APPORTIONMENT

Presented to

Maryland Business Tax Reform Commission

Paul Nolan

Manufacturer’s Alliance of Maryland

January 7, 2010

What is Apportionment?

- Under the Due Process and Commerce Clauses of the U.S. Constitution, States are permitted to tax the income of a multistate corporation if the State applies a formula that fairly apportions a percentage of the corporation’s income attributable to business activities inside and outside the State.
- Apportionment is required regardless of the business income reporting model, i.e., under separate or combined reporting, some apportionment approach must be used.
- Thus, apportionment is a separate issue to consider in business tax reform recommendations.

Why Apportion?

- A corporation may transact business in more than one State.
- Sufficient contact with a State results in nexus.
- Nexus is the basis for a State's tax jurisdiction.
  - A person with nexus in a State can be subject to tax in that state.
- In order to avoid taxing the same income in multiple jurisdictions, some methodology is needed to allocate a corporations profits between "In-State" and "Out-of-State" portions.
- Theoretically, the allocation should eliminate multiple taxation of same income / profits.

HISTORY

- Uniform Division of Income for Tax Purposes Act (UDIPTA) 1957
  - **National Conference of Commissioners on Uniform State Laws promulgated UDIPTA to**
    - **bring about uniformity among states in taxing multistate income and**
    - **provide a basis for avoiding duplicate taxation apportioning income of a corporation that is taxable in two or more states.**
  - **Model to apportion income that is generated in more than one state.**
  - **Equal weighted 3 factor formula**
    - **Sales**
    - **Payroll**
    - **Property**
  - Example of the mechanics of an apportionment formula is presented in the Appendix.
- Multistate Tax Commission (MTC) adopted the UDIPTA three factor formula on August 4, 1967 when the Multistate Tax Compact became effective.
- Thereafter, most States with income taxes adopted the three factors using equal weighting of apportionment factors.
- 1980’s - States began to change - weighting sales two or three times.

HISTORY (continued)

- Constitution gives broad latitude to States to determine apportionment factors.
  - Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978)
  - Iowa case involving a statute prescribing single sales factor for apportionment.
  - Court relied on prior Supreme Court precedent that a State’s choice of apportionment formula will be constitutionally upheld unless a taxpayer can prove income attribution to a state by clear and cogent evidence is inappropriate – by showing that the income attributed to the state is in fact “out of all reasonable proportion to the business transacted in that State”.
  - The U.S. Supreme Court opined in favor of the use of single sales factor and did not require use of a three factor formula.

Current Trend
Apportionment Factors increasingly used as an Economic Incentive

- Why did States change the apportionment formula?
- State concern over adverse effects of business tax competitiveness and economic development.
  - Reduce the significance of payroll and property factors and increase importance of sales factor.
  - Majority of states now use apportionment formulas that “double-weight” or more the sales factor.
  - Only 10 states still use equal weighted 3 factor formula.

Current Trend
Single Factor Apportionment

- 100% sales factor apportionment
  - Arguably a better measure of economic activity for purposes of apportionment.
    - Payroll and property factors vary widely by type of industry.
    - Payroll and property factors can be distortive and create unlevel playing fields.
      - » Examples - manufacturing vs. services, tangible vs. intangible
  - Does not penalize in-state corporations.
    - Additional incentive to expand or hire employees outside the state to work in state.
    - Taxes on the economic actual output in the state – sales activity.
  - Eliminates the disincentive for out of state corporations to increase their payroll and property in a state that exists under three factor.
  - Increases the relative tax liability of out of state corporations or those with little investment in the state (i.e., those that do not own property or payroll in the state).
  - Fully “in-state” businesses, i.e., small business with no outside state business, pay the same under the three factor and single factor.

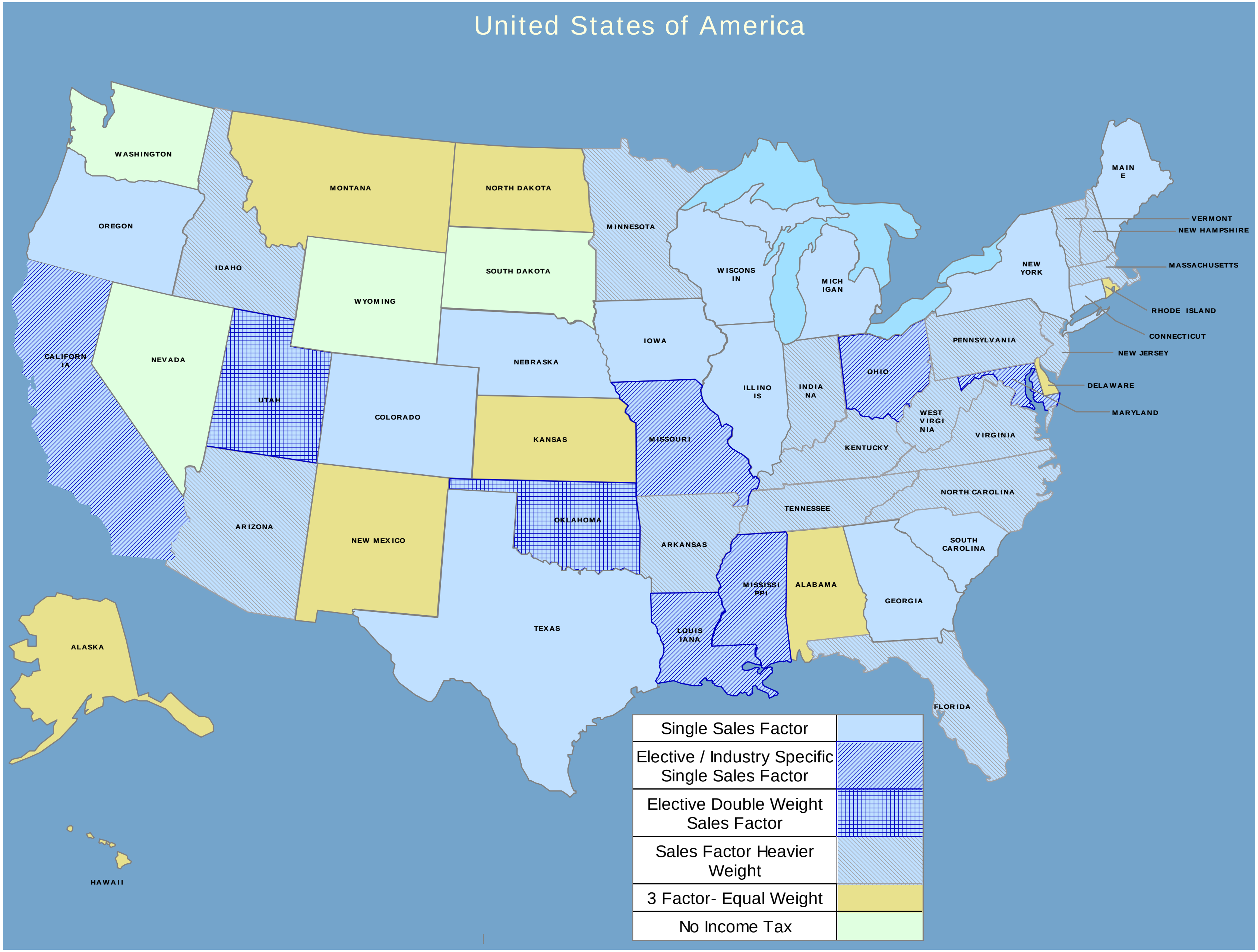
Current Trend
Single Factor Apportionment

- States using Single Sales Only (12 States)
  - Colorado - Maine - Ohio
  - Georgia - Michigan - Oregon
  - Illinois - Nebraska - Texas
  - Iowa - New York - Wisconsin
- States moving in the direction of single sales factor:
  - South Carolina – fully implemented 2011
  - Minnesota – phase in from 2007 – 2014
  - Indiana – phase in from 2007 – 2011
  - Pennsylvania – super-weighted sales factor of 90% for 2010

Current Trend
Single Factor Apportionment

- In the recent past, the trend towards single sales factor has been occurring **<u>with</u>** the trend towards corporate tax reform.
- States changing laws to address perceived corporate tax abuse have also adopted single sales factor, regardless of the separate or combined reporting.

  – California – beginning in 2011, taxpayers may elect single sales factor
  – Ohio – Commercial Activity Tax (fully phased in April 1, 2009)
  – Michigan – Michigan Business Tax (January 1, 2008)
  – New York – Combined report only if there are substantial intercompany transactions (2007) – single factor
  – Texas –Consolidated Gross Margin – single sales factor (January 1, 2008)
  – Wisconsin - combined reporting enacted in June 2009 retroactive to tax years beginning after January 1, 2009 – single sales factor included.


United States of America
WASHINGTON
OREGON
CALIFORN IA
NEVADA
IDAHO
MONTANA
WYOMING
UTAH
ARIZONA
COLORADO
NEW MEXICO
NORTH DAKOTA
SOUTH DAKOTA
NEBRASKA
KANSAS
OKLAHOMA
TEXAS
MINNESOTA
IOWA
MISSOURI
ARKANSAS
LOUIS IANA
WISCONS IN
ILLINO IS
MICH IGAN
INDIA NA
OHIO
KENTUCKY
TENNESSEE
MISSISSI PPI
ALABAMA
GEORGIA
FLORIDA
SOUTH CAROLINA
NORTH CAROLINA
VIRGINIA
WEST VIRGI NIA
PENNSYLVANIA
NEW YORK
MAIN E
VERMONT
NEW HAMPSHIRE
MASSACHUSETTS
RHODE ISLAND
CONNECTICUT
NEW JERSEY
DELAWARE
MARYLAND
ALASKA
HAWAII
Single Sales Factor
Elective / Industry Specific Single Sales Factor
Elective Double Weight Sales Factor
Sales Factor Heavier Weight
3 Factor- Equal Weight
No Income Tax

Maryland

- Current law – Three-factor formula with double-weighted sales factor and a single sales factor for manufacturers with more than 25 employees.
- Maryland's recent history is consistent with other states in enacting corporate tax reforms and addressing apportionment factors.
- Recent changes to Maryland statute and its enforcement that have addressed the type of abuses sometimes associated with separate reporting rules:
  - Section 482 Powers – Comptroller may use to adjust net income among related taxpayers;
  - Delaware Holding Companies - mandatory add-back for related party transactions addition modification and limited amnesty window; and
  - Addition for dividends paid deduction for a captive REIT.
- Single sales factor encourages "in-state corporations" to invest more in property and payroll in Maryland.
- Single sales factor encourages "out-of-state corporations" to invest "in state" in property and payroll in Maryland.

Example

MD Headquartered Co

100,000 Net Income

50% Property

50% Payroll

35% Sales x 2 = 70%

170 / 4 = 43% (3 Factor DW Sales)

Results under 3 Factor:

100,000 X 43%= 43,000 TI

Results under Single Sales Factor:

100,000 X 35% = 35,000 TI

Out of State Co

100,000 Net Income

0 % Property

0% Payroll

35% Sales x 2 = 70%

70 / 4 = 18% (3 Factor DW Sales)

Results under 3 Factor:

100,000 X 18% = 18,000 TI

Results under Single Sales Factor:

100,000 X 35% = 35,000 TI

Consequences

- In state corporations are not penalized.
- In state corporations are encouraged to invest more in property an payroll.
- Out of state corporations are not discouraged to move into the state.
- More level playing field for MD multistate corporations paying higher taxes to other jurisdictions where the trend is to use single sales factor.

Recommendation

- Recognize the fact that in a “Feds, Eds, Meds and Beds” dominated economy, the state corporate revenue base should reach those businesses providing goods and services to Maryland and not incent those businesses to supply from outside Maryland.
- Continue to use Apportionment as an economic incentive for jobs.
- Continue to use single factor apportionment for manufacturers.
- Consider expanding single factor apportionment for all corporations, regardless of the business reporting model used, i.e., separate returns or combined reporting.

Appendix

Apportionment Calculation Steps

$$\frac{\left[\dfrac{\text{Maryland Receipts}}{\text{U.S. Receipts}} + \dfrac{\text{Maryland Receipts}}{\text{U.S. Receipts}} + \dfrac{\text{Maryland Property}}{\text{U.S. Property}} + \dfrac{\text{Maryland Payroll}}{\text{U.S. Payroll}}\right]}{4}$$

Maryland Receipts	500
U.S. Receipts	1,000
Maryland Property	1,000
U.S. Property	10,000
Maryland Payroll	300
U.S. Payroll	2,000

$$\frac{\left[\dfrac{500}{1{,}000} + \dfrac{500}{1{,}000} + \dfrac{1{,}000}{10{,}000} + \dfrac{300}{2{,}000}\right]}{4}$$

$$\downarrow$$

$$\frac{\left[0.50 + 0.50 + 0.10 + 0.15\right]}{4}$$

$$\downarrow$$

$$\frac{1.25}{4}$$

$$\downarrow$$

$$0.3125$$

Appendix
State Apportionment Formulas

- 3 Factor – equal weight (9 states & DC)
  - Alabama, Alaska, District of Columbia, Delaware, Hawaii, Kansas, Montana, New Mexico, North Dakota & Rhode Island
- Modified 3 Factor – sales double weighted or more
  - Arizona, Arkansas, Florida, Idaho, Kentucky, Massachusetts, Minnesota, New Hampshire, New Jersey, North Carolina, Pennsylvania, Tennessee, Vermont, Virginia, & West Virginia

Appendix
State Apportionment Formulas

- Single Sales Factor
  - Colorado, Georgia, Illinois, Iowa, Maine, Michigan, Nebraska, New York, Ohio, Oregon, Texas & Wisconsin
  - Phase In: Indiana, Minnesota & South Carolina
- Industry Specific / Elective Formulas
  - Single Sales Factor (Industry Specific)
    - Connecticut, Louisiana, Maryland, Mississippi, Missouri
  - Singles Sales Factor (Elective)
    - California
  - Double Weighted Sales Factor (Elective)
    - Oklahoma, Utah