
Corporate Income Tax: *Computing Taxable Income*

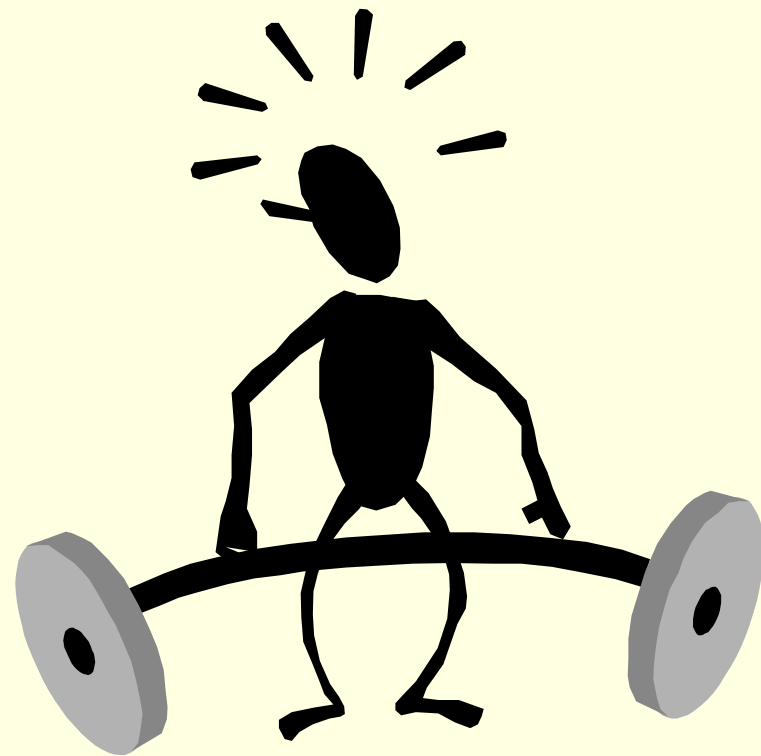
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September 5, 2006

How Should State Compute Corporate Taxable Income?

- “The authority of the Secretary of Revenue to require taxpayers to file consolidated returns. The study of this issue may include consideration of whether the State should require some corporations or all corporations to file a consolidated return.”
- Review of Recent Corporate Income Tax Policy Decisions
- Overview of State Filing Options
- Look at Filing Requirement in NC
- How Should NC Compute C Taxable Income?

What is Happening?

- Corporate Income Tax as Percentage of GF Revenues
- State Policy Decisions
 - Tax credits
 - Adoption of federal taxable income
- Structural Weaknesses in State Corporate Tax Systems – State Filing Options



NC Policy Decisions

- Tax Incentives for New & Expanding Businesses
 - Set income, health insurance, and environmental standards
 - Cap credit
 - Forfeiture provisions
 - Credits sunset
 - Annual reports
- Federal Taxable Income
 - Annually review

Corporate Tax ‘Loopholes’



- Product of structural weaknesses in state corporate income tax statutes – Separate Entity Returns
- Corporations with subsidiaries in multiple states can devise ways to shift income from high effective tax rate state to a low effective tax rate state

NC and Corporate Tax “Loopholes”

- Definition of business income
 - 2002 enacted broad definition
 - ‘All income that is apportionable under the United States Constitution’
- ‘Nowhere income’
 - 2005 considered ‘throwout’ legislation
- Income shifting through Passive Investment Company (PIC)
 - 2001 enacted royalty income reporting option
 - ‘Tweaked’ legislation several times
 - 2006 expanded reporting option to include other intangible assets

Shortcomings of Anti-PIC Laws

- Anti-PIC legislation addresses only one mechanism by which a corporation may seek to minimize its tax liability through income shifting
- Corporations have legitimate reasons other than tax avoidance for creating PICs
- Difficult to draft legislation that distinguishes a legitimate from a tax-motivated payment

Corporate Tax ‘Loopholes’



- Multi-state corporations can devise ways to shift income
- Product of how state computes corporate taxable income – Based upon a state’s filing method
- **SEPARATE ENTITY RETURNS**

Calculation of Corporate Income Tax

- Determine amount of profits subject to apportionment
 - Federal taxable income + State modifications
 - State filing options
- Apply NC apportionment formula to determine NC taxable income
 - Three factors – Sales, Property, Payroll
 - Double-weighted sales
- Multiply NC taxable income by tax rate and subtract applicable tax credits

Calculation of Profits...

- **Determine amount of profits subject to apportionment**
 - Federal taxable income + State modifications
 - **State filing options**
- Apply NC apportionment formula to determine NC taxable income
 - Three factors
 - Double weighted sales
- Multiply NC taxable income by tax rate and subtract applicable tax credits

State Filing Options

- Five Broad Categories
 - Mandatory separate entity returns
 - Elective consolidated returns
 - Mandatory combined unitary reporting
 - Discretionary combined unitary reporting
 - A hybrid system
- Lack of Uniformity among States
- *MTC: Model Statute approved that would require combined reporting for corporations engaged in a unitary business (June 21, 2005)*

State Filing Options – Separate Entity Returns

- Corporation with nexus determines its income based on stand-alone operations of its business
- Multi-state corporations – Apply apportionment formula
- Creates an opportunity to create legal structures and intercompany transactions that shift income
- 5 states require separate entity returns with no exceptions

State Filing Options – Consolidated Returns

- Affiliated corporations must file consolidated financial statements under GAAP
- Affiliated corporations may file consolidated federal return
- Parent and subsidiary structure in which all affiliates are at least 80% owned by another group member
- About 30 states permit consolidated returns

State Filing Options – Combined Reporting

- Based on unitary group
- A unitary group is two or more commonly controlled corporations that are engaged in the same trade or business
- Members of a unitary group determine their state taxable income by apportioning the group's combined business income to the taxing state on the basis of combined apportionment factors
- About 17 states require combined reporting

North Carolina – Hybrid Filing

- Separate Return
 - G.S. 105-130.14
 - Cannot file a consolidated return unless specifically directed to do so by Secretary
 - Must determine State net income as if a separate return had been filed for federal purposes

North Carolina – Hybrid Filing

- Secretary may require ‘consolidated return’
 - G.S. 105-130.6
 - Net income of a corporation that is a parent, subsidiary, or affiliate of another is to be determined by eliminating all payments and charges in excess of fair compensation
G.S. 105-130.5(a)(9) and G.S. 105-130.5(b)(2)
 - If separate company returns do not ‘disclose the true earnings’ of the corporation as a result of the use of intercompany transfer prices ‘in excess of fair compensation’

North Carolina: Hybrid Filing

- Secretary may require different method of calculating income to more clearly reflect true income
 - G.S. 105-130.15
 - G.S. 105-130.16
 - Neither statute mentions 'consolidated return'
- Debate over Secretary's authority to require consolidated return
 - Scope of authority, procedure, and penalties
 - Issue currently under litigation in Wal-Mart case

Is there a Comprehensive Solution?

■ **Combined Reporting**

- Comprehensive way to nullify income shifting strategies
- Single most important state corporate tax reform measure
- Means to modernize state tax codes to adapt to the growth in multi-state corporations
- *State Corporate Income Taxes 2001-2003, February 2005*
 - *Joint Project of Citizens for Tax Justice & the Institute on Taxation and Economic Policy*

Combined Reporting

■ WHAT IS IT?

It is a method of calculating the income of a group of related corporations for tax purposes

■ HOW?

It looks beyond the legal structure of separate incorporations to determine whether two or more related corporations are engaged in a **single unitary business**

■ WHY?

To ensure the income of a multi-state corporation is computed and apportioned in the same manner as a single corporate business

Issues re: Combined Reporting

- Optional or mandatory
- Definition of 'unitary business'
- Type of combined reporting
 - Worldwide
 - Water's edge
 - Domestic
- Which affiliates to include
- Administrative and compliance costs
- Transitional issues
- Fiscal impact

How Should NC Compute Corporate Taxable Income?

- Make current statutes clearer
- Require consolidated return if corporations file federal consolidated return
- Require combined reporting

