws, they make modifications to taxable federal income that reflect differences from federal policy. For example, a state may "decouple" from certain federal tax provisions in order to maintain the state's tax base.[12] In addition, states are prohibited from taxing interest on federal debt obligations.

Additions and subtractions to corporate federal taxable income vary significantly among the states. Additions may include the following:

- interest income from state and local debt obligations;
- state, local, and foreign income taxes paid;
- federal carryover deductions for net operating losses;
- federal dividends-received deductions;
- federal bonus depreciation;
- royalty and interest expenses paid to related parties;
- expenses related to state tax credits;
- expenses related to income that is exempt for state tax purposes.

Some subtractions from federal taxable income include:

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[11]Healy, John C. and Schadewald, Michael S. 2005 Multistate Corporate Tax Guide, Vol 1. (Chicago: CCH Incorporated, 2005), p. I-11.

[12]For example, 31 states decoupled from the "bonus depreciation" provision of the Jobs and Growth Tax Relief Reconciliation Act of 2003 and 18 states decoupled from the "qualified production activities deduction" provision of the American Jobs Creation Act of 2004.

- interest received on federal debt obligations;
- state net operating deductions;
- state dividends-received deductions;
- expenses related to federal tax credits;
- federal gross-up income with respect to foreign subsidiaries.[13]

States that are not tied directly to the federal tax base may incorporate federal income and deduction provisions (e.g., Minnesota). Arkansas defines income and allowable deductions in state law. Michigan taxes businesses on the basis of value-added (the tax is being phased-out), while Texas taxes on the basis of earned surplus (retained earnings) or net worth. Twenty-eight states (including Montana) and the District of Columbia impose a flat rate on net income and the remainder impose graduated rates. Some states impose separate tax rates on financial institutions and other types of businesses. Pennsylvania also imposes a capital stock tax, a foreign franchise tax, and a corporate loans tax.

In 1961, the Montana Legislature specifically adopted the federal definition of gross income to include the income from all sources within the state that is recognized in the determination of the corporations's federal income tax liability (Ch. 235, L. 1961).[14] Federal taxable income (line 28, excluding federal net operating losses and special deductions) is the starting point for determining Montana taxable income. Several items are added to and subtracted from the federal base to determine Montana taxable income. Additions to federal taxable income in Montana include:

- Montana corporation license tax;
- other state, local, and foreign income taxes;
- federally exempt municipal interest;
- contributions used to compute Montana's tax credit for a contribution to a qualified endowment under 15-31-161, MCA;
- extraterritorial income exclusion;[15]
- capital loss carryover and other additions.

Subtractions include:

- Internal Revenue Code "Section 243" dividends received deduction;
- nonbusiness income (nonbusiness income is taxed in the state in which it is earned);

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[13]Healy and Schadewald, *op. cit.*, p. I-12.

[14]Gross income is now defined as "all income recognized in determining the corporation's gross income for federal income tax purposes" (with adjustments).

[15]The extraterritorial income exclusion was repealed by the American Jobs Creation Act of 2004 because the World Trade Organization declared that the exclusion is illegal under international law.

- other deductions (e.g., current year capital loss).[16]

**Net Operating Loss Carryforward and Carryback**

Corporations are allowed to reduce taxable income by carrying back or carrying forward net operating losses. A net operating loss occurs when a business's deductions exceed its operating income for the tax year. The rationale for allowing net operating losses is to tax businesses on the basis of the business cycle rather than individual tax years; the taxpayer is allowed to offset its bad years against its good years with net operating losses. A carryback of a net operating loss generally results in a tax refund in the carryback year, while a carryforward generally reduces tax liability in the carryforward year. In Montana, the carryback period is 3 years and the carryforward period is 7 years (15-31-119, MCA). A taxpayer may elect to forgo the carryback period for the tax year of the net operating loss.

For federal income tax purposes, a corporation is allowed to carry back losses 2 years and carry forward 20 (previously 3 years back and 15 years forward). The Job Creation and Worker Assistance Act of 2002 temporarily extended the 2 year carryback to 5 years for net operating losses incurred in 2001 and 2002. Although several states conform to the federal provisions, most states have adopted their own provisions by eliminating carrybacks, establishing shorter periods, or limiting the dollar amount allowed in a given year. Twenty-four states do not allow net operating loss carrybacks. Illinois and Nebraska previously conformed with federal rules. Illinois now allows a 12-year carryforward period and Nebraska allows a 5-year carryforward. Nineteen states (including Montana) and the District of Columbia allow carrybacks (2-5 years) and carryforwards (5-20 years). Vermont follows federal provisions for net operating losses but does not allow a refund for a net operating loss carryback; the effect is to reduce the amount of the net operating loss that may be carryforward.

**Apportionment of Income**

A significant amount of state corporation income taxes are paid by multistate or multinational corporations. The income of a corporation that operates in more than one state or country is apportioned for tax purposes to each state in which the corporation operates. The apportionment of income formula is the ratio of the corporation's business activity in the state to the corporation's total business activity. Adjusted federal taxable income is apportioned to each state according to its apportionment formula. The apportionment formula typically includes in-state sales to total sales, in-state payroll to total payroll, and in-state property to total property of the corporation.[17] These factors serve as a proxy for benefits received by a corporation doing

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[16]The additions and subtractions are derived from "Overview of Montana Corporation License Tax", presented by Brian Staley, Department of Revenue, to the Legislative Interim Tax Reform Study Committee, June 14, 2004, and to the Revenue and Transportation Committee, July 9, 2005.

[17]In-state mileage to total mileage may be included in the apportionment formula for businesses that transport persons or property.

business in a state and thus the amount of tax a state can impose for those benefits.[18] The formula is used to ensure that a corporation's overall business activity is properly assigned to each state in which it operates.

Separate Reporting: States that calculate the taxable income and apportionment percentages of a parent corporation without regard to subsidiaries are known as separate entity states. States that take into account the income and apportionment of parent companies and subsidiaries are known as combined unitary reporting states.

Under separate reporting, each corporation pays tax only on its own income regardless of its connection with other corporations. In separate entity states, tax revenue may be affected by corporate restructuring, transfer pricing, and the creation of holding companies. These tax strategies may result in shifting income or profits to low tax states or to states that do not tax corporate income ("nowhere income"). Many states (including combined reporting states) have a "throwback rule" that allocates sales to the state of origin if the seller is not taxable in the destination state. Under certain conditions, some states may require consolidated or combined reporting (if separate reporting does not adequately account for income) or grant permission to the taxpayer to file combined reporting.

Combined Reporting: Under combined reporting, a commonly controlled group of corporations engaged in a unitary business computes state taxable income on a combined basis. A unitary business is generally one that has unity of ownership, unity of operation, and unity of use.[19] This method of reporting income allows members of the unitary business to offset profits of an affiliate with losses of other affiliates. It also prevents the possible manipulation of transactions between affiliates that may occur with separate accounting. Most states do not allow or do not require combined reporting. Montana is one of 13 states that require combined unitary reporting.

UDITPA: The Uniform Division of Income for Tax Purposes Act is a model law for apportioning the income of a corporation that is taxable in more than one state. The model law was developed in 1957 to deal with the apportionment of taxable corporate income.

In 1969, Montana adopted the provisions of UDITPA by enacting the Multistate Compact. Article 1 of the compact sets forth the purposes of the law:

(1) facilitate proper determination of state and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes;

(2) promote uniformity or compatibility in significant components of tax systems;

(3) facilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration;

(4) avoid duplicative taxation.

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[18] Atkins, Chris, "A Twentieth Century Tax in the Twenty-First Century: Understanding State Corporate Tax Systems", Background Paper No. 49 (Washington, D.C.:Tax Foundation, 2005, available from http://www.taxfoundation.org/publications/printer/1096.html; Internet; accessed October 11, 2005) p. 6.

[19] *Ibid.*, p. 4.

The net income of a multistate or multinational corporation doing business in Montana is allocated by a three-factor, simple-average apportionment formula. If, for example, 1/3 of property of a multistate firm is located in Montana, 1/3 of its payroll is paid in Montana, and 1/5 of its sales occur in Montana, about 29 percent of its net income would be subject to taxation in Montana: (33.3% + 33.3% + 20%)/3 = 28.9%.

One of the shortcomings of apportionment in general is that more than 100 percent of income may be taxed or that some income may escape taxation.

**Erosion of the Corporate Tax Base**

According to William F. Fox and LeAnn Luna, the relative importance of state corporation taxes has declined since the mid 1980s. State corporate taxes measured as a percent of corporate profits (effective tax rate), taxes as a percent of total state tax revenue, and taxes as a percent of gross domesticate product have generally declined since 1982-1986. They cite four reasons that have contributed to the decline in the relative importance of state corporation income tax revenue: cyclical declines in profits, reductions in the federal corporation tax base, state policy decisions to reduce corporate tax burdens (including tax concessions, changes to the apportionment formula, and the creation of limited liability companies), and more aggressive corporate tax planning.[20]

One example of state policies affecting the taxation of corporations is the weighting of sales in the apportionment formula. In 1990, 34 states used the 3-factor, simple-average apportionment formula.[21] Now, only 13 states, including Montana, use simple-average apportionment. The rest of the states at least double weight the sales factor. Oregon, which in 1990 used simple-average apportionment, will use a single sales factor apportionment formula beginning in 2007.

Giving more weight to the sales factor in the apportionment formula is promoted for economic development in order to attract more investment to the state, either by expansion of existing multistate businesses or the location of new multistate businesses in the state. Double-weighting sales increases the tax on some corporations, decreases it on others, and has no effect on others. Giving greater weight to the sales factor may bring a larger share of a multistate corporation's income into the taxing state. On the other hand, giving greater weight to sales usually results in lower taxes for corporations that have a greater proportion property and payroll in the state than do other corporations. If sales were double weighted in Montana, the amount of taxable income apportioned to the state in the example above would be 26.6% compared with 28.9%: ((33.3% + 33.3% + 20% + 20%)/4 = 26.6%), or about an 8% reduction. The weighting of apportionment factors does not affect taxes paid by businesses that operate entirely within the state. Some states

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[20]Fox, William F. and Luna LeAnn, "State Corporate Tax Revenue Trends: Causes and Possible Solutions", *National Tax Journal* (National Tax Association Symposium: Policy Issues for Taxing Times, Volume LV, No. 3, September 2002, pp. 491-508.

[21]See Table 26 (Corporate Income Tax Details, by State) in *Significant Features of Fiscal Federalism*, Vol. 1 (Washington, D.C.: U.S. Advisory Commission on Intergovernmental Relations, 1991) pp. 76-82.

(e.g., Connecticut, Massachusetts, Missouri, and Rhode Island) allow taxpayers in certain industries to apportion income using a single-sales factor formula.

According to Richard Pomp, the trend to weighting the sales factor more heavily led to a $500 million loss in revenue and probably did not promote economic development.[22] On the other hand, Chris Atkins cites a study by Austan Goolsbee and Edward Maydew that found that reducing the weight of the payroll factor and more heavily weighting the [sales factor] increases in-state employment. He points out that the study notes that job growth is a zero sum game if other states follow suit.[23]

**Nexus**

Nexus is the term used to determine whether a multistate corporation has sufficient presence within a state to have its income apportioned to that state for tax purposes. The U.S. Constitution and Public Law 86-272 establish the limits to which a corporation's income may be subject to tax and provide a degree of uniformity in state tax laws.[24] Public Law 86-272 prohibits states from imposing a net income tax on income derived from interstate activities within the state that arise from the solicitation of orders for tangible personal property and the orders are filled and delivered from out of state.[25]

There is controversy on whether physical presence or economic presence is a better indicator of a business's taxable activity within a state. In April 2005, Rep. Bob Goodlatte introduced HR 1956, the "Business Activity Tax Simplification Act of 2005". The bill would revise existing law by, among other things, extending the application of Public Law 86-272 to all business activity taxes.[26] It would also establish a physical nexus test. A business entity would have physical presence in a state if it has property or employees within a state for a period of more than 21 days.

The November 7, 2005, issue of *State Tax Notes*, contains a report by the National Association of Governors on the legal implications and the revenue losses to states if HR 1956 were enacted. The same issue contains a response to that report by the Council on State Taxation.

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[22]Pomp, Richard D., "The Future of the State Corporate Income Tax: Reflections (and Confessions) of a Tax Lawyer", in The Future of State Taxation, edited by David Brunori (Washington, D.C.: Urban Institute Press, 1998).

[23]Atkins, *op. cit.*, p. 7.

[24]Healy and Schadewald, *op cit.*, p 43.

[25]Public Law 86-872 was enacted in 1959 to deal with a U.S. Supreme Court decision that the Commerce Clause did not prohibit a state from taxing an out-of-state corporation whose only activities were the solicitation and filling of orders from customers in the state. *Northwestern States Portland Cement v. Minnesota*, 358 U.S. 450 (1959).

[26]On September 27, 2005, a subcommittee of the House Committee of the Judiciary held a hearing on the bill.

**The Eye of the Beholder**

Charles McLure makes the following observations in assessing the condition (or as he puts it, the "nuttiness") of state corporation income taxes:

- Not all states provide for combination or unitary businesses [most do not];
- States that do provide for combination do not necessarily define a unitary business the same way;
- Even when states use the same apportionment factors to divide the business income of multistate corporations, they do not all assign the same weights to the various factors;
- The current trend is to place a disproportionate weight on the sales factor in an effort to attract economic activity [uniformity does not necessarily require the simple-average apportionment formula];
- States do not use identical definitions of the apportionment factors, especially sales; and
- The existence of substantial sales in a state does not imply taxable nexus, even if the state employs only sales to apportion income.[27]

Other analysts of state tax policy may not agree with these observations about the "nuttiness"of state corporation income taxes, but the observations do indicate some weaknesses may exist in the disparate approaches that the states have taken in the taxation of corporate income.

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[27]McLure, Charles E., Jr., "Understanding the Nuttiness of State Tax Policy: When States Have Both Too Much Sovereignty and Not Enough", *National Tax Journal* (Washington, D.C.: National Tax Association, September 2005) p. 565.