Corporate Income Taxes

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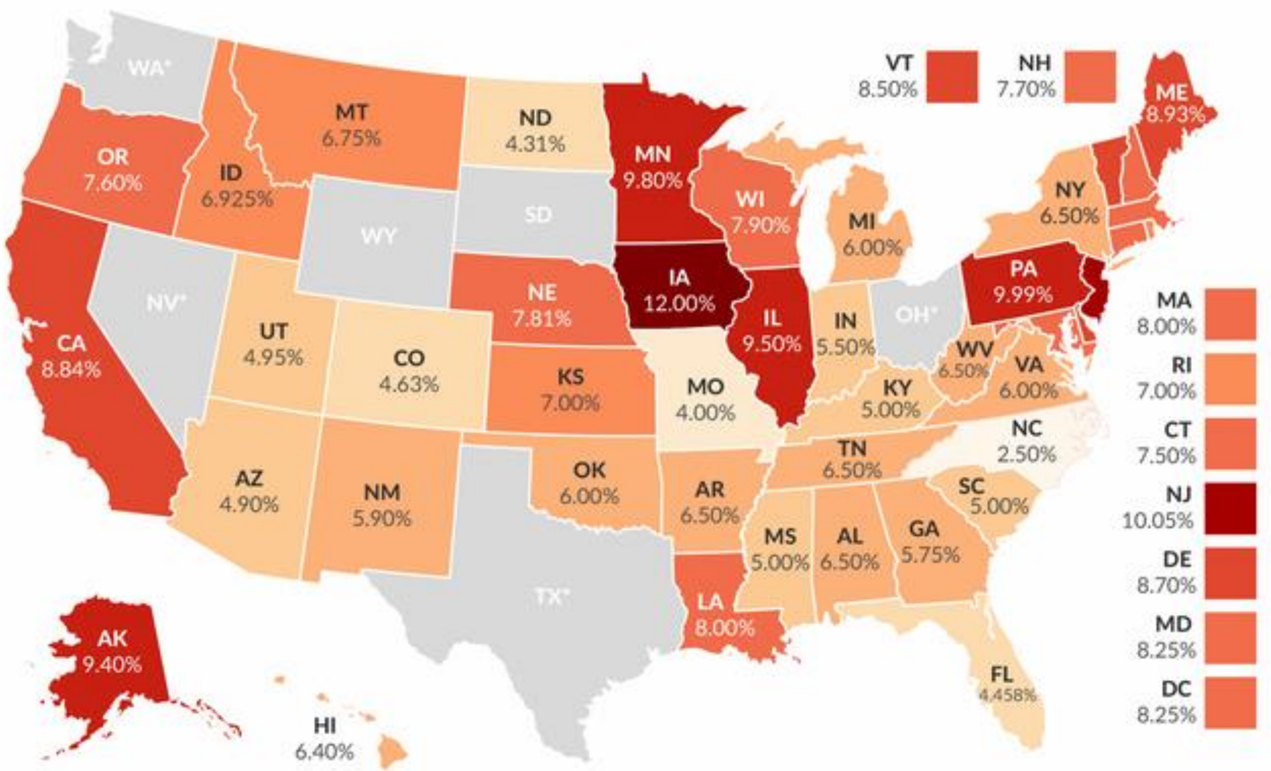
Who pays?
Legal entities

- US Resident C-Corporations:
  - Protection from personal liability.
  - Taxed at entity level by 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 passthrough entities:
  - Partnerships, LLCs, S-Corps, sole proprietors.
  - While these entities shield owners from personal liability, they typically do not pay entity-level tax. Instead, income passes through directly to owners, who are taxed by the personal income tax.
  - 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%, lowered in 2018 by the TCJA from the top rate of 35%.
- Vermont uses federal taxable income with certain adjustments
  - No deductions allowed for bonus depreciation, non-VT bond interest, or federal operating losses.
  - Allows deductions for certain income added at the federal level, related to foreign credits and certain job creating credits. Starting in tax year 2022, a business expenses deduction for cannabis establishments.
  - Vermont's corporate tax rate is tiered. The top marginal rate is 8.5%, and there are minimum taxes based on gross receipts.

Top Marginal Corporate Income Tax Rates as of January 1, 2020



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 and Oregon have 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. Florida's corporate income tax rate willl return to 5.5% for tax years beginning on or after Jan. 1, 2022. Georgia's corporate income tax rate will revert to 6% on January 1, 2026. The state could see a drop to 5.5% in 2020, 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 5.25% on July 1, 2020. The rate is scheduled to decrease to 4.9% by 2022. Mississippi continues to phase out the 3 percent bracket by increasing the exemption by $1,000 a year. This year, the exemption is $3,000. By the start of 2022, the 3 percent bracket will be fully eliminated. New Hampshire's rate is 7.9% for tax periods ending before Dec. 31, 2019. 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 10.5 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 the income of a corporation to tax it?

- What is the income of the taxpayer?

  Unitary combined reporting v. separate reporting

- How is income is apportioned to state?

  Apportionment Factors

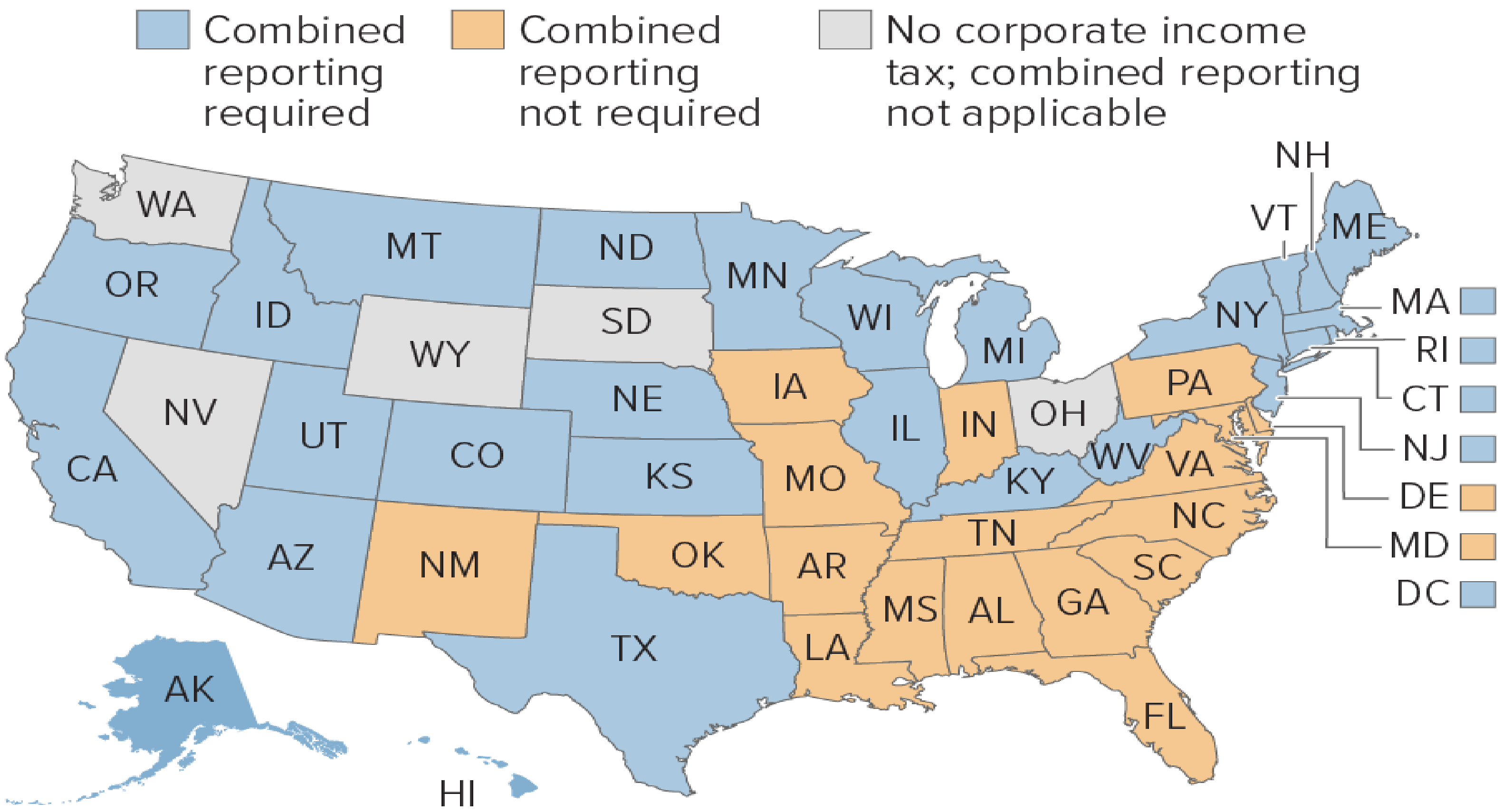
What is the income?

- 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 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, 2020, 28 states and the District of Columbia, including Vermont, have adopted some form of unitary combined reporting.

28 states require combined reporting



+NM as of Jan. 1, 2020

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.

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Apportionment

- Historically, almost all states used an equally weighted, three-factor formula based on property, payroll, and sales. In the last two decades, most states have moved towards a double-weighted sales or single sales factor.
- Vermont uses a 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 2021 -- as of January 1, 2021)

ALABAMA *	Double wtd Sales	MONTANA *	3 Factor
ALASKA*	3 Factor	NEBRASKA	Sales
ARIZONA *	Sales/Double wtd Sales	NEVADA	No State Income Tax
ARKANSAS *	Sales	NEW HAMPSHIRE	Double wtd Sales
CALIFORNIA *	Sales	NEW JERSEY	Sales
COLORADO *	Sales	NEW MEXICO *	3 Factor/Sales
CONNECTICUT	Sales	NEW YORK	Sales
DELAWARE	Sales	NORTH CAROLINA *	Sales
FLORIDA	Double wtd Sales	NORTH DAKOTA *	3 Factor/Sales
GEORGIA	Sales	OHIO	N/A (2)
HAWAII *	3 Factor	OKLAHOMA	3 Factor
IDAHO *	Double wtd Sales	OREGON	Sales
ILLINOIS *	Sales	PENNSYLVANIA	Sales
INDIANA	Sales	RHODE ISLAND	Sales
IOWA	Sales	SOUTH CAROLINA	Sales
KANSAS *	3 Factor	SOUTH DAKOTA	No State Income Tax
KENTUCKY *	Sales	TENNESSEE	Triple wtd Sales
LOUISIANA	Sales	TEXAS	Sales
MAINE *	Sales	UTAH	Sales
MARYLAND (3)	75.0% Sales, 12.5% Property & Payroll	VERMONT	Double wtd Sales
		VIRGINIA	Double wtd Sales/Sales
MASSACHUSETTS	Sales/Double wtd Sales	WASHINGTON	No State Income Tax
MICHIGAN	Sales	WEST VIRGINIA *	Double wtd Sales
MINNESOTA	Sales	WISCONSIN *	Sales
MISSISSIPPI	Sales/Other (1)	WYOMING	No State Income Tax
MISSOURI *	Sales	DIST. OF COLUMBIA	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

(1) Mississippi provides different apportionment formulas based on specific type of business. A single sales factor formula is required if no specific business formula is specified.

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(2) Ohio Tax Department publishes specific rules for situs of receipts under the CAT tax.

(3) Maryland is phasing in a single sales factor for tax years after 2022.

Legislative Action over the past few years

Sourcing of Intangibles

- 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.

Sourcing of Intangibles

- **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.
- **Market Based Sourcing:** Allocates service revenue to the state which the benefit is received and will be used
  - Location of where the service is used or delivered is the key parameter

- **Vermont adopted Market Based Sourcing in 2019**

Cost of Performance Example

- 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 Example

- 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.
  - 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.

Changes to Apportionment/Single Sales

- Vermont is currently a three factor apportionment state
  - Payroll, property, and double weighted sales
- Committee has discussed placing increased emphasis on the sales factor, and gradually phasing out the payroll and property factor.
  - Specifically, over three tax years, increasing the factor to triple-weighted then quadruple weighted sales, and then single sales factor.
- Bill has not passed committee
- Revenue estimate last year:
  - -$1.3 million in Year 1, -$3.3 million in Year 2, -$8.35 million in Year 3, -$11.1 million in Year 4

Joyce and Finnegan

- Vermont taxes corporations based upon the profits of the unitary group
- When a state has unitary reporting, it has to decide whether a member of a unitary group triggers nexus in the state
- **Joyce method:** a corporation is considered to be taxable if only the corporation itself has taxable nexus in the state.
  - Vermont is currently a Joyce state
- **Finnegan method:** a corporation is taxable if any member of the unitary group is taxable.
- **Example:** three companies, all part of a unitary group, each with a $1 million in sales.
  - Company A has nexus in Vermont whereas Companies B and C do not and have operations elsewhere.
  - Under Joyce: only $1 million from Company A are apportioned in the sales factor to Vermont.
  - Under Finnegan: all $3 million of the group’s sales are apportioned in the sales factor to Vermont
- About half of states with unitary combined reporting are Joyce and half are Finnegan.

Throwback and Throwout

- Public Law 86-272 says that a state cannot subject a corporation to its income tax if the corporation is only soliciting sales in the state but otherwise does not have “nexus.”
  - If a company owns a kiosk, warehouse, employee in a state, it has nexus.
  - However, if a company solicits an order from a Vermonter, the order is fulfilled in another state, and delivered to the Vermonter using a common carrier, the company does not have nexus and has 86-272 protection.
- This creates “nowhere” income for corporations that operate across many states
  - Example: A company with $10 million in net income in 10 states, split $1 million per state, of which Maine and Vermont are included.
  - In Maine, where it solicits orders, it does not have sufficient nexus and has 86-727 protection so Maine cannot apply its CIT to the $1 million sold in Maine.
  - Assuming the company has nexus in the other 9 states, then in effect, only $9 million net income is subject to state corporate income taxes. $1 million becomes nowhere income.

Throwback and Throwout

- **Throwback Rule: Requires the company to "throwback" nowhere income into its numerator for sales apportionment purposes.**
  - In the example, Vermont would "throwback" the $1 million in Maine nowhere income into the apportionment so Vermont's sales factor would be: $1 million (VT) + $1 million (nowhere income) divided by $10 million, so 20%.

$$\frac{\$1\ million\ in\ Vermont\ income + \$1\ million\ in\ Maine\ \text{"}nowhere\ income\text{"}}{\$10\ million\ in\ nationwide\ income} = 20\%$$

- **Throwout Rule: Requires the company to "throwout" nowhere income from its numerator for sales apportionment purposes.**
  - In the example, Vermont would "throwout" the $1 million in Maine nowhere from the numerator so Vermont's sales factor would be $1 million (VT) divided by $9 million

$$\frac{\$1\ million\ in\ Vermont\ income}{\$10\ million\ in\ nationwide\ income\ - \$1\ million\ in\ Maine\ \text{"}nowhere\ income\text{"}} = 11.1\%$$

- Vermont has a throwback rule for most income, but a throwout for intangibles
- Repeal of the throwback rule was part of the corporate tax bill last year which did not move out of committee

80/20 Rules

- Vermont taxes the income of a unitary group, rather than individual separate entities.
- What about members of the group that operate primarily outside the US?
- **80/20 rule:** excludes from the apportionment calculation the member of the group if more than 80% of the business comes from sales outside the US.
  - Vermont says that an 80/20 company (overseas business operation) does not need to be counted for apportionment.
- Committee considered repealing Vermont's 80/20 rule, which would mean any overseas business operations would need to be added to the apportionment factors for the unitary group.