Corporate Income Taxes

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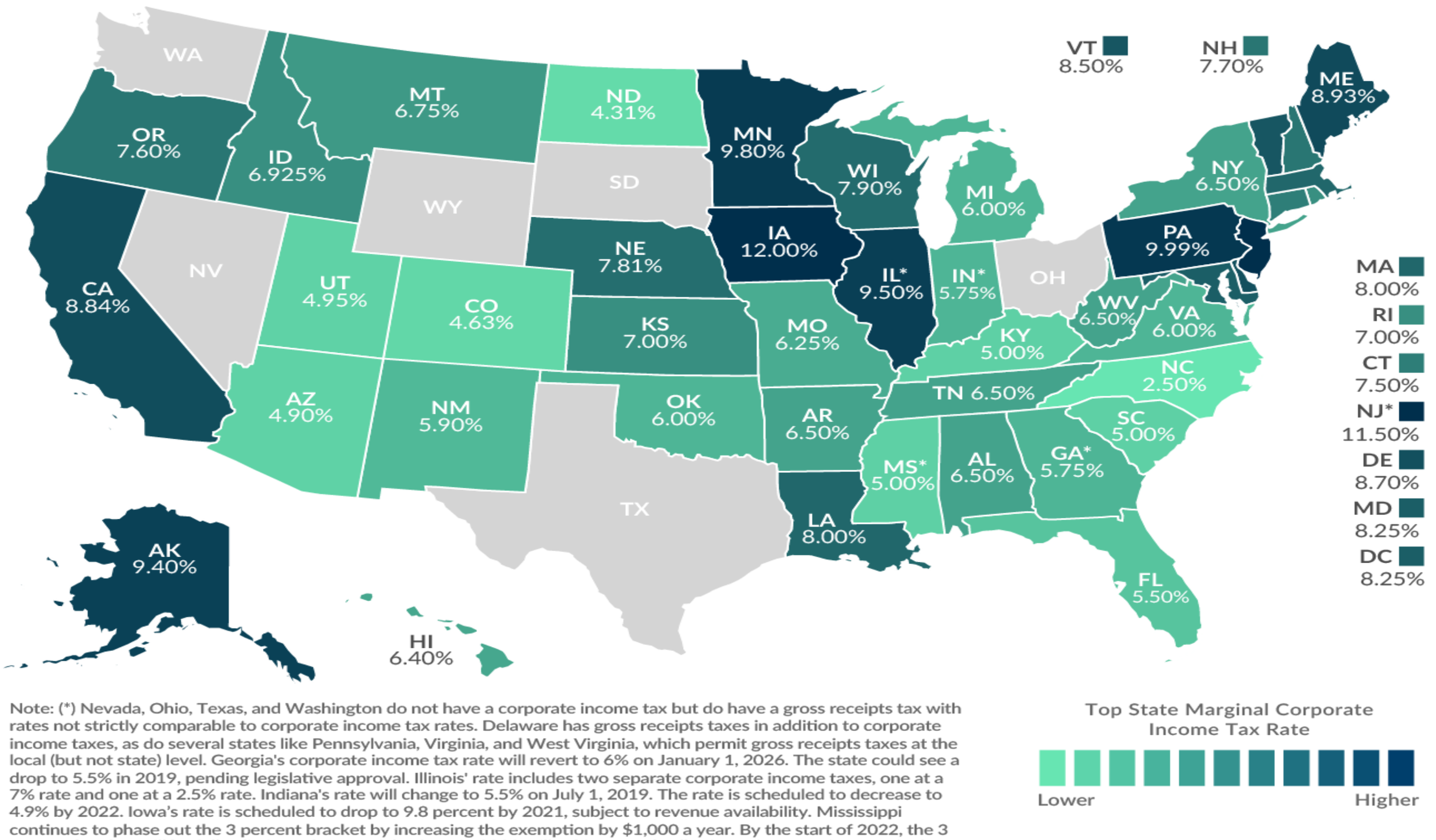
Who pays?
Legal entities

- US Resident C-Corporations:
  - Protection from personal liability.
  - Taxed at entity level with corporate tax.
  - Shareholders pay individual income taxes on dividends and capital gains on the appreciation of shares.
  - Main advantage today is ability to raise money on public markets.
- NOT pass through entities:
  - Partnerships, LLCs, S-Corps.
  - While these entities shield owners from personal liability, they typically do not pay entity level tax – income passes directly through to owners.
  - Cannot be used to raise public investment.

How do they pay?

- Taxable income is calculated at the federal level.
  - Taxable income is equal to a corporation's receipts less allowable deductions—including the cost of goods sold, wages and other employee compensation expenses, interest, nonfederal taxes, depreciation, and advertising.
  - Federal corporate tax rate is a flat 21% -- was lowered from a top rate of 35% by the TCJA.
- Vermont uses federal taxable income with certain adjustments
  - Do not allow deductions for bonus depreciation, non-VT bond interest, or federal operating losses.
  - Permit deductions for certain income added at the federal level related foreign credits and certain job creating credits.
  - Vermont rate is basically 8.5%, with minimum taxes based on gross receipts.

Top Marginal Corporate Income Tax Rates as of January 1, 2019



Note: (*) Nevada, Ohio, Texas, and Washington do not have a corporate income tax but do have a gross receipts tax with rates not strictly comparable to corporate income tax rates. Delaware has gross receipts taxes in addition to corporate income taxes, as do several states like Pennsylvania, Virginia, and West Virginia, which permit gross receipts taxes at the local (but not state) level. Georgia's corporate income tax rate will revert to 6% on January 1, 2026. The state could see a drop to 5.5% in 2019, pending legislative approval. Illinois' rate includes two separate corporate income taxes, one at a 7% rate and one at a 2.5% rate. Indiana's rate will change to 5.5% on July 1, 2019. The rate is scheduled to decrease to 4.9% by 2022. Iowa's rate is scheduled to drop to 9.8 percent by 2021, subject to revenue availability. Mississippi continues to phase out the 3 percent bracket by increasing the exemption by $1,000 a year. By the start of 2022, the 3 percent bracket will be fully eliminated. Potential reform in 2020 will subject nearly all Missouri companies to a single sales factor appointment, permitting a rate reduction from 6.25% to 4%. In New Jersey, the rates indicated apply to a corporation's entire net income rather than just income over the threshold. A temporary surcharge is in effect, bringing the rate to 11.5 percent for businesses with income over $1 million. In addition to regular income taxes, many states impose other taxes on corporations such as gross receipts taxes and franchise taxes. Some states also impose an alternative minimum tax and special rates on financial institutions.

Sources: Tax Foundation; state tax statutes, forms, and instructions; Bloomberg Tax

How do states identify corporate income to tax?

- What is the income of the taxpayer?

  Unitary combined reporting v. separate reporting

- How is income is apportioned to state?

  Apportionment Factors

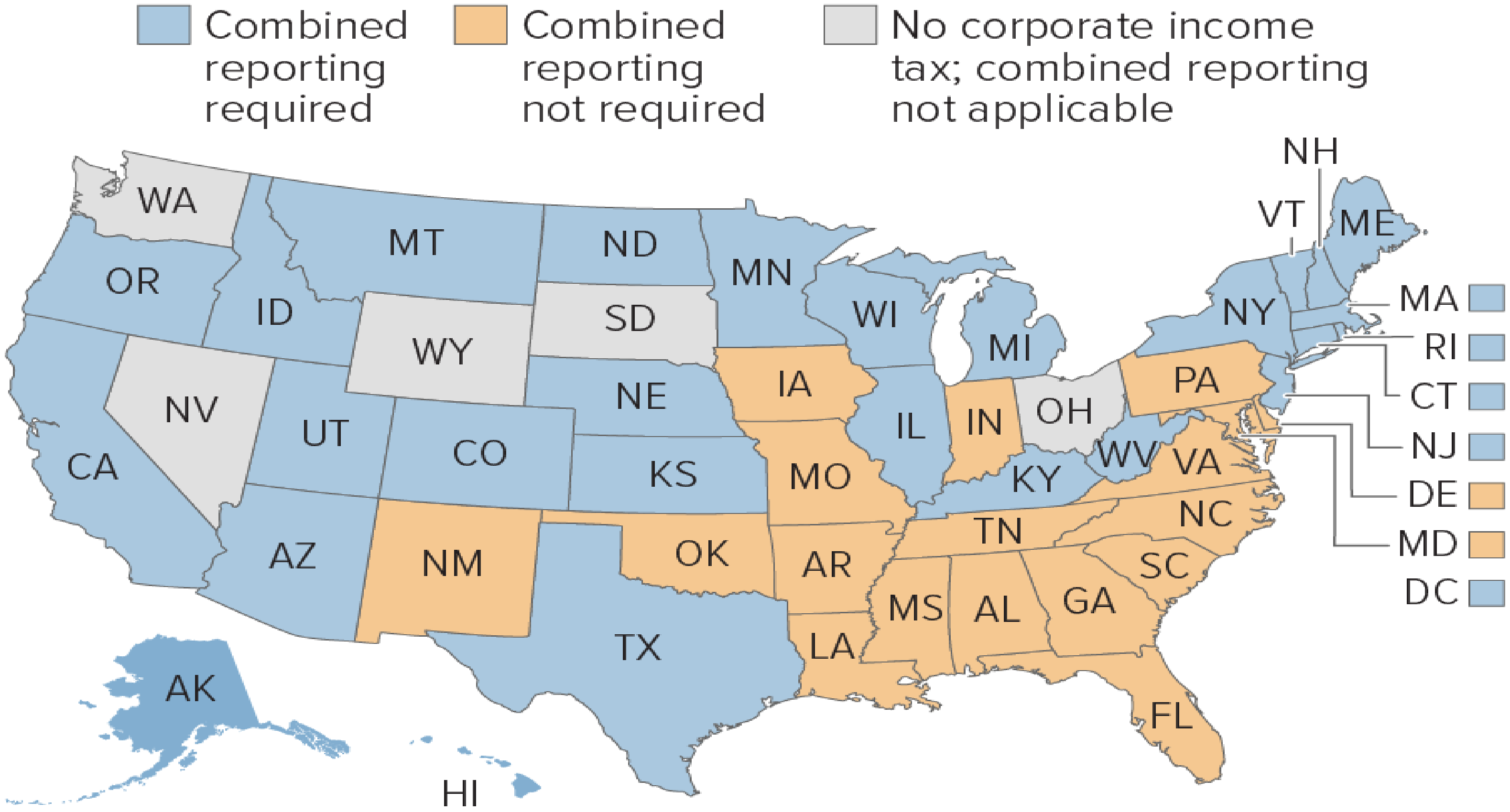
What is the income?

- Most large multistate corporations are composed of a “parent” corporation and a number of “subsidiary” corporations owned by the parent.
- Corporations can shift income between related companies in an effort to reduce their liability. Example:
  - A parent establishes a subsidiary in a state that does not tax income from intangible assets, such as copyrights and patents, and transfers those assets to that company.
  - The parent establishes a subsidiary in a different state to conduct the business. That subsidiary pays the intangible holding company royalties for use of the intangibles, and writes off the payments as an expense.
  - Viewed as separate entities, the parent benefits from the jurisdiction that does not tax intangibles, and from the jurisdiction that allows the expense.

Unitary Combined Reporting

- Under combined reporting, these related corporations that are part of a “unitary group” are generally treated as one entity for tax purposes.
  - Supporters of combined reporting say that this grouping of corporations eliminates distortions and tax planning opportunities caused by intercompany transactions, whether legitimate or otherwise, within the group.
  - Opponents say that combined reporting creates other distortions by attributing income to the wrong jurisdiction, because the calculation simply averages the income and apportionment of all the businesses that actually have different economic profitability.
- As of January 1, 2019, 27 states and the District of Columbia, including Vermont, have adopted some form of unitary combined reporting.

27 States Plus D.C. Require Combined Reporting for the State Corporate Income Tax



Note: Combined reporting treats a parent company and its subsidiaries as one entity for state income tax purposes, thereby helping prevent income shifting.

Source: John C. Healy and Michael S. Schadewald, "2018 Multistate Corporate Tax Guide, Vol. 1," Kentucky HB 487 (2018), effective January 1, 2019; New Jersey AB 4262 (2018), effective July 1, 2019.

Apportionment

- Historically, almost all states used an equally weighted, three-factor formula that uses property, payroll and sales. In the last two decades, most states have moved towards a double-weighted sales or single sales factor.
- Vermont uses double weighted sales factor, so a corporation’s apportionment percentage is the average of:
    - VT property/total property
    - VT wages/total wages
    - VT sales/total sales (x2)

STATE APPORTIONMENT OF CORPORATE INCOME

(Formulas for tax year 2019 -- as of January 1, 2019)

ALABAMA *	Double wtd Sales	MONTANA *	3 Factor
ALASKA*	3 Factor	NEBRASKA	Sales
ARIZONA *	Sales/Double wtd Sales	NEVADA	No State Income Tax
ARKANSAS *	Double wtd Sales	NEW HAMPSHIRE	Double wtd Sales
CALIFORNIA *	Sales	NEW JERSEY	Sales
COLORADO *	Sales	NEW MEXICO *	Sales
CONNECTICUT	Sales	NEW YORK	Sales
DELAWARE (3)	75% Sales, 12.5% Property & Payroll	NORTH CAROLINA *	Sales
		NORTH DAKOTA *	3 Factor/Sales
FLORIDA	Double wtd Sales	OHIO	N/A (2)
GEORGIA	Sales	OKLAHOMA	3 Factor
HAWAII *	3 Factor	OREGON	Sales
IDAHO *	Double wtd Sales	PENNSYLVANIA	Sales
ILLINOIS *	Sales	RHODE ISLAND	Sales
INDIANA	Sales	SOUTH CAROLINA	Sales
IOWA	Sales	SOUTH DAKOTA	No State Income Tax
KANSAS *	3 Factor	TENNESSEE	Triple wtd Sales
KENTUCKY *	Sales	TEXAS	Sales
LOUISIANA	Sales	UTAH	Sales
MAINE *	Sales	VERMONT	Double wtd Sales
MARYLAND (4)	66.6% Sales, 16.6% Property & Payroll	VIRGINIA	Double wtd Sales/Sales
		WASHINGTON	No State Income Tax
MASSACHUSETTS	Sales/Double wtd Sales	WEST VIRGINIA *	Double wtd Sales
MICHIGAN	Sales	WISCONSIN *	Sales
MINNESOTA	Sales	WYOMING	No State Income Tax
MISSISSIPPI	Sales/Other (1)	DIST. OF COLUMBIA	Sales
MISSOURI *	3 Factor/Sales		

Source: Compiled by FTA from state sources.

Notes:

The formulas listed are for general manufacturing businesses. Some industries have a special formula different from the one shown.

* State has adopted substantial portions of the UDITPA (Uniform Division of Income Tax Purposes Act).

Slash (/) separating two formulas indicates taxpayer option or specified by state rules.

3 Factor = sales, property, and payroll equally weighted.

Double wtd Sales = 3 factors with sales double-weighted

Sales = single sales factor

Apportionment Methodologies

- Apportionment formula: property, payroll, **sales**
  - How do we allocate the sales of intangible property (mostly services)? What is the origin?
  - Is the origin of the service where it was created?
    - Example: Expedia writes code for it's program at it's headquarters (Washington State)
  - Or is it where it was delivered?
    - Example: Vermont customer uses Expedia to book a trip. The service was delivered in Vermont but created in Washington.

Cost of Performance

- **Cost of Performance Sourcing:** service revenue is apportioned to where the income-producing revenue is completed
  - Location of the recipient of the services is not a factor
  - If the service produces revenue across multiple states, the revenue is apportioned entirely to the state where the greatest proportion of revenue is earned.
- Vermont is a Cost of Performance state

Cost of Performance

- Example:
  - Company A is based in Maryland and only sells services
  - Sells services nationwide, of which a small proportion is into Vermont
  - **What is this company's apportionment in Vermont?**
    - If they have no property or payroll in VT, it would be zero- the service was completed in Maryland, not Vermont.
      - Vermont customers were the recipient
    - They would owe no corporate income tax in Vermont

Market-Based Sourcing (MBS)

- Allocates service revenue *to the state which the benefit is received and will be used*
- Example (not necessarily based on Maryland's actual law)
  - Company A based in Maryland completes a service in Maryland and sells it to Vermont customers.
  - If VT had MBS, Company A would have income apportioned to Vermont because the service revenue was derived from the Vermont-based customer
  - Company A would have apportionable sales in VT and therefore, pay Corporate Income Tax.

What do other states do?

- 26 states, including VT use Cost of Performance Sourcing
- 19 states have market based sourcing
  - 15 have shifted in the past 6-8 years
- 6 have no corporate income tax

Source: https://www.ftb.ca.gov/law/regs/25136-2/05182018-Income-Producing-Activity-Cost-of-Performance.pdf

Why might a state use COP?

- Legacy method- the rules are clear(ish)
  - Multistate Tax Commission adopted rules for uniformity in the 1960s
- States with more domestic-based firms producing goods might be better suited for COP
- States with many domestic service based firms could choose COP to capture all sales, not just those delivered in their state

Why might a state use MBS?

- Economy is more and more service based
  - Corporate tax base could be a more accurate reflection of the firm's customer base
- States with less service-based companies may want to benefit from the economic activity from out-of-state firms.
  - Avoid the "all-or-nothing" tax situation
- States who are large net importers of services might benefit from MBS
- Cost of Performance may be a tax disadvantage to home state service firms with significant out of state sales
  - Almost all NE states are MBS

Would we generate new revenue by switching to MBS?

- \$140,000 in FY20, growing to \$850,000 in FY21
- Other state's experience saw a 0.5% to 1% increase in their corporate tax revenues upon switching from COP to MBS