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A brief history

- U.S. states began using formulary apportionment at the end of the 19th century for purposes of levying the property and capital stock tax on the transcontinental railroad system.
- Instead of measuring the property value in each state, companies measured the total property value (tracks, franchise, rolling stock, etc.) as a single unit and distributed the total value across the states according to the value of the railway lines in each state relative to the total value in all of the states.
- The so-called "unit rule" of formulary taxation that apportioned the value of the entire enterprise, or unit, arose from this process.
- In 1911, Wisconsin because first state to adopt the corporate income tax and it used a formula based on shares of property, cost of manufacture and sales.

The Massachusetts formula

- In 1920, Supreme Court validated use of formulary apportionment method for state corporate income tax
- By 1930s, most states had adopted the formulary method
- In 1933, National Tax Association recommended that states adopt the equally-weighted, three-factor formula based on property, payroll and sales, that was then the most commonly used formula
- The 1957 Uniform Division of Income for Tax Purposes Act (UDITPA) provides definitions of the apportionment factor and formula.
- By 1950s, nearly all states used the Massachusetts formula

This uniformity didn't last

- In 2004, the double-weighted sales formula was the most common state formula
- Just 14 states used the Massachusetts formula
- Movement away from formula with property and payroll stemmed, in part, from McLure (1981) who showed that measuring state income using a formula composed of property, payroll and sales effectively transforms the state corporate income tax into a tax on property, payroll and sales

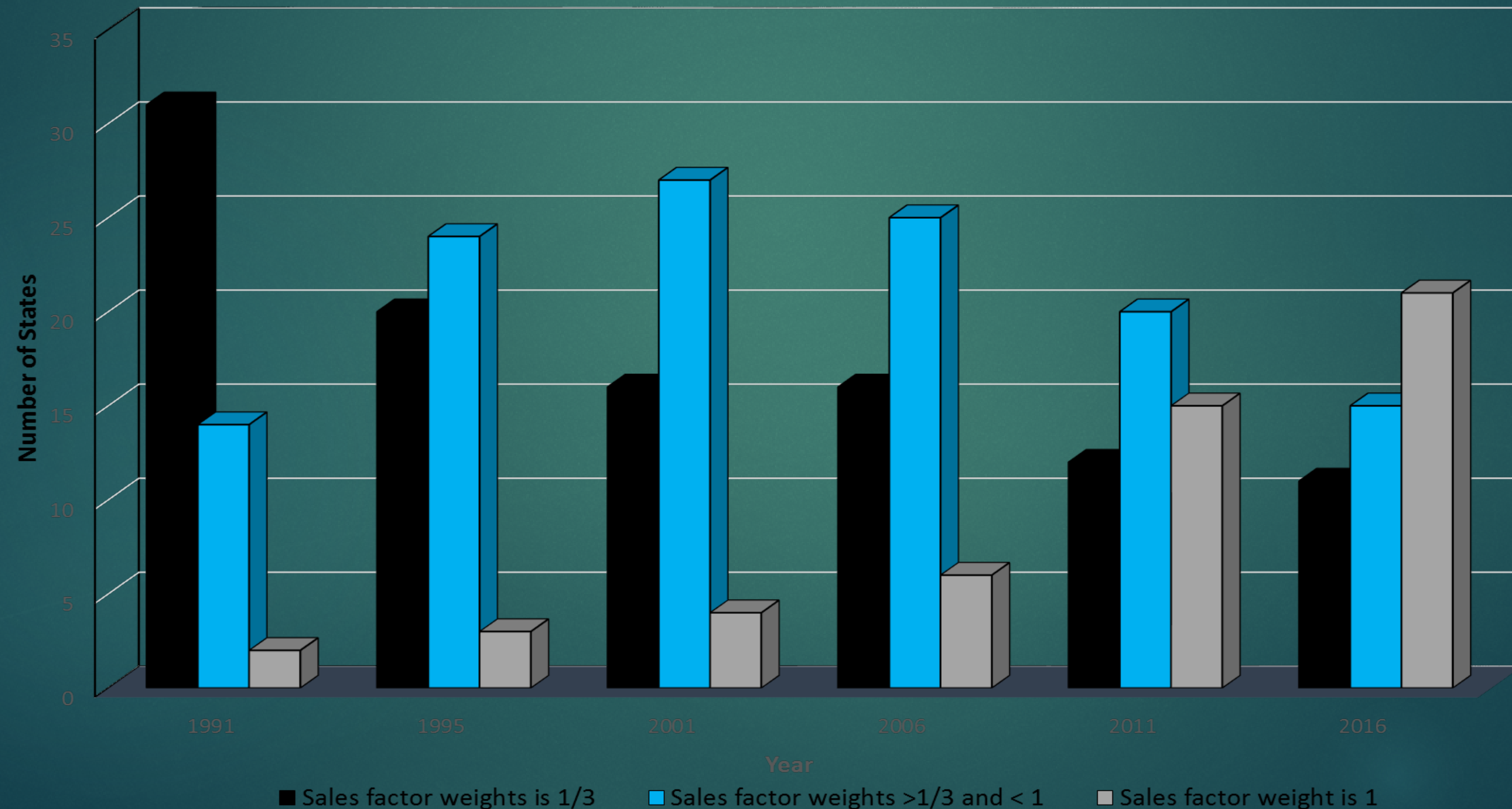
Empirical evidence

- Weiner (1994) found that states that reduced the weight on the property factor stimulated additional state investment spending.
- Goolsbee and Maydew (2000) found that manufacturing employment increases in states that reduce the weight on the payroll factor
- Gupta and Hofman (2003) found that new capital expenditures fell as the tax burden on capital increased
- Reidel (2010) found that German MNEs adjusted their payroll costs to reduce their tax liability
- RESULT: States moved away from apportioning on location of where profits are generated to where sales are located

U.S. State Formulary Apportionment

Three-factor, equally weighted:	6 states
Single-factor sales:	23 states plus District of Columbia
Double-weighted sales:	7 states
Option to choose sales only or double-weighted sales:	4 states
Other formulae with option or super-weighted sales:	5 states
No state corporate income tax:	4 states
Gross receipts tax	2 states

Sales factor apportionment weight: 1991, 1995, 2001, 2006, 2011, 2016



Nexus to tax

- Since enactment of Public Law 86-272 in 1959, states can't tax net income of a corporation organized in another state if its only in-state activity is solicitation of orders, for sales of tangible personal property that are shipped from outside the state.
- The "physical presence" test of Quill applies to sales taxes, not income taxes
- P.L. 86-272 created so-called "nowhere income" that was not taxable in any state; thus, states adopted a 'throwback rule' that returned such sales to origin state for taxation
- In *Geoffrey* (1993), South Carolina taxed the tangible income earned by an out-of-state company because the presence of the trademark created a nexus.
- Many states considering taxing on the basis of "economic nexus"

Some issues to consider with the apportionment factors

- Sales are measured at destination and, if not taxed in the destination, are thrown back to the origin state
- Without the throwback rule, companies could generate nowhere income. Some states also use a throw out or a throw around rule
- Intangible income is included in sales factor if the income-producing activity is performed in the state, with an allocation based on costs of performance
- Multistate Tax Commission has a "factor presence nexus" test that includes sales of digital products
- The property factor generally does not include intangible property
- Payroll does not include payments made to independent contractors; compensation is based on Federal unemployment compensation rules

Corporate Income Tax Rates

- Maximum rate: 12 percent in Iowa
- Minimum rate: 0 percent in four states (Nevada, South Dakota, Washington, Wyoming)
- States with a single-factor sales formula (or no CIT) have an effective tax rate of zero on property and payroll.
  - 29 states (incl. DC) have a zero ETR on property and payroll
- Statutory tax rate is not a key factor in business investment decisions in these states

Consolidation and combined reporting

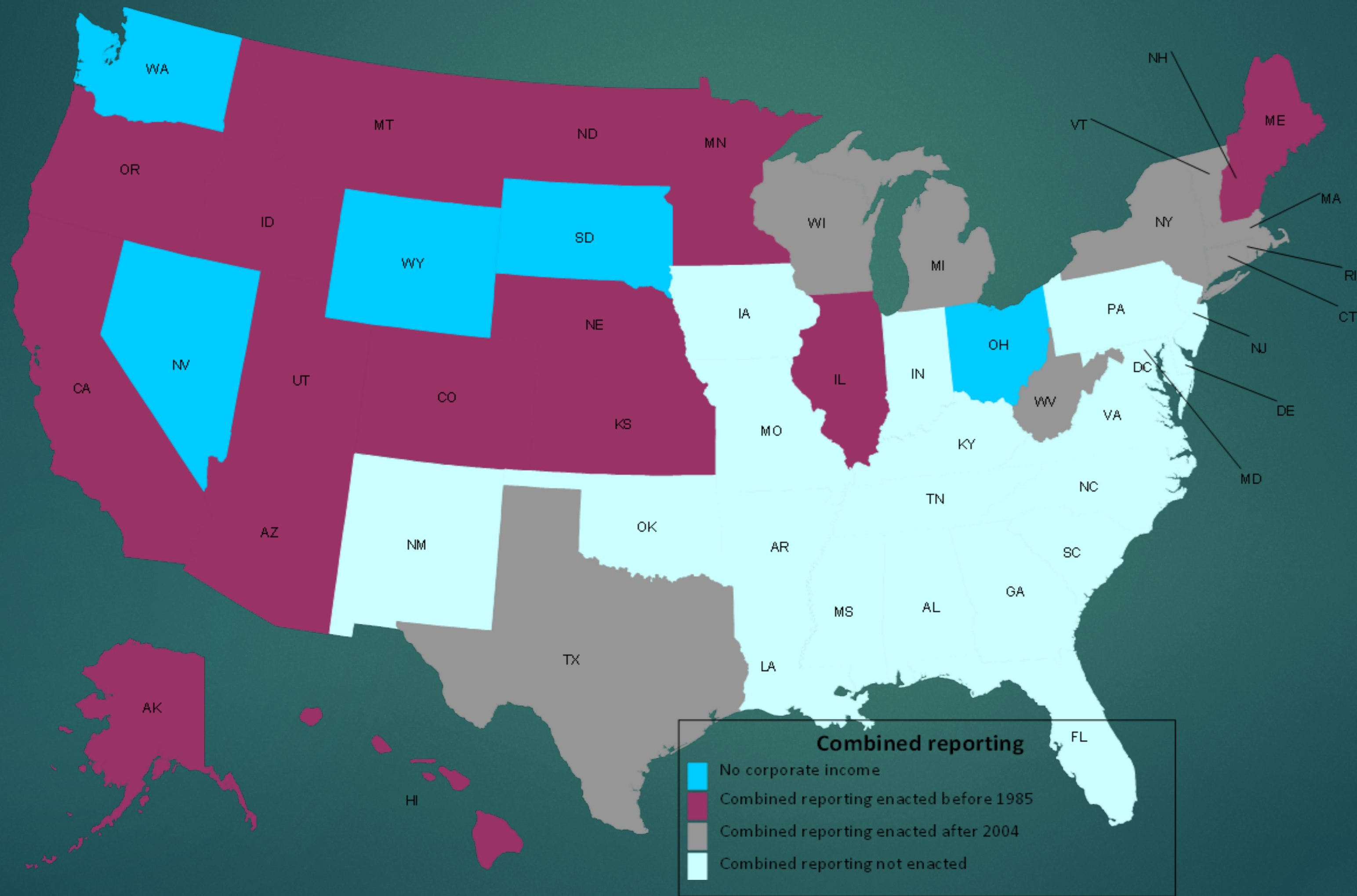
- For federal tax purposes, an affiliated group of corporations may elect to file a consolidated returns.
- Many states allow affiliated corporations to file a state consolidated return
- Some states require members of a commonly controlled group of corporations to file as if they were separate economic entities
- Many states require members of a unitary business group to compute their taxable income on a combined basis
- Unitary group does not have a uniform definition, but includes vertically integrated business, entities with centralized management, common ownership, functional integration etc.

Combination in the U.S. States

- Combined reporting: 26 states including DC
- Water's edge: 18 states including DC
- Worldwide combined reporting available: 7 states
  - Water's edge election: 4 states
  - Worldwide election: 3 states

  - In Tennessee, only financial institutions, REITS, and hospital companies are required to file combined returns
  - Oregon and Montana require entities with affiliates in specified tax havens to include those entities in the return

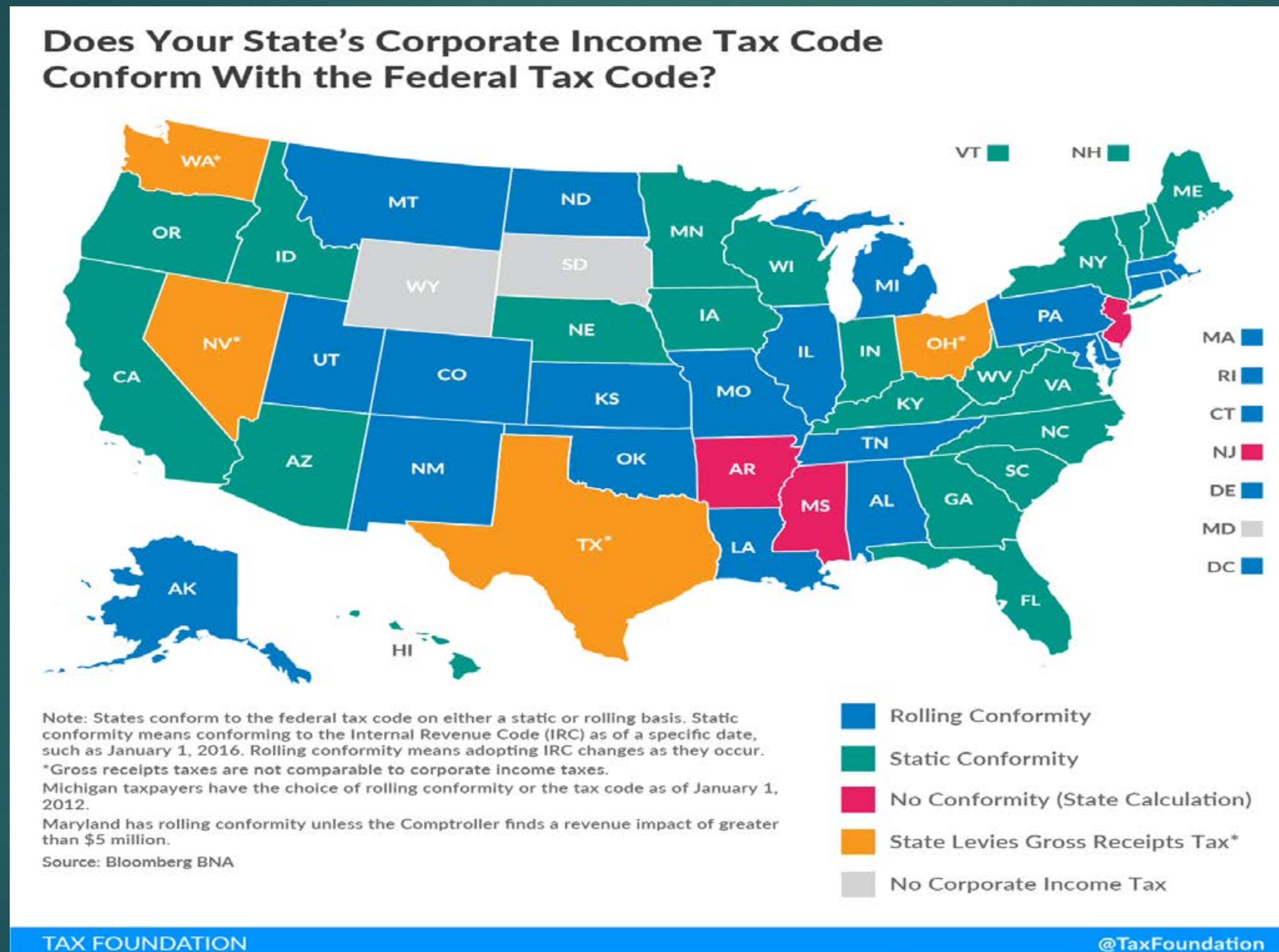
Combined reporting, 2016

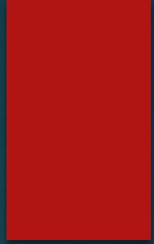


The tax base

- States generally begin with federal taxable income (line 28 or line 30 from the federal return, form 1120) and add or subtract state modifications, such as for net operating losses and depreciation
- States can conform on a "rolling" or a "static" basis as of a specific date
- The amount after making state adjustments is the state tax base; States then make adjustments for business income
- States apportion business income and allocate non-business income to specific states
- States add apportioned business income and allocated non-business income to obtain the state taxable income or loss

41 states conform with federal tax





Company
Tax Reform in the
European Union
Guidance from the United States and
Canada on Implementing Formulary
Apportionment in the EU
Joann Martens-Weiner