



MULTISTATE TAX COMMISSION

# **Income & Franchise Tax Audit Manual**

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Multistate Tax Commission  
Income & Franchise Tax Audit Manual

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## **1. Introduction**

1.01 The Joint Audit Program of the Multistate Tax Commission (“MTC” or “Commission”) was initiated in the early 1970s under the auspices of Article VIII of the Multistate Tax Compact.

1.02 This Income & Franchise Tax Audit Manual (“IFTAM” or “manual”) sets forth the procedures that Commission auditors follow in performing a joint audit on behalf of the Joint Audit Program member states who have elected to participate in a specific audit.

1.03 The information provided in the MTC IFTAM does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted by Joint Audit Program member states since the manual was last updated.

1.04 The IFTAM is provided for the guidance of the Commission’s joint audit staff and is not authoritative, and may neither be cited to support an audit position nor relied upon by a taxpayer. The laws of the states for which a joint audit is being conducted govern audit positions with respect each state. The manual merely reflects the Commission’s internal joint audit procedures and guidelines.

1.05 Any suggestions or corrections are welcomed and should be communicated to Commission’s Joint Audit Program director.

## 2. Definitions

2.01 This section lists terms and definitions use extensively in multistate audits; in many cases, the terms are statutorily defined by the states, and there may be differences among the states in how a particular term is defined. Auditors will need to develop a general, working knowledge of these terms and definitions.

2.02 *Allocation.* A method of sourcing taxable income to a state or other political subdivision. Nonbusiness income is allocated to a state if it can be specifically sourced to that state. For state tax purposes, nonbusiness income is usually allocated to the state of the corporation's commercial domicile, or to where the property giving rise to the income is located.

2.03 *Apportionment.* A method of attributing income to the states in which a multistate or multinational corporation is doing business. A portion of the corporation's income is divided (based on an apportionment formula) among the taxing states.

2.04 *Apportionment Formula.* The manner of computing the portion of a taxpayer's income subject to tax in a particular state. The standard Uniform Distribution of Income for Tax Purposes Act (UDITPA) formula is the average of three factors multiplied by the taxpayer's business income. The three factors are: property, payroll and sales. Variations of this formula are also used in various states.

2.05 *Business Activity.* Business activity refers to transactions and activity occurring in the regular course of a particular trade or business of a taxpayer.

2.06 *Business Income.* Generally, this is income which arises from the regular course of a taxpayer's trade or business. It includes income from tangible and intangible property, if such property constitutes an integral part of the taxpayer's regular trade or business.

2.07 *Combined Reporting.* A method of measuring the tax liability of a corporation. An apportionment formula is applied to the combined unitary income of the corporation and its affiliates.

2.08 *Combined Report.* A combined report is a report in which the business income and apportionment factors of a unitary group of corporations are combined for purposes of determining each taxpayer's share of the unitary business income.

2.09 *Commercial Domicile.* The principal place from which the trade or business of the taxpayer is directed or managed.

2.10 *Compensation.* Wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

2.11 *Consolidated Returns.* Under federal law, a filing method which allows certain related corporations (over 80 percent ownership) the convenience of filing a single tax return and paying one tax amount

2.12 *Fiscalization.* The process of placing the income and formula factors of unitary corporations with differing accounting periods onto a common taxable year-end in order to compute a combined report.

2.13 *Foreign Corporation.* For state purposes, a corporation which is organized under the laws of another state. For federal purposes, a corporation organized in a foreign country.

2.14 *Intrastate Apportionment.* The process of determining the unitary income apportioned and allocated to each taxpayer in a combined group. This process is necessary in order to determine the individual tax liability for each taxpayer, as well as to properly compute items such as NOLs, AMT, and tax credits.

2.15 *Nexus.* A connection or link between a corporation and a state, which is sufficient to empower the state to tax the corporation's income.

2.16 *Non-business income.* Generally, nonbusiness income is all income which is not business income (i.e., the income doesn't arise from the taxpayer's normal business activities).

2.17 *PL 86-272.* Public Law 86-272 (15 USCA 381) was enacted in 1959 to limit the states' ability to tax interstate commerce. It provides that a state cannot impose a net income tax on a business if the business activities within the state are limited to the solicitation of sales of tangible personal property.

2.18 *Sales.* All gross receipts of the taxpayer not allocated as nonbusiness income.

2.19 *State.* Any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any Territory or Possession of the United States, and any foreign country or political subdivision thereof.

2.20 *Taxable in another state.* For purposes of apportionment and allocation of income, the taxpayer is taxable in another state if either of two conditions exist: (1) a taxpayer is taxable in another state if within that state it is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; (2) a taxpayer is also taxable in another state if that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether the state actually imposes such a tax upon the taxpayer.

2.21 *Taxpayer.* A taxpayer is any person or bank subject to the tax imposed under each state's tax laws.

2.22 *Throwback sales.* When sales of tangible personal property are shipped from an office, store, warehouse, factory, or other place of storage in a state where a corporation is taxable to a state where the corporation is not taxable, those sales are assigned to the state from which the goods were shipped (the state of origin). Sales subject to this exception to the general rule of assigning sales to the destination state are referred to as throwback sales. If the taxpayer is not taxable in the state from which the property was shipped, the double throwback rule is applicable.

2.23 *UDITPA.* The Uniform Distribution of Income for Tax Purposes Act, also Article IV of the Multistate Tax Compact. UDITPA was drafted by the National Conference of Commissioners on Uniform State Laws to provide rules for the allocation and apportionment of income of multistate businesses. Once the tax base (e.g., net income) has been defined by a state, UDITPA operates to define business and nonbusiness income, to define the apportionment formula which is used to apportion business income, and provides specific rules for the allocation of nonbusiness income.

2.24 *Unitary Business.* Generally, a corporation or group of business entities engaged in business activities which constitute a single trade or business.

### 3. Pre-Audit Procedures

3.01 This section will explain how a Commission joint auditor should prepare to conduct an audit. It will explain how an audit is assigned and time frames for responses from the states in the audit program. It will also detail what sources auditors should use to investigate the taxpayers' activities. This section will also explain how an auditor determines the audit period, develops an audit plan and file organization.

3.02 *Audit assignments.* The income tax supervisor will assign audits from the Commission's inventory to individual auditors within six months from the time the audit was selected by the audit committee. The individual auditor becomes the lead auditor.

3.03 *Request for audit authorizations from the states.* The income tax supervisor will instruct the MTC audit program administrative assistant to send audit authorizations to the states in the income tax audit program. The administrative assistant will also send the income tax checklist with the authorization request. The administrative assistant will maintain a list of the appropriate state contacts for signing audit authorizations.

3.04 *Authorization deadline for the states.* The States should return the signed authorizations within 30 days. The lead audit will verify that that the states correctly completed the authorization request. At the expiration of the authorization deadline, the lead auditor will inform the income tax supervisor of the names of the States which have indicated their intention to participate. The income tax supervisor will follow up with the states who have not responded. States may not participate in an audit if no authorization has been signed and the field audit work has begun unless specific approval has been given by the MTC audit director.

3.05 *Gathering information before starting the audit.* The auditor will use various resources to gather taxpayer information prior to starting the audit. The auditor will use information submitted with the income tax nomination forms and the income tax checklist. The auditor should also obtain copies of annual report and 10 K. The auditor should make use of the internet to explore the taxpayer's web page and other information regarding the company, with the understanding that the current web page may not reflect facts applicable to the time period under audit.

3.06 *Individual state transcripts and tax returns.* The auditor will review the tax returns or transcripts submitted by the states. The auditor will also input pertinent data to appropriate schedules for each state. The auditor will review the returns and prior audit reports to determine any material audit issues.

3.07 *Work load review form and daily log.* The auditor will set up the work load review form which will be used throughout the audit. This form will be updated monthly and given to the income tax supervisor at the end of each month. This will

enable the supervisor to keep abreast of any activity on the audit. In addition the auditor will also open an electronic daily log file for each audit. The auditor will record any daily activity on the particular audit.

3.08 *Audit file organization.* The auditor will set up an audit organization file for each audit. This file will include all hard copies of tax returns and transcripts, audit authorizations, correspondence with the taxpayer and states, waivers, and schedules by state. The auditor should also review the Commission's file back-up guidelines and follow them.

3.09 *Determination of audit period.* Prior to calling the taxpayer, the auditor will review the audit authorizations to determine which years the States want audited. Most states have a 3 year statute of limitations from the date the returns were filed. The auditor should determine if there is sufficient time to begin the audit before the first year's statute of limitation expires. The auditor should endeavor to begin the audit field work one year before the earliest statute of limitations expires. The auditor will get approval from the audit supervisor if there is a need for an adjustment to starting date of audit period.

3.10 *Scope of the audit.* The auditor will review all information thus far received. The auditor will look for any material issues that may be present. The issues may include but not limited to such items as unitary filing, nexus issues, apportionment problems, business/non-business items, intangible holding companies and any abusive tax avoidance transactions.

3.11 *Initial audit plan.* The auditor will establish an initial audit plan. The auditor has the flexibility to determine how to proceed on the audit. The auditor may want to start with single entity states or combination states. The auditor may also decide to start with specific audit issues. The auditor should be aware that the initial audit plan may be adjusted during the audit if so desired. The auditor must be flexible in working with the taxpayer to adjust the audit plan if needed.

## 4. Statutes of Limitation & Waivers

4.01 Statutes of limitation set time limits within which an action must be started. They typically set a deadline for the valid assessment of taxes by the tax authority and the time in which a refund may be claimed. A waiver is an agreement between the taxpayer and the state to extend the statute of limitations (“SOL”).

4.02 *Timely Completion of Audit; Extension of SOL.* An audit should not be started by an auditor if the SOL on the first year of the audit period is less than a year.

The auditor will make every effort to complete the audit before the expiration of the current state SOL time period. When waivers are required to extend the time period, the auditor will make every effort to estimate accurately the completion date of the audit and will request that the taxpayer extend the time period to a date at least six months beyond the estimated completion date for all participating states. This additional time is needed for the state’s own review and assessment purposes.

The auditor will attempt to minimize the number of times a waiver has to be requested.

4.03 *SOL Control Procedure.* The following control procedure will apply:

4.03(a) *Discuss Waiver Policy with Taxpayer.* At the initial audit appointment the auditor must discuss with the taxpayer both the Commission’s waiver policy and the taxpayer’s waiver policy.

4.03(b) *Responsibility of Auditor in Charge.* Each auditor is responsible for making sure that no statute of limitation expires without the auditor having seen to it that the affected states are forewarned sufficiently early to enable them to issue assessments.

4.03(c) *Obtaining a Waiver.* At least three months prior to the expiration of any statute of limitations, the auditor will obtain from the taxpayer a waiver of the statute of limitations which has been properly executed by an officer of the corporation who is authorized to sign it. Exhibit \_\_\_\_\_, MTC Form 0400-A and the attachment MTC Form 0400-B should be used for this purpose.

4.03(d) *Preparation of Waiver.* One MTC Waiver Form 0400-A with an attached MTC Form 0400-B (list of all filers by state) can be used for all states in the audit with the exception of Missouri and New Jersey. For Missouri and New Jersey a separate waiver form is required for each taxpayer that filed returns in the state.

4.03(e) *Sufficiency of Extension.* In obtaining waivers, the auditor should seek to establish an expiration date sufficiently in advance to permit the completion of the audit without requiring further waivers. The suggested period of extension is one year from the expiration of the earliest statute.

4.03(f) *Completeness of Waivers.* The auditor will make sure that the waiver(s) are complete for all participating states with respect to the taxpayer and to all of its affiliates which are involved in the audit.

4.03(g) *Preparation of Statute Control checklist.* The auditor will prepare the statute control checklist listing all of the returns that are being audited. When a waiver is signed the waiver expiration dates as per the waiver will be entered. This control list will be updated as new waivers are signed. See Exhibit 4B (MTC Form 0400-C).

4.03(h) *Supervisor Review of Waivers.* The supervisor will determine if review of waivers and the auditor's statute control list is required prior to mailing the waivers to the taxpayer for signature. Supervisor review of waivers and statute control checklists is required for all auditor trainees. All auditors are required to provide copies of all signed waivers to their supervisor. The audit supervisor must maintain copies of these waivers.

4.04 *Taxpayer Refusal to Sign Waivers.* If a taxpayer refuses to sign a waiver the auditor must immediately consult with the audit supervisor. The audit will then be completed to the best of the auditor's ability so the audit can be sent to the states to make assessments.

4.05 *Monthly Statute Control Report.* The audit supervisor will submit a monthly statute control report to the Joint Audit Program director. The director will distribute this report to the Audit Committee contacts.

4.06 *Waiver Policy.* See Exhibit \_\_\_\_\_ for a copy of the Commission's Waiver Policy.

## 5. Working with Taxpayers

5.01 The MTC serves as an operating arm of the member states through the joint Audit Program. The MTC Audit Program conducts its audits in a professional and timely manner. The MTC audit staff endeavors to adhere to the state's laws and regulations for both income and sales tax. As a representative of each state, the MTC staff is bound by the confidentiality laws of each state. The MTC audit staff will adhere to the following:

- Practicing professional courtesy during the audit.
- Requesting information that is pertinent to the audit based on each state's requirements.
- Conducting the audit as efficiently as possible.
- Discussing all audit findings with the taxpayer.
- Making every effort to accommodate the taxpayer's schedule.
- Requesting waivers when needed to allow sufficient time for the states and taxpayer to review the audit findings.

Consequently, The MTC expects that the taxpayers will:

- Respect the Commission's role as representative of the states to conduct the audit.
- Extend professional courtesy to the MTC audit staff.
- Respond to the information requests in a timely manner.
- Sign reasonable waiver requests unless prevented by a formal, written policy.

5.02 *Initial Contact with Taxpayer.* After finding the taxpayer's telephone number in the audit file or correspondence from the state (or by searching for the telephone number on the Internet), the auditor will contact the taxpayer by telephone. The initial conversation with the taxpayer will involve audit logistical questions at first and then more detailed questions. The following matters will be discussed:

5.02(a) The auditor will obtain the appropriate point of contact for the audit.

5.02(b) The auditor will inform the taxpayer contact that member states have authorized the MTC to conduct an audit.

5.02(c) The auditor will inform the taxpayer which states are participating and also the states that may potentially join.

5.02(d) The auditor will discuss audit appointment dates with the taxpayer. If the auditor can't secure a timely appointment, then waivers need to

be discussed. Once dates have been agreed upon, the assigned auditor records those dates in the workload review given to his or her supervisor each month (See Exhibit \_\_\_\_\_) and in their own personal calendar. These dates will be identified in the engagement letter written for the taxpayer (See Exhibit \_\_\_\_\_).

5.02(e) The assigned auditor can describe the basic operations of the MTC and guide the taxpayer to the MTC Website for more information.

5.02(f) The assigned auditor will inform the taxpayer that an audit plan will be discussed at the initial meeting.

5.03 *Procedures for a Non-Responsive taxpayer.* If a taxpayer does not respond to repeated attempts to make contact (either by letter, phone, or e-mail), the assigned auditor will send a certified letter to the taxpayer giving the taxpayer a seven day response window to make contact with the auditor. If there is no response to the certified letter, the auditor's supervisor will be made aware of the situation to determine the best way to proceed.

5.04 *Initial Written Correspondence with Taxpayer.* After the initial telephone conversation with the taxpayer, the auditor will send the taxpayer an engagement letter (See Exhibit \_\_\_\_\_). The engagement letter can be modified to fit the situation with the individual taxpayer.

5.05 *Initial Meeting.* The following should be discussed at the initial meeting with the taxpayer:

5.05(a) Waiver policies of both MTC and Taxpayer

5.05(b) Audit plan

5.05(c) IDR policy of 30 days

5.05(d) Steps of the audit process

5.05(e) MTC personnel that can be involved in the audit (e.g., auditor(s), audit supervisor, Joint Audit Program director, and legal division staff)

5.05(f) Taxpayer personnel including personnel outside of tax department (attorneys, accountants, or consultants) that may be involved in the audit

5.05(g) Taxpayer's policy relating to corresponding via e-mail and copies of documents.

5.05(h) Safeguarding taxpayer's documents at the taxpayer's location

5.06 Conducting the Audit.

5.06(a) The auditor should discuss major audit issues as they arise.

5.06(b) Handling Information & Document Requests (IDRs) —

(1) A response date (within 30 days) should be written on the IDR.

(2) The auditor needs to follow-up prior the 30 day response date to the status of the responses to the IDR.

(3) If the taxpayer does not respond to the IDR within 30 days, the auditor should obtain a written response/explanation for not responding. The auditor should also inform the MTC supervisor.

5.06(c) When a complex issue arises, the auditor should —

(1) Encourage the taxpayer to provide a statement that supports their position.

(2) Inform the MTC supervisor and the state liaison, if necessary.

5.06(d) Preliminary audit schedules will be issued.

5.06(e) Allow the taxpayer ample time to review and respond to the preliminary audit schedules unless the taxpayer refuses to extend a short statute date.

5.07 Concluding the Audit.

5.07(a) Any adjustments to the preliminary schedules will be made.

5.07(b) The auditor should offer the taxpayer a closing conference. If the taxpayer declines, the auditor should insure that all recommendations are conveyed and understood by the taxpayer. The auditor should know the taxpayer's position regarding the recommendations and should note it in the report.

5.07(c) The auditor is not permitted to release a copy of the narrative. The states in the Joint Audit Program have established that the taxpayer must obtain this directly from each participating state.

5.07(d) The auditor will inform the taxpayer that billings and protests will be handled directly by each individual state.

5.07(e) The auditor may assist the taxpayer and states during the protest process.

## 6. Nexus

6.01 Nexus is a measure of the connection that a taxpayer has with a particular state. Once a taxpayer has established sufficient nexus, it is subject to tax by that state.

Each new auditor will be expected to take the MTC Nexus School as soon as possible. The auditor will receive a nexus school book which contains a description of all US Supreme Court cases which deal with income tax nexus. Also included in the book will be numerous state court cases which deal with income tax nexus. The auditor will retain this book and refer to it when investigating nexus issues for income tax purposes.

6.02 *Audit Procedures for Nexus Investigations.* After analyzing all state income and franchise tax filings for states participating in the joint audit, the auditor should review the consolidated federal returns and financial statements to determine if there are any affiliates that have not filed in those states.

For any non-filing affiliates, the auditor should endeavor to understand the affiliate's business activities and how they conduct business, both as a whole and in a particular state. If needed, the auditor should obtain a state by state analysis of property, payroll, and sales to determine whether there are sufficient activities in a particular participating state to initiate a nexus investigation.

When considering the materiality of a nexus issue, the auditor must take into account the effects of P.L. 86-272 (discussed in paragraph 6.04 of this section) and other exemptions from tax in the particular states at issue (such as the exemptions for insurance companies). A business may be immune from tax in a particular state because of P.L. 86-272 protection or other exemptions, regardless of any nexus it may have.

Circumstances not involving sales of tangible personal property eliminate P.L. 86-272 considerations, but the sales factor rules will need to be carefully considered in order to determine whether nexus within a particular state will have a significant tax effect. For example, even if a corporation derives income from intangible property used within the state, that income may only be included in the sales factor if the greater proportion of the income producing activity occurs within the state. Without factor representation to assign income to a particular state, the establishment of nexus may not result in any more than the minimum tax.

6.03 *Use of MTC Nexus Questionnaire.* Initially, the auditor should obtain from the taxpayer a completed "Multistate Tax Commission Nexus Questionnaire" (or version adapted for the particular audit) for each state participating in the joint audit for the tax years during which any affiliate of the taxpayer did not file returns in any participating state (See Exhibit \_\_\_\_\_).

6.03(a) *Follow-up Investigation.* After receiving the completed MTC Nexus Questionnaire, the auditor should compare the responses to the questionnaire with previous information obtained regarding the conduct of the affiliate's business. To verify the accuracy of the responses, the auditor may, if necessary, coordinate the following with the taxpayer:

- Review of procedural manuals for sales representatives
- Review of instructional manuals for sales representatives
- Interview in-state employees or representatives
- Interview appropriate district, regional managers, or vice presidents familiar with the affiliate's sales operations
- Interview in-state customers of the affiliate

6.03(b) *Document Requests for Nexus Audits.* The following documents should be requested while conducting a nexus audit:

(1) Annual Report & 10K. This information will give significant information regarding the operations of the company and any affiliates.

(2) Federal Consolidated 1120 Return. The returns will give information concerning any company owned in the corporate group and the general business activity of each of the companies. The affiliates will be found on Schedule 851.

(3) State Apportionment Factors. This information will give the location of sales by destination, property by state and payroll by state. Property should include fixed assets, inventory, land, and rent expense.

(4) Job Descriptions for Salesmen. This information will describe the salesmen activities and territories. Close inspection should be made to see if duties of salesmen go beyond the protection of Public Law 86-272.

(5) Expense Reports for Salesmen. Expense reports are very important to discover what the salesmen are actually doing. It is important to get the description of the salesmen daily activities when obtaining the expense reports.

(6) Warranty Contracts. It is important to determine how warranty work is conducted. The auditor needs to determine if any warranty work is conducted in the state. The auditor needs to determine if warranty work is provided by third parties. The auditor must also determine if the cost for repairs is included in the price of the product being sold.

(7) Independent Contractor Agreements. The auditor should determine whether or not the company uses independent contractors for sales activity. The auditor should ask for any contracts with independent contractors. The auditor should determine if the independent contractor creates nexus for the company.

(8) Company Policy or Procedure Manuals. These are important documents to discover how the company operates.

(9) Delivery Records. These records will help determine if products are delivered by company owned vehicles, which may create nexus in a state.

(10) In House Publications or Newsletters. Often these documents may contain information that may be helpful in determining nexus.

(11) CPA Consolidating Workpapers. The company may be required to provide for potential state tax liabilities. These are often detailed in the Tax Provision Account (TPA). The companies are often reluctant to release this information, and because of their sensitivity, requests for the TPA should be used where taxpayers are not cooperating with routine information requests or there indications of suspicious tax avoidance.

6.03(c) Determination of Nexus. After completing the nexus investigation, the auditor should contact the Commission's legal staff to discuss the facts and circumstances and determine if any additional information should be sought. Upon completion of the fact gathering process, the decision as to whether nexus exists as to any participating state for any tax year should be arrived at jointly between the auditor and the legal staff.

If needed, the auditor or legal staff should discuss the findings with the applicable state(s) to obtain their feedback whether there is a strong basis for asserting nexus based on that state(s) laws, statutes, regulations, or policy.

6.03(d) *State Request for Nexus Audit*. When a state participates in an audit of a taxpayer which has not filed returns for any of the tax years under audit, the auditor will conduct a nexus audit. Prior to the initiating of the nexus audit, the state should agree to assist by gathering information located within its borders (See Exhibit \_\_\_\_).

#### 6.04 Public Law 86-272

Public Law 86-272 was enacted by Congress on September 14, 1959, to prohibit states from imposing an income tax upon a taxpayer whose only activity within a state is solicitation of orders for the sale of tangible personal property (15 USC §381). If the activity falls within the parameters of P.L. 86-272, the state has no right to impose a tax obligation on the taxpayers.

The immunity provided by Public Law 86-272 is expressly limited to interstate commerce. No such immunity applies with respect to foreign commerce.

For sellers who are not protected by P.L. 86-272 because their sales are not sales of tangible personal property, the due process clause of the federal constitution provides the standard for determining whether or not the seller is subject to the taxing jurisdiction of the state into which sales are being made.

6.04(a) *Narrow Interpretation Applies to P.L. 86-272.* It is the policy of each member state to impose its tax, subject to legislative limitations, to the fullest extent constitutionally permissible; and to construe the provisions of P.L. 86-272 narrowly so as to apply that law to only those limited circumstances to which Congress clearly and reasonably intended for it to apply.

6.04(c) *General Limitations on P.L. 86-272 Protection.* Thus, P.L. 86-272 affords no protection to a taxpayer which is incorporated in the state into which the sales are being made. Also, since P.L. 86-272 applies only to sales of tangible personal property, it does not pertain to the selling or providing of services; the leasing, renting, or licensing or other disposition of personal property; or the selling, leasing, renting, licensing, or other disposition of real estate, intangibles, or any other type of property. Nor does it apply to sales which consist of a mixture of tangible personal property and services, e.g. photographic development, fabrication of customer's materials, installation of equipment, and architectural and engineering services.

6.04(d) *Activities Unprotected by P.L. 86-272.* To be protected by P.L. 86-272, in-state activity (other than through an independent contractor, as set forth below) must be limited to solicitation of interstate sales which are approved out-of-state and for which deliveries are made from outside the state. Any other activity unrelated to solicitation is not protected. Unprotected unrelated activities, such as those which are not an integral part of the solicitation of orders, include:

- (1) Making repairs or providing maintenance;
- (2) Collecting delinquent accounts;
- (3) Investigating credit worthiness;

- (4) Installing or supervising installation;
- (5) Conducting training courses, seminars or lectures;
- (6) Providing engineering functions;
- (7) Handling customer complaints;
- (8) Approving or accepting orders;
- (9) Repossessing property;
- (10) Securing deposits on sales;
- (11) Picking up or replacing damaged or returned property;
- (12) Hiring, training, or supervising personnel;
- (13) Providing shipping information, and coordinating deliveries;
- (14) Maintaining a sample or display room for more than 14 days during the tax year;
- (15) Carrying samples for sale, exchange, or distribution in any manner for consideration or other value;
- (16) Owning, leasing, maintaining or otherwise using any of the following facilities or property —
  - Repair shop;
  - Parts department;
  - Purchasing office;
  - Employment office;
  - Warehouse;
  - Meeting place for directors, officers, or employees;
  - Stock of goods;
  - Telephone answering service;
  - Mobile stores, e.g. trucks with driver salesmen; or
  - Real property or fixtures of any kind;
- (17) Consigning tangible personal property to any person, including an independent contractor; and

(18) Maintaining, whether by an in-state or an out-of-state resident employee, an office or place of business, whether in-home or otherwise.

6.04(e) *Activities Protected by P.L. 86-272.* The following in-state activities are protected by P.L. 86-272, i.e., they will not result in the loss of protection for otherwise protected sales:

- (1) Advertising campaigns incidental to missionary activities;
- (2) Carrying of samples only for display or for distribution without charge or other consideration;
- (3) Owning or furnishing of autos to salesmen;
- (4) Forwarding of inquiries and complaints to the home office;
- (5) Incidental and minor advertising, e.g., notice in a newspaper that a salesman will be in town at a certain time;
- (6) Missionary sales activities;
- (7) Checking of customers' inventories for re-order, but not for other purposes;
- (8) Maintaining of sample or display room for 14 days or less during the tax year; and
- (9) Soliciting of sales by an in-state resident employee of the taxpayer, provided that the employee maintains no in-state sales office or place of business, whether in-home or otherwise.

6.04(f) *Independent Contractor Activities Protected by P.L. 86-272.* Independent contractors may engage in the following limited activities in the state without causing the out-of-state taxpayer to lose its protection under P.L. 86-272:

- (1) Soliciting sales;
- (2) Making sales; and
- (3) Maintaining a sales office.

Sales representatives who represent a single principal are not considered to be independent contractors and are subject to the same limitations as employees. The maintenance of a stock of goods in-state by the independent contractor under

consignment or any other type of arrangement with the principal eliminates the protection of P.L. 86-272 and the principal is subject to the taxing jurisdiction of the state.

6.04(g) *Meaning of Solicitation.* To qualify for the safe harbor provided by Public Law 86-272, a corporation must limit its employees' in-state activities to the solicitation of orders. Despite its importance as a qualification requirement, Public Law 86-272 does not define the phrase solicitation of orders; however, the proper interpretation of the phrase has been addressed by the U.S. Supreme Court.

In the Wrigley case, the Court defined solicitation of orders as encompassing "requests for purchases" and "those activities that are entirely ancillary to requests for purchases — those that serve no independent business function apart from their connection to the soliciting of orders." The Court also held that a de minimis level of non-solicitation activities does not cause a company to lose the protections afforded by Public Law 86-272, and that whether non-solicitation activities are sufficiently de minimis to avoid the loss of tax immunity depends on whether that activity establishes a "nontrivial additional connection with the taxing state."

Although taxpayers and the states will differ in their interpretation of the phrases "entirely ancillary" and "nontrivial additional connection," the Court's ruling in Wrigley nevertheless provides a uniform standard applicable to all states, as well as establishing a de minimis exception to the activities that are not protected by Public Law 86-272.

6.04(h) *Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States under Public Law 86-272.* The Commission has adopted guidelines for applying P.L. 86-272 designed to reflect the standards established by the Wrigley decision (See Exhibit \_\_\_\_). Contained in those guidelines are examples of activities that are generally considered to exceed solicitation, as well as examples of protected activities.

Auditors should keep in mind that these rules are not intended to cover all possible situations. Each case will have to be judged on its own facts. More importantly, those facts must be considered in the context of the taxpayer's activities within the state as a whole, as well as the state's policy and practice.

#### 6.05 Economic Presence Nexus.

The U.S. Supreme Court has long held that a state may constitutionally tax an out-of-state company that derives benefit from the taxing state, even where it has no physical presence in the state. An up-to-date list of court cases regarding economic presence nexus is maintained as part of the Commission's Nexus School training materials; this list will be an invaluable reference for the auditor in dealing with this issue.

Some states apply thresholds of activity to determine whether nexus through economic presence exists with the state for income tax purposes. Other states assert economic presence nexus based on the existence of specific types of activity that occur within the state regardless of the amount.

Establishing nexus solely through economic activity is very fact intensive, so gathering as much information as possible is critical.

The assertion of economic presence nexus is a contentious issue that will likely be challenged by the taxpayer. The audit supervisor should be notified if this issue arises during the audit.

#### 6.06 Nexus through an Agency Relationship

Activities performed within a state may establish nexus even when the activities are performed by an agent of the taxpayer, rather than the taxpayer itself. That an agent performs the activities does not diminish the benefits the taxpayer is realizing from the state. Whether the agent also performs activities for other principals is unimportant (although only the activities performed on behalf of the taxpayer may be considered in determining whether the threshold for nexus has been met).

The relevant test for determining nexus thus focuses on the nature and extent of the activities within a state, regardless of whether those activities are performed directly by the taxpayer or by an agent on the taxpayer's behalf.

The U.S. Supreme Court has held that the in-state presence of a representative of an out-of-state seller who conducts regular and systematic activities in furtherance of the seller's business, creates nexus.

Note that corporations will often act as agents for unitary affiliates.

## 7. Unitary Investigation

### 7.01 Applying the Unitary Business Principle through Combination

7.01(a) *Preliminary Unitary Consideration.* There are three important aspects of the unitary business: (1) the unitary business principle is a judicially defined principle by the U.S. Supreme Court, the U.S. Courts of Appeal, and numerous state courts; (2) common ownership always involves the potential of a unitary business; and (3) a Supreme Court challenge to a state court determination of unity will be unsuccessful if the state court applied the proper constitutional standards and if its judgment “was within the realm of permissible judgment.” It is important to apply each state’s laws, regulations, and case law to each unitary determination; entities should not necessarily be considered unitary because the burden is on the taxpayer to demonstrate otherwise.

The constitutional test revolves solely around one issue: whether the entities involved share value to an extent not capable of precise identification or measurement — beyond the mere flow of funds arising out of a passive investment or a distinct business operation. The controlling question is whether value is added to the integrated operations through conduct that cannot reasonably be characterized as normal activity to oversee an investment. Resolution of this often complex and time consuming question involves investigations of documents and personnel in addition to accounting records.

7.01(b) *Application of Unitary Business Principle.* Application of the unitary business principle involves four separate but interdependent determinations.

(1) The Contours of the Unitary Business — before the net income of a trade or business, i.e., a unitary business, can be determined, one must determine what constitutes that trade or business. It may include only a portion of the taxpayer’s business activities and it may include the activities of commonly owned affiliated corporations or other legal entities. If the trade or business includes the activities of two or more commonly owned and controlled affiliates, a “combined report” is required. Be aware that an enterprise may consist of one or more unitary businesses that do not constitute one over-arching unitary business (e.g., a diversified conglomerate).

(2) The Net Income of the Unitary Business — after one has ascertained the contours of the unitary business, one must determine the net income of that business. The main problem here is to determine which income constitutes business income and which

constitutes nonbusiness income, i.e., which income is and which is not functionally related to the trade or business carried on in part in the taxing state. Under current due process constitutional standards, the issue of which income is functionally related to the unitary business is not clear. In the case of income from stock investments in subsidiaries, a functional relationship involves more than the general enrichment of the investor corporation from passive stock investments in discrete businesses which are totally unrelated to the business of the investor. See the Computation of Income manual section for further detail.

(3) The Expenses Related to the Net Income — unrelated expenses must not be deducted in determining the amount of net income. See the Computation of Income manual section for further detail.

(4) The Formulary Percentage of the Unitary Business — the property, payroll and sales associated with the production of the net income of the unitary business are included in the apportionment factors of the apportionment formula. This involves combining the factors of all the entities of the unitary business for both numerator and denominator purposes and then applying the resulting percentage to the apportionable net income. See Section 7, Apportionment, for further detail.

701(c) *The Nature and Purpose of a Combined Report.* A combined report is an accounting method used to determine what portion of the net income of a corporate member of a unitary group of corporations is reasonably related to the corporation's presence and activities in the taxing state. The purpose of the combined report is to treat a business conducted by a group of corporations in the same manner for state income tax purposes as it would be treated were it conducted by a single corporation operating through divisions. In both instances, the unitary business principle is used to determine what divisions or commonly owned and controlled corporations are engaged in a unitary business, what constitutes the net income of that business, and how that income is to be apportioned.

701(d) *Common Ownership and Control.* Common ownership does not exist unless the corporation is one which is a member of a group of two or more corporations more than 50 percent of the voting stock of each member of which is directly or indirectly owned by a common owner or by common owners, whether they be corporate or non-corporate entities, or by one or more of the member corporations of the group. Examples of common ownership are:

Corporation P owns 51% of the voting stock of corporation S1, corporation S1 owns 49% of the voting stock of corporation S2 and corporation S2 owns 51% of the voting stock of S3. Common ownership exists between P and S1 and between S2 and S3. No common ownership exists between P and S2 or S3 or between S1 and S2 or S3. If S1's ownership of stock in S2 were increased to 51%, then all four of the corporations would be commonly owned. The same would be true if P owned 2% of the stock of S2 in addition to S1's 49% of S2.

It must be noted that the ownership must be accompanied by actual control as a prerequisite to a unitary determination.

701(e) *Unitary Business Defined for Combined Reporting.* Business activities or operations carried on by two or more corporations are unitary in nature when the corporations are related through common ownership and control and when the trade or business activities of each of the corporations are of mutual benefit, dependent upon, or contributory to the activities of one or more of the corporations. This may be evidenced by facts which establish that the business of the commonly owned group of corporations is functionally integrated or is managed and controlled as a single business enterprise with resulting economies of scale rather than as separate discrete business enterprises carried on by each commonly owned corporation.

Examples of functional integration are: centralized manufacturing, warehousing, accounting, legal staff, personnel training, financing, purchasing, insurance, advertising, tax administration, and budgeting; coordinated expansion or contraction of business; integrated sales force, production activities, research and development activities, and physical facilities; and intercompany flows of goods and services.

Examples of centralized management are common officers or directors, exchanges of personnel, communication between management personnel, common planning, parental approval of major decisions of subsidiaries, common employment and personnel policies, common financial reports, common financial and production and pricing standards, common organizational and supervision of operational functions, common handling of public and governmental relations, common publications, common communications facilities, use of common physical facilities, common business organizational reports, use of common executive personnel, and common transportation facilities.

Economies of scale are closely associated with functional integration and centralized management as well as with the more elusive standard of the transfer of value. In fact, anything that is done in common by a parent and its subsidiaries strongly suggests the presence of economies of scale. For example, centralized

purchasing by a parent for its subsidiaries would indicate savings through more efficient and more economical purchasing.

The ultimate question is whether transfers of value take place between members of the affiliated group that would not be present between unrelated, independent, discrete business enterprises.

All of these aspects of unity tie in with the original Butler Bros. decision's three unities test of ownership, operation (staff functions) and use (line functions).

*701(f) Determining the Contours of a Unitary Business*

(1) Burden of Proof — the task of the auditor is to establish and relate all pertinent facts in such a way and with such documentation as to support any conclusion as to what the contours of the business are.

(2) Horizontal Relationships — business activities carried on by two or more commonly owned and controlled corporations are generally unitary when all activities of the corporations are in the same general line of business and exhibit sufficient functional integration and sufficient economies of scale. For example, commonly owned or separately incorporated grocery stores will usually be engaged in a unitary trade or business.

(3) Vertical Relationships — business activities carried on by two or more commonly owned and controlled corporations are generally unitary in nature when the various members are engaged in a vertically structured enterprise. An example of this type of integration and interdependency is to be found in the metals industry, in which the business consists of the exploration, production, manufacture, and distribution of products.

(4) Strong centralized management — the members of a group of commonly owned and controlled corporations which might otherwise be considered to be carrying on separate trades or businesses are considered to be engaged in a unitary trade or business when a strong centralized management determines significant policy for each corporation's primary business activities and when central offices are performing such functions as accounting, financing, advertising, researching, or purchasing. Truly independent corporations would perform such functions themselves.

## 7.02 Audit Procedures applicable to unitary investigations

Making a unitary determination is very fact specific, so it is important for the auditor to adequately develop the facts and document them in the unitary section of the audit narrative. Each audit is unique and the unitary factors that apply to each audit, and the importance of each, will vary. Following is a list of the general procedures that the auditor must follow in conducting a unitary investigation.

7.02(a) Review the returns that have been filed in all of the combined states participating in the audit. Compare these filings, documenting your findings as to whether these filings are consistent, etc. Remember that states may differ in determining whether entities constitute a unitary business.

7.02(b) Review prior audit reports, if any, for all participating states to find out what the conclusions of any unitary investigations were, and whether they are relevant to your audit.

7.02(c) It is very important for the auditor to have a good understanding of the taxpayer's business before focusing on the details of the unitary relationship. The information the auditor should use to learn about the taxpayers business is discussed in the Pre-Audit section of this manual. The information to be requested for the unitary investigation will then be tailored to the specific taxpayer.

7.02(d) Review the unitary and combination requirements for all participating states. The auditor must determine whether there is any state specific information that needs to be requested from the taxpayer with respect to this issue.

7.02(e) If the taxpayer has filed combined returns in all of the states that require it and, after analyzing the returns, it appears that there is no issue with unity, the auditor must discuss this with the taxpayer. If appropriate, the taxpayer should sign a unitary concession letter (Exhibit \_\_\_\_\_).

7.02(f) Prepare test checks for combination for each participating state in order to assess the significance of the unitary issue.

7.02(g) Discuss the unitary issue with the taxpayer and determine what their position is.

7.02(h) If the taxpayer did not file combined returns but agrees that it is unitary, and is in agreement that a unitary investigation will not be conducted, the taxpayer will be required to sign a unitary concession letter (Exhibit \_\_\_\_\_).

7.02(i) Issue a general Unitary Questionnaire (Exhibit \_\_\_\_\_) to the taxpayer. In states that have unique requirements a questionnaire specific to that state should be issued in addition to the general questionnaire.

7.02(j) As a follow up to the unitary questionnaire the auditor may have to develop further information requests. See paragraph 7.03 below for guidance in determining what information needs to be gathered.

7.02(k) The auditor may determine that it would be useful to request copies of combined returns or prior audit reports from non-participating states. These can be requested from the taxpayer or obtained through exchange of information agreements with states.

The auditor must document the facts developed and information received related to the relevant unitary factors thoroughly and objectively in the audit narrative.

### 7.03 Suggested Approach to Unitary Determination

The following list of suggestions may help the auditor to develop unitary and non-unitary facts. The suggestions apply for each audit year. The list should be used only for reference purposes as needed. As usual, common sense and de minimis concepts apply in determining the extent of utilization of any of these suggestions. The audit report should include pertinent information, whether it evidences unity or non-unity.

7.03(a) *Corporate Ownership Structure.* List each significant subsidiary, year incorporated, year acquired (if an already existing business), and percent of the subsidiary's stock that is owned. Indicate whether any other affiliate or parent owns any portion of the subsidiary's stock and, if so, the percentage owned. Provide a chart if a complex second and third tiered ownership situation is involved.

7.03(b) *Parent Operational Structure.* Briefly describe the functions of each of the parent's operating divisions. Indicate: the location of each manufacturing or other operations facility included in each division; the specific products produced or otherwise processed at each plant or facility and/or the regular services rendered by each division; the names and positions of the key officials of each division and the city in which each is headquartered.

Whenever possible, obtain charts showing these divisions and any sub-units as well as the reporting lines of authority.

7.03(c) *Subsidiaries Operational Structure.* For each subsidiary, indicate where it is headquartered, where each of its manufacturing or other operations facilities is located, the specific product it manufactures or processes or distributes at each facility or the regular services where it renders at each location.

Identify its principal operating officials and the location at which each performs his/her services. Describe the extent, if any, to which each subsidiary reports to and is under the operational control of a particular division of the parent or of another affiliate. Stating such information in chart form may be helpful.

7.03(d) *Common Officers and Directors*

(1) For the parent corporation, separately for each audit year, list the names and positions of all corporate officers through the assistant or vice levels (e.g., vice-presidents, assistant secretaries, and treasurers).

(2) For the parent corporation, separately for each audit year, list the name of each director, the chairman, and the vice-chairman. Determine which directors were officers of the parent during the audit year and which position each of them held. For those board members who were not officers of the parent, indicate which were officers of any affiliate, the affiliate name and the position held there.

(3) For each significant subsidiary, for the first audit year and separately for the last audit year, obtain the same information indicated in (1) above.

(4) For each subsidiary, obtain the same information requested in (2) above for the first audit year and separately for the last audit year.

7.03(e) *Parent Management Structure*

(1) Obtain a complete description of the parent's organizational structure showing the chain of command and reporting lines from the president or chief executive officer down through the organization, including its divisions. A chart or charts to illustrate this should be obtained, if at all possible. A major corporation will usually have such charts.

(2) Obtain a complete description, for all principle U.S. and foreign affiliates, of regular procedures and requirements for reports to the parent on such items as current sales, current profit or loss statements, annual budget, requests for new or expanded production and distribution facilities, and other periodic reports. Identify each category of required report and indicate whether it moves through a particular division of the parent or directly to the headquarters office

of the parent and, if so, to what official or unit at the parent's headquarters.

(3) Obtain a complete description of the functions and responsibilities of each of the officers at the parent's headquarters as to both the parent's operations and the operations of any subsidiaries.

(4) Obtain a complete description of the organization of the parent's Board of Directors and its committees, and the names of the members of each committee. A chart which shows this information may be available. Describe the duties and authority of each committee as to budgets, acquisitions, financing, new or expanded facilities, salaries of principal officers, etc., both for the parent itself and for its subsidiaries.

7.03(f) *Intercompany Sales.* Sales often move from parent to subsidiary, from subsidiary to parent, or from subsidiary to subsidiary. Summary schedules which lump subsidiaries as a group without further breakdown are not helpful in determining the extent of possible unity among the related corporations. The auditor should obtain the following data, for each audit year —

(1) For the parent, its total sales to all buyers, its total inter-affiliate sales, the name of each subsidiary to which it made sales, and the separate amount of sales to each subsidiary. Indicate also the general category or categories of products involved in these sales if the parent produces several different types of products.

(2) For the parent as to its purchases from subsidiaries, the name of each selling subsidiary, the separate amount and type of products purchased from it, and the amount of the parent's total purchases from all sources.

(3) For each subsidiary making inter-affiliate purchases from the parent or other subsidiaries, the separate amount and type of products purchased from each affiliate and the total amount of the purchasing corporation's purchases from all sources.

(4) For each subsidiary making inter-affiliate sales, the name of the affiliate, the separate amount and type of product sold to it, and the selling subsidiary's total sales to all buyers.

(5) Obtain copies of transfer pricing studies and other inter-company sales agreements.

7.03(g) *Intercompany Financing*

(1) Identify loans from parent to subsidiaries existing at the beginning of the audit period. Show separate amount for each borrowing subsidiary, and determine the specific purpose for each substantial loan and whether it bears interest.

(2) Determine the extent of any repayments made on each of such loans during each audit year.

(3) Identify all new loans made by the parent during each audit year separately in amount as to each borrowing subsidiary. Indicate the purpose of the loan and whether it bears interest.

(4) Identify new loans made during each audit year by a subsidiary to the parent or to another subsidiary as to year, amount, lending affiliate, borrowing affiliate, purpose, and whether it bears interest.

(5) Obtain data showing to what extent, if any, the parent corporation was a guarantor of any loan which was obtained by a subsidiary during the audit period or which was outstanding during that period. Identify the year in which each loan was made, its amount, the name of the borrowing subsidiary and the purpose of the loan.

(6) Identify for each subsidiary for each audit year the amount of loans which it obtained from outside sources independently and of which the parent was not a guarantor.

7.03(h) *Royalty Income*

(1) As to royalties received by the parent, for each audit year, specify the total amount received from all sources, the total amount received from all affiliates, and the amount received from each affiliate. Describe which particular type or types of rights controlled by the parent were exchanged for its right to receive these royalty payments from each affiliate.

(2) To the extent that any subsidiary received royalty payments either from the parent or from some other affiliate, provide the same detailed information as indicated in a) above.

(3) Identify all situations in which a manufacturing plant of the parent and a manufacturing plant of a subsidiary produce identical

products. Have the taxpayer explain to what extent, in such situations, the patents, processes, and trademarks furnished by the parent, or vice versa, do or do not involve royalty payments.

(4) Obtain copies of related party licensing agreements.

7.03(i) *Research*

(1) Identify the location of each research facility, the scope of its activities, the number of personnel, and the specific types of research conducted.

(2) Provide the same data as in a) above for each research facility conducted by any subsidiary.

(3) Explain in detail to what extent coordination, exchange of data, associated programs, and any other ties existed between a research facility of the parent and a research facility of a subsidiary or between facilities of two or more subsidiaries.

(4) Identify all principal brand-name products sold during the audit years by domestic and foreign subsidiaries which are directly traceable to and result from research projects at the parent in current or prior years. (This type of information about the results of research projects can often be found in annual reports for current and prior years and is usually available if the corporate group deals in such items as drugs, cosmetics, household appliances, toiletries, non-prescription medicines, or other types of mass production consumer products new versions of which are periodically introduced to the market.)

(5) Obtain copies of related party research agreements.

7.03(j) *Training Programs and Manuals*

(1) Obtain a detailed description of each of the major operational and administrative areas for which the parent has developed and used written manuals.

(2) Explain which of these, if any, were utilized by any principal subsidiary. Explain which principal subsidiaries used these manuals and which did not.

(3) Obtain a description of each type of major periodic training program or school conducted by the parent. Determine: how many

people at what position levels were trained annually under each program; and the scope of the program coverage.

(4) Determine the extent to which people from each principal subsidiary were or were not involved in each of the programs or schools identified in item (3) above.

7.03(k) *Computer Services.* Determine whether the parent supplies computer support for its subsidiaries or vice versa —

(1) Obtain a list of each location at which the parent corporation maintains computer facilities. Explain which general type of usage (such as production data, sales data, accounting data, etc.) is provided at each location and obtain a complete description of the scope covered by each.

(2) Obtain a list of locations at which each subsidiary maintains computer facilities. Provide the same information as in (1) above for each location. Explain the extent to which each of these locations is tied in with one or more computer facilities of the parent to receive or exchange data, and indicate which ones have no connection with the parent's facilities.

7.03(l) *Insurance.* Typical types of insurance carried by the parent and its subsidiaries will include fire, comprehensive casualty, theft, group health, and group life.

(1) Indicate the specific types of insurance carried by the parent corporation. In any instance in which more than one type is negotiated through a single agent, identify the agent and the particular types of insurance it handles. Indicate to what extent any type of insurance coverage is negotiated separately at the division or other unit level rather than as overall coverage for the entire parent corporation.

(2) Provide similar information concerning the principal subsidiaries, and indicate the extent, if any, of all premium restrictions which result from using the same agent(s).

(3) Identify each subsidiary which independently negotiates for its own various insurance coverage.

7.03(m) *Legal Services*

(1) Determine the regular services performed by the legal staff of the parent corporation; and report the number of attorneys on that staff.

(2) Indicate which subsidiaries received or provided legal services from or to the parent or affiliates. Obtain specifics, if possible.

(3) Report to what extent and for what specific services private law firms were retained by the parent, or by any subsidiary; indicate to what extent, if any, the same law firm regularly provided services to more than one affiliate.

7.03(n) *Centralized Accounting*

(1) Describe the major aspects of the parent's accounting system, which principal subsidiaries utilize it to what extent, and which principal subsidiaries did not use it.

(2) Report to what extent, if any, the subsidiaries were charged for central accounting services, the amounts charged to each, and the method or methods used to determine the amounts charged.

7.03(o) *Centralized Purchasing*

(1) Describe any central purchasing activities of the parent as to specific categories of purchases, which particular principal subsidiaries received the benefits of such activities, and which particular principal subsidiaries did not.

(2) Report the amounts of such purchases for each audit year to determine whether the activities were significant or relatively minor.

7.03(p) *Advertising*

(1) Describe the extent, if any, to which the parent operated an advertising division or department, indicating in detail what specific activities it conducted for each principal category of products and the number of people it regularly employed for these activities.

(2) Report which principal subsidiaries received the benefits of or utilized the advertising produced by the parent, the extent to which they were charged for this central advertising activity, how the

charges were determined, and which principal subsidiaries either independently produced their own advertising or did not use any of the centrally produced advertising materials. Determine the annual advertising costs of the parent and of each affiliate for each audit year.

(3) Determine whether the subsidiaries referred to their parent in their advertising, e.g., ABC Corporation, a subsidiary of XYZ Corporation.

7.03(q) *Pension Plans*

(1) Obtain detailed information concerning each pension plan of the parent corporation, indicating which categories of officers or employees were eligible for each plan, whether it was contributory or noncontributory, and its general provisions as to when benefits became payable; and specify to what extent it involved any stock option provisions. (If stock options were provided under a separate plan, treat that separately.) List detail about the personnel who administer each plan and list which company they are employed by.

(2) Describe to what extent, if any, officials and/or employees of subsidiaries were eligible for any of the parent's pension plans. If they were eligible, report which principal subsidiaries were included in each of the parent's plans and which were not.

(3) Obtain the same information for each pension plan at each principal subsidiary.

7.03(r) *General Administrative Services*

(1) Obtain similar information with respect to the providing of any other centralized services, e.g., public relations, affirmative action, and governmental relations.

(2) The costs of centralized services may or may not have been charged to subsidiaries for whose benefit they were performed. If the parent apportioned such costs, report the total costs for each audit year, the specific items of service or activity by the parent which these costs represented, the actual amount charged to each principal subsidiary, the method or methods used for apportioning the charges, and the name of each principal subsidiary which was not charged any portion of such costs.

7.03(s) *Newly Acquired Subsidiaries*

(1) Obtain a detailed history of the operations of the new affiliate up to the date of its acquisition. Determine when it was incorporated, where headquartered, the nature of its principal income-producing activities, the location of each manufacturing or other facility and the products manufactured or services provided at each facility. Determine the extent, if any, to which it had any regular business relationships, such as selling to or purchasing from either its new parent or any of the parent's subsidiaries in the years preceding the acquisition.

(2) Determine whether the new parent or any of its subsidiaries held any minority interest in the new corporation prior to the acquisition date. If so, explain the extent of such ownership and when acquired.

(3) Obtain a list of the names and positions of all of the officers of the newly acquired corporation as of the beginning of the year during which the acquisition occurred.

(4) Obtain a list of the names of all of the directors of the newly acquired corporation as of the beginning of the year during which the acquisition occurred. Cross-check with lists of the officers and directors of the parent and its subsidiaries at the start of that year and determine which, if any, of the directors were either officers or directors of the parent or of any of its subsidiaries.

(5) Obtain details concerning the acquisition. Determine the date when it occurred, the percentage of shares held after the acquisition, what the selling price was, and whether payment was in cash or shares of the parent's stock or a combination of both. Determine whether there was any agreement as a part of the sale that some or all principal officers were to be retained to continue to operate and manage the acquired corporation as before and, if so, what continuing employment commitment was made by the parent to each such officer.

(6) Obtain a list of the names and positions of all of the officers of the acquired corporation as of the end of the year during which the acquisition occurred. As to any new officers, determine which, if any, were also officers or directors of the new parent or of any other subsidiary and, for each of them, the time when they obtained the additional position.

(7) Obtain the same information with respect to the directors of the newly acquired corporation at the end of the acquisition year.

(8) Obtain the same information with respect to all of the officers of the newly acquired corporation.

(9) Obtain the same information with respect to the newly acquired corporation.

(10) For the acquisition year and each subsequent year, prepare a separate list of changes instituted by the parent at the newly acquired corporation during that year alone, and of the dates on which instituted.

(11) Determine the extent to which the new parent provided any centralized service to the acquired corporation, the nature of the service, and when it began to be provided to the acquired corporation.

#### 7.03(t) *Intercompany Personnel Transfers*

(1) Determine whether any person who became a new officer in the parent during the audit years had previously been an officer or key employee in a subsidiary of the parent. If so, determine his/her position formerly held, the year when he/she became an officer of the parent, and the number of prior years' service in the subsidiary and any other affiliates.

(2) Obtain a list of any non-officer key employee transfers between affiliates for each audit year. These would include persons at the supervisor level or above at production plants, at distribution centers, and on administrative staffs. For each such person, list the name, the year of transfer, the old position held in which affiliate, and the new position held in which affiliate. This list should include transfers between the parent and subsidiaries as well as transfers between subsidiaries.

#### 7.04 Lines of Business

The activities of many large corporate businesses are very complex. The organizational structures of many such businesses may constitute two or more unitary businesses; and one or more of those unitary businesses may consist of lines of business for which, even though they are unitary and technically combinable, the combining of their income and factors clearly will not produce a fair and reasonable result. Examples would be the combining of a retail line with a financial line, a manufacturing line with a

retail credit line, a railroad with an oil company, an airline with a hotel chain, and a tobacco distributorship with a restaurant chain.

The airline and railroad examples are rather obvious problems since several states will apply to them formulas that differ from the standard three-factor formula. Indeed, the MTC itself has adopted regulations which set forth such a special formula for each of those industries. In some instances, the answer may be not to combine such lines in one report even though the unities and flows of value exist.

In such instances, however, it may be necessary to review the attribution of income between the two lines to ensure that income has not been misallocated between them on the basis of separate accounting. Adjustments may be called for if such misallocation is perceived. Having determined the apportionable income of each line, it is then appropriate to apply the applicable formula to that income. The results of the two formulary calculations can then be combined to produce the recommended assessment against the appropriate member or members of the unitary business.

This does not disregard the unities. It simply complies with the overriding constitutional requirement that the result be fair and reasonable.

In many instances, the two lines will be owned and controlled by a holding company which will engage in various financial operations for the benefit of the entire unitary business. Thus, it may invest temporarily excess operating funds for the two lines on a short term basis pending an operating need for them. The return on such unitary business investments should be included in the apportionable income of the two lines on some reasonable basis, e.g., proportional to the split of all other apportionable income or proportional to the split of gross receipts.

The very nature of a holding company is that it owns, controls, and manages its subsidiaries and that it conducts no operating business. That is its reason for existing. Therefore, the unities required for combination will always exist in such cases; but the auditor must still pursue the collection of all pertinent information to support a unitary determination.

This can be a more complicated task in the case of a conglomerate. If the parent actually conducts an operating business which is separate and distinct from the unitary business of its subsidiaries, though, it may be that that operating business is only one of two unitary businesses in which the conglomerate engages, the second being that of managing and controlling its diversified subsidiaries. Such organizational challenges will try the mettle of any auditor.

#### 7.05 Other Documents to Examine and Other Unitary Information

The following is a list of other documents and information that can be useful in determining unity.

7.05(a) *Corporate Minutes (Including All Committees)*. The minutes may reveal why major corporate actions have been taken, and why the organization is structured the way that it is. Centralized functions may be commented upon. The discussions of major policy decisions and the reports of segment managers may be helpful in ascertaining whether centralized management exists. Statements contained in the minutes will become building blocks for follow-up questions used in interviews of officers.

In addition to board of directors minutes, the auditor should review minutes of Committee & Sub-committee meetings. If the minutes are not very detailed, the agendas that are sent to the directors may be helpful.

7.05(b) *Business Plans and Agendas*. Business plans and agendas provide insight into the degree of involvement of centralized management. Business plans may include strategic plans, budget plans, long-term plans, and mission & values statements.

7.05(c) *Employee Communications*. In addition to information about general business operations, employee communications might be helpful in ascertaining the existence of employee transfers and management involvement in the various operations. Items to review include: company bulletins and announcements, employee newsletters, company orientation materials and historical publications

7.05(d) *Manuals*. Manuals can provide information on the degree of centralized functions, common practices, and management involvement. A specific list of all manuals should be requested to insure that all manuals have been identified. When reviewing manuals, auditors should request the version that was in effect for the years under audit. If that version is not available, the auditor should ask the taxpayer to confirm or document whether the specific information relied upon from the manuals existed during the audit years. Some types of manuals which taxpayers may have would include: policy and procedure manuals, operating manuals such as advertising, accounting, and marketing manuals, forms manuals, and internal audit manual.

7.05(e) *Consolidated CPA Workpapers*. These files may contain the following useful information: intercompany account analyses and other consolidation workpapers, administrative files that may include an overview of how the corporation is structured, an analysis of corporate minutes and extracts of significant comments, management comment letters, financial statements by entity, SEC, Regulatory and Government filings, and tax return workpapers. Because of their sensitivity, requests for these workpapers should normally only be used where taxpayers are not cooperating with routine information requests or there indications of suspicious tax avoidance.

7.05(f) *Court Actions.* Various court actions involving the taxpayer could provide information regarding the operations or about the inner workings of the company. Some of this information may be found in a Lexis search but a separate inquiry may also be made in this area along with a review of the annual report and SEC 10-K. Key officers or managers may be asked whether they have been deposed as to facts about company operations. If the answer is yes, the following steps should be undertaken: transcripts of testimony should be reviewed, depositions should be reviewed, and the nature of actions taken should be determined. Deposition transcripts or exhibits are public in nature and not subject to the argument of attorney/client privilege.

7.05(g) *Speeches.* Speeches given by executives at conferences, stockholder meetings or other business gatherings provide valuable insight into company operations. Through the interviewing process, inquiries may be made to help determine what speeches were given. Some of the areas to explore include: transcripts of shareholder meetings, newspaper articles, employee newsletters, videotapes shown to employees, and conference agendas. Be careful not to over rely on what is said in speeches since they are often given for a specific purpose in a particular context and represent “puffery” or exaggeration.

7.05(h) *Conference Materials, Press Releases, Testimony before Congressional or Regulatory Agencies.* These sources might be helpful in understanding the interactions between companies and involvement of management. The existence of such information might be identified through a research service search.

7.05(i) *Internal Audit Reports.* Internal audit reports can be a very helpful source of information. Reports issued to management will set forth the level of compliance with established company policy and procedures. The following information may be obtained: internal audit reports along with the report to management, internal audit manuals and procedures, and reports other than internal audit reports, if any, generated by internal audit.

7.05(j) *Capital Expenditure Authorizations.* Capital expenditure authorizations help determine the degree of centralized management. The policy and procedures manual should be reviewed to determine the levels of authorization and the approval procedures for capital expenditures. The approval limits at the subsidiary or divisional levels should be documented.

7.05(k) *Management Fee Allocation Workpapers.* Management fee allocations can be used for determining centralized management involvement. The auditor should identify the amount of charges made to the specific subsidiary, analyze the charges to determine the components of the management fee, and

determine how the management fee is calculated. The auditor should obtain copies of all written management agreements or contracts, if any.

7.05(1) *Regulatory Reports.* Regulatory reports required to be filed with various federal and state agencies can provide extensive information as to the background and operations of the company as well as financial information that will be useful for examining income, apportionment factors, and other issues. Some types of regulatory reports are specific to an industry (i.e., banks are regulated by the FDIC and state banking agencies; electric companies are regulated by the Public Utilities Commission, airlines are regulated by the Federal Aviation Administration, etc.). Other reports are required when a corporation takes certain actions. (For example, when large corporations are involved in mergers or acquisitions, they may file extensive information with the Federal Trade Commission pursuant to the Hart-Scott-Rodino Antitrust Improvements Act of 1976. Information provided by such filing includes details of intercompany sales, product lines, locations of factories, a description of the acquisition, and studies, surveys, analysis, and reports prepared for the purpose of evaluating the acquisition.)

Once all of the documentation has been examined, interviews of key officers may be necessary to tie together the pieces and to expand upon the auditor's findings

## 8. Computation of Income

### 8.01 Starting Point Used for Computing State Taxable Income

8.01(a) Most states conform to the federal law with regard to definitions of gross income, etc.

8.02(b) Most states start with Federal Taxable Income from the federal Form 1120. This will be either F.T.I. Line 28 or Line 30. Line 28 of federal Form 1120 is federal taxable income before net operating losses and special deductions; line 30 of federal Form 1120 is federal taxable income after net operating losses and the federal special deduction for dividends.

8.01(c) Some state statutes do not require modifications to Federal Taxable Income line 28 or line 30 but rather make their own computation based on either line 28 or line 30 and provide for reconciliation to the income per the federal 1120.

### 8.02 Reporting Methods

8.02(a) *Separate Company (Single Entity) Returns.* Each company that has nexus in the state is required to file an income tax return.

8.02(b) *Combined Reporting.* The members of an entire group of corporations engaged in a unitary business may be required or allowed to file combined reports to compute the combined income of all members of the group. The reporting companies are the companies that have nexus in the state.

(1) The purpose of a combined report is to determine the state income of those members of the group doing business in-state, to adjust for intercompany transactions between members of the unitary group, and to prevent the avoidance of tax by shifting income and deductions between members.

(2) The ownership percentage for determining the unitary group members is normally 50% or greater as opposed to the 80% requirement to file a federal consolidated return.

(3) Types of Combination —

- **Worldwide Combination.** This type of combination requires that all corporations engaged in a unitary business be included in the combined report regardless of where

they are located, including those organized or operating in foreign countries.

- Domestic or water's edge combination. In a domestic combination, only domestic corporations are combined. A water's edge combination includes the taxpayer corporation and its affiliated entities, but the income and apportionment factors to be considered in the combined report would be limited to income derived from or attributable to sources within the United States.

8.02(c) *Consolidated Reporting.* Some states that require corporations to file single entity returns provide for an election to file a consolidated return. Some states can compel the filing of consolidated returns in cases where there is distortion of income. There are two types of consolidated returns and some general requirements such as having control of a majority of the voting stock, etc.

(1) Nexus Consolidation. This type of consolidation requires the inclusion of the income of all members of the affiliated group that have nexus in the state. The computation of consolidated state taxable income involves adding up each members separate net income or loss, reflecting intercompany eliminations.

(2) Consolidation of Federal Affiliated Group. This type of consolidation requires the inclusion of the income of the entire federal affiliated group.

### 8.03 Separate Company (Single Entity) Returns

The auditor should compare the pro-forma federal returns filed with the state returns with the federal profit and loss statement and balance sheet included with the federal affiliated group (consolidated federal 1120).

The auditor should analyze consolidated federal eliminations and any other consolidating adjustments that may apply to the separate entity filer. There are usually differences in state limitations for a separate entity filer compared to the affiliated group within the consolidated federal return.

Examples of such items can be capital gains and losses, contributions, dividends.

### 8.04 Computation of Domestic Combined Income

Line 28 or line 30 of the Consolidated Federal 1120 will be the beginning point, depending on the state. Depending on the state law, additions to the above will be made for the Federal 1120 Income of Unitary Domestic Companies not included in the

consolidated return (i.e., Section 936 possession companies and companies owned more than 50% but less than 80%). Any non unitary domestic companies that have been included in the consolidated federal 1120 return will be subtracted. Review intercompany transactions to see if Federal 1120 Consolidating Adjustments (transactions between Consolidated 1120 unitary companies and unitary companies not included in the Consolidated 1120) need to be revised. Eliminate dividends between combined domestic companies. The result will be Domestic Combined Income.

#### 8.05 Computation of Worldwide Combined Income

8.05(a) *Computation.* Domestic Combined Income will be the beginning point. The income of foreign unitary affiliates will be added to that. Intercompany dividends will be eliminated to the extent that they are derived from income which has previously been included in the apportionable income. Adjust for changes in the Profit in Inventories or Assets applicable to the combining of foreign companies. The result will be Worldwide Combined Income before Special Federal Deductions. If the Federal Special Deductions (N.O.L.D., Dividends Received Deduction) are allowable for a given state, they will be state adjustments.

8.05(b) *Source Documents.* The SEC 10 Ks and the Annual Reports to shareholders can often be used as source documents for determining worldwide income. When all affiliated companies included in the financial reports are more than 50% owned and are members of the unitary business, subtract from the financial report income the domestic book income determined from Schedule M 1 of the Federal 1120s. The remainder will be the foreign source income. This item is generally verifiable from the taxpayer's financial consolidating workpapers, which will usually reflect any adjustments made for financial report purposes that may not be allowable for tax reporting purposes. Reverse these adjustments and add this revised foreign source income to the U.S. consolidated taxable income reported on the Federal Form 1120 as a starting point. There will be no need to adjust for intercompany profits in inventories or assets, as these items will have been eliminated in the consolidated financial statements. If all affiliated companies in the Forms 10 K or Annual Reports are not unitary, develop the worldwide combinable financial data on a company by company basis from reliable source data discussed in the following paragraphs.

8.05(c) *Use of Federal Schedule M-3 in Computing Worldwide Income.* The Federal Schedule M-3 is effective for any taxable year ending on or after December 31, 2004. The Federal Schedule M-3 will make the computation of unitary worldwide income for large corporations much easier for state auditors, especially in cases where the top parent of the unitary group is a U.S. corporation. Following is a brief discussion of this schedule.

(1) Requirements for Completing the Schedule. In general, this schedule must be filed by a corporation required to file Form 1120, U.S. Corporation Income Tax Return, that reports on Form 1120 at the end of the corporation's taxable year total assets that equal or exceed \$10 million. However, a corporation is only required to complete certain sections of Schedule M-3 in the first taxable year the corporation is required to file Schedule M-3.

(2) Detail Shown on the Schedule. Part I, lines 4 through 11 of the Schedule M-3 is a consolidated schedule that reconciles the taxpayer's worldwide net income (loss) per the income statement of the financial statements to the net income (loss) of the corporations included in the U.S. tax return (the U.S. consolidated tax group). Following is a brief explanation of this part of the schedule:

Line 4 - Start with worldwide consolidated net income (or loss) from the income statement.

Line 5 - Remove net income (or loss) of foreign corporations that are included in Line 4, but not in the U.S. consolidated tax group.

Line 6 - Remove net income (or loss) of U.S. corporations that are included in Line 4, but not in the U.S. consolidated tax group (for example, 51% to 79%-owned U.S. subsidiaries).

Line 7 - Include net income (or loss) of corporations that are consolidated for federal income tax purposes, but are not included on Line 4.

Line 8 -Adjust (remove or include) eliminations of intercompany transactions that relate to non-includible entities removed in lines 5 and 6 or included in line 7, leaving only intercompany eliminations that relate to includible entities. Generally, for those corporations removed on Lines 5 and 6, Line 8 will add back dividends received by the U.S. consolidated tax group and adjust for minority interests included on Lines 5 or 6.

Line 9 - Include adjustments for differences between the taxpayer's income statement year and tax return year.

Line 10 - Include any other necessary adjustments and attach a detailed schedule of those adjustments.

Line 11 - Line 11 is the net income (or loss) per the income statement of the consolidated tax group. Taxpayers that did not prepare

financial statements would enter net income (or loss) per books and records for the U.S. consolidated tax group.

#### 8.06 Income of Foreign Affiliates

The determination of foreign affiliates' income will largely depend upon whether the foreign affiliates have a U.S. based parent or a foreign based parent. The actual audit procedures to be used in determining income of foreign affiliates will depend in part on the records available from a particular taxpayer and the circumstances encountered in a particular audit. The actual method used for determining and verifying income of foreign affiliates is mainly a question of judgment.

If there is a foreign-based parent, the annual reports can be used to determine worldwide income but the figures will have to be converted to U.S. dollars.

#### 8.07 SEC Forms 10 K and Annual Reports and Their Uses

Reconcile the income reported per the state tax return to some verifiable amount in the Annual Report or audited financial statements, particularly when foreign affiliates are included in the combined report. Use the most readily available sources to reconcile income of domestic corporations and foreign affiliates to the annual reports or to financial statements. If foreign affiliates are included in the state combined return as filed, the reconciliation may entail no more than comparing the income reported per their returns and domestic book income with the annual report income. For very large taxpayers, however, reconciling state tax return income to a world-wide annual report income figure or some other SEC filing will be a difficult undertaking that may not be practical or useful.

The Securities and Exchange Commission (SEC) Forms 10 K and corporate annual reports can often be used as source documents for the determination of worldwide combined income. Steps that can be taken in the verification process include the following.

Determine whether all affiliates are included in the Annual Report or SEC Form 10 K. The notes to the financial statements will disclose whether consolidated statements are filed.

Using SEC Form 10 K and Annual Reports, determine worldwide book income. If companies which are over 50 percent owned are not included in the Annual Report or SEC Form 10 K, obtain a copy of their separate statements and add their book income to consolidated book income.

Determine the book income of domestic affiliates. Determine U.S. domestic income by using Schedule M 1 of the consolidated Federal Form 1120. Line 1 of Schedule M 1 reflects net income per books. Check to see whether all U.S. affiliates are

included in the consolidated Federal Form 1120 since there may be U.S. affiliates filing separate Federal Forms 1120, 1120F, or, in the case of a Foreign Sales Corporation, Federal Form 1120 FSC. In the event that affiliates are filing separate returns, add Line 1 of the separate Schedule M 1 to the income of the consolidated domestic subsidiaries.

The result of accumulating book income and the federal tax provision per the Schedules M 1 will be domestic book income per the Federal Forms 1120.

Subtract the domestic book income, determined in Step 3, from the worldwide book income, determined in Step 2. The difference will be so called foreign source book income. If a copy of consolidating income statements or CPAs' long form report is available, book income of consolidated foreign subsidiaries should be readily verifiable.

Compare the foreign source book income arrived at in Step 5, with the foreign source income derived from Federal Forms 5471 discussed below, for reasonableness.

Ask the taxpayer to reconcile any material difference between the foreign source income derived from the SEC 10 K or Annual Report and that shown on Federal Forms 5471.

Discrepancies may include domestic as well as foreign adjustments, and may include the following —

8.07(a) Consolidating adjustments.

8.07 (b) Differences in the taxpayer's method of accounting for book purposes versus tax purposes.

8.07 (c) Omission of income for one or more entities.

8.07 (d) Under reporting of income per the Federal Forms 5471.

8.07 (e) Inclusion of non deductible reserves in book income.

Once any material differences are satisfactorily explained, the auditor should have a reasonable figure for worldwide foreign source income. If the differences cannot be explained satisfactorily, the auditor should protect the state's interest by using the larger of the available figures for foreign income.

#### 8.08 Consolidated Working Papers and Their Uses

The consolidated statements appearing in the Annual Report or SEC Form 10 K show an overall picture of the financial position and operating results of the parent and those subsidiary companies which are operated under a common or unified control. For purposes of the consolidated statements, the independent legal existence of the separate

companies is disregarded. The consolidated statements do not present the financial position and operating results of a single legal entity. These statements show the data of a business entity or economic unit consisting of a group of legal corporate entities. Consolidated statements should not be viewed as substitutes for the legal accounting statements which reveal the financial position and operating process of the individual legal entities. Both the consolidated and the individual legal entities statements should be available since each type serves distinct purposes and supplies data not revealed by the other. Request the consolidating working papers as a normal field audit practice; particularly when foreign affiliates are involved, because the individual legal entity's financial statements will usually be the best available source for determining the income of each foreign affiliate.

#### 8.09 Source of Foreign Financial Statements

Foreign affiliates' individual financial statements, which have been translated into U.S. dollars and expressed in conformity with generally accepted U.S. accounting principles, are usually the best sources for determining foreign source income for inclusion in the combined report. Usually, the most readily available source of the foreign affiliates' individual financial statements is the consolidated working papers which are prepared to support the preparation of the consolidated financial statements. The working papers are usually prepared in a format which allows the combining of similar items of each individual legal entity and the eliminating of intercompany items by listing each entity horizontally.

#### 8.10 Information Included in Consolidated Statement

Included in the useful information that can be obtained from the consolidated working papers are:

8.10(a) Intercompany transactions which can be used to help substantiate unity, such as intercompany receivables and payable, intercompany purchases and sales, interest, rents, other intercompany revenue and expense items, intercompany loans and financing, and intercompany unrealized profit.

8.10(b) Currency translation gains and losses.

8.10(c) Income and financial position on an individual company basis.

8.10(d) Differences in accounting methods used by the various members of the group.

8.10(e) Differences in accounting periods.

#### 8.11 Form 5471, Information Return With Respect to Controlled Foreign Corporations

This form can be used as an alternative source for determining the income of foreign affiliates. Keep in mind, when using Form 5471 as a source, that the form is an information return and usually is not audited by a Federal agent. As a result, taxpayers are sometimes not as diligent in its preparation as they should be. Attempt to reconcile the total of the foreign source income derived from Forms 5471 with the Annual Report or SEC Form 10 K income. Useful information which can be obtained from Form 5471 includes:

8.11(a) Profit and loss statement for the accounting period.

8.11(b) Balance sheet as of the end of the accounting period.

8.11(c) Analysis of changes in surplus accounts.

All three of the above statements are required to be filed in conformity with general accepted U.S. accounting principles in such form and detail as is customary for the foreign corporation's accounting records.

8.11(d) Analysis of intercompany transactions between foreign corporations and related corporations, both foreign and domestic, which is useful for developing unitary/non unitary data.

8.11(e) Principal business activity, name, country of incorporation, ownership interest, principal business location, and accounting period for each foreign affiliate.

8.11(f) Profit (loss) for the taxable year per book income before taxes with adjustments to determine earnings and profits for U.S. tax purposes.

8.11(g) Nature of business, accounting period, principal business location, and controlling U.S. corporation.

8.11(h) Unrealized exchange gains (losses), charges to reserves, depletion, and capital gains and losses.

8.11(i) Income taxes paid to foreign countries.

## 8.12 Foreign Book Income

Of the four states in the MTC audit program that require or permit worldwide reporting, two of the states require the use of book income of the foreign subsidiaries and two of the states provide the taxpayer the option of using book income of the foreign subsidiaries or the book income adjusted to tax accounting standards as would be required by the IRC if the corporation were incorporated in the United States.

### 8.13 RAR Adjustments

Take RAR adjustments into account in determining income. Prepare a separate schedule detailing such adjustments.

### 8.14 FSC Income

FSCs are no longer in existence; the FSC provisions were repealed as of Sept. 30 2000. The extraterritorial income exclusion (ETI) was enacted as part of the repeal of the FSC provisions after the World Trade Organization (WTO) decided that the FSC provisions were prohibited export subsidies given to US exporters designed to provide the same relief as the European value added tax (VAT) exemption. The ETI was repealed for transactions after Dec. 31, 2004. There were some transition rules.

## 9. State Adjustments

9.01 Most state income tax statutes are based on federal statutes; however there are usually some variances in computing state taxable income. State modifications are the adjustments needed to reconcile federal taxable income to state taxable income.

State modifications vary by state. This chapter covers the most common state adjustments.

State modifications fall into two broad categories: additions to income and deductions from income. Additions will increase federal taxable income and deductions will decrease federal taxable income.

### 9.02 Additions to Income

#### 9.02(a) *Taxes*

(1) Federal Law. State, local, and foreign income taxes are deductible expenses for federal income tax purposes. For federal tax purposes, a taxpayer can elect to take a foreign tax credit. If the foreign tax credit is elected the foreign income taxes are not deductible.

(2) State Law. Most states provide that some or all of these taxes are not deductible. Since these taxes have been deducted in computing federal taxable income they must be added back for state purposes.

(3) Audit Procedure. The state, local, and foreign income taxes must be verified to the taxpayer's workpapers detailing the deduction for taxes on the Federal 1120, line 17.

#### 9.02(b) *Federal Exempt Interest*

(1) Federal Law. IRC Section 103 provides that interest income earned on obligations of state or local governments is not taxable. This is called municipal interest. The amount of Federal Exempt Interest (Municipal Interest) is reported on the Federal 1120 on Schedule M-1, line 7 as income for book purposes but not for tax purposes. It is not taxed for federal purposes. The municipal interest should also be listed on the Federal 1120, Page 3, Schedule K, line 9. Also note that taxpayers are required to report investments in municipal obligations on the balance sheet, Federal 1120, Schedule L, line 5.

(2) State Law. Many state statutes provide that interest on obligations of state or local governments that are excludable from gross

income for federal income tax purposes must be added back. In some states interest on obligations of the home state are not added back.

(3) Audit Procedure. The addback for municipal interest is obtained from the Schedule M-1, line 7 detail. If the taxpayer has reduced the amount for interest earned from obligations of the home state verification must be provided in the taxpayer's workpapers.

In cases where you are auditing a company that earns a material amount of municipal interest and has more than one corporate location that invests funds the taxpayer must provide 51 state apportionment detail for the municipal interest.

#### 9.02(c) *Depreciation Adjustments*

(1) Federal Law. Federal law provides that taxpayers are not allowed to expense the cost of assets that are considered capital in nature. Instead, an annual depreciation deduction (cost recovery) is allowed. Depending on when an asset was placed in service the federal depreciation method that applies will be IRC Section 167, ACRS or MACRS. Federal Law also provides for a Section 179 Expense deduction in the year an asset is placed in service. In addition, the federal Job Creation and Worker Assistance Act of 2002 allows additional first-year depreciation equal to thirty percent (30%) of the adjusted basis of property placed in service between September 11, 2001, and September 10, 2004. (IRC Section 168(k))

(2) State Law. Most states follow the federal depreciation methods. A few states do not and provide that federal depreciation must be added back to income and a state depreciation adjustment computed. As for the states that are part of the MTC audit program, the only depreciation adjustments that are currently required relate to the disallowance of the federal bonus depreciation allowed under the federal Job Creation and Worker Assistance Act of 2002. Most of those states require that a state depreciation deduction be computed without the bonus depreciation deduction and the difference between the state and federal depreciation is either an addition or subtraction adjustment.

(3) Audit Procedure. If the taxpayer has made no depreciation adjustment, the auditor must determine if one is required by inspecting the federal depreciation schedule (Form 4562) and the related workpapers. Those figures are used as a starting point in computing any required state depreciation adjustment.

9.02(d) *Federal Capital Loss Carryovers deducted on the Federal Return*

(1) Federal Law. IRC Section 1211(a) limits the deduction for capital losses to the amount of capital gains. Excess losses become carryovers.

(2) State Law. Some states do not follow federal law on capital losses and adjustments must be made.

(3) Audit Procedure. The federal return form Schedule D must be inspected to determine if a capital loss carryover has been utilized on the federal return. This amount will be an addition adjustment for states that do not follow the federal rules.

9.02(e) *Expenses Attributable to Income Not Taxed by the State*

(1) Law. Most state statutes contain provisions allowing for the addition of expenses related to income that is not taxed by the state.

(2) Audit Procedure. The first step is to determine if the taxpayer made such an addition adjustment if there is income not taxed by the state reported on the return. If not, there is an audit adjustment and the amount must be computed. If an addition has been made, the taxpayer's workpaper showing the computation of the amount added back should be reviewed to determine if the computation is done according to any specific state law provisions and that all expenses that should be included in the addition are actually included.

9.02(f) *Safe Harbor Lease Adjustments*

(1) Law. Some state statutes provide that safe harbor lease transactions are not recognized by the state. This is not a common adjustment anymore.

(2) Audit Procedure. These amounts are obtained from the detail to the Federal Schedule M-1 and the taxpayer's workpapers.

9.02(g) *Federal DRD and NOLD for states that start at Line 30*

(1) Law. This addition only applies in states that provide that the Federal Taxable Income, Line 30 is the starting point in computing the state taxable income. If the state provides for a state computed NOL deduction and / or dividend subtraction, these amounts will be added back.

(2) Audit Procedure. The amount of the Federal DRD is obtained from the Federal 1120, line 29(b) and the amount of the Federal NOLD is obtained from the Federal 1120, line 29(a).

9.02(h) *Federal ETI Exclusion*

(1) Federal Law. IRC Section 114 provides that gross income doesn't include extraterritorial income for transactions after Sept. 30 2000 and before December 31, 2004. The exclusion is claimed on the Federal Form 8873. The extraterritorial income exclusion was enacted as part of the repeal of the FSC provisions after the World Trade Organization (WTO) decided that the FSC provisions were prohibited export subsidies given to US exporters designed to provide the same relief as the European value added tax (VAT) exemption. The ETI was repealed for transactions after Dec. 31, 2004. There were some transition rules.

The ETI exclusion was replaced by the Qualified Production Activity Income (QPAI) deduction enacted as part of the American Jobs Creation Act (P.L. 108-357) in 2004. This deduction is contained in IRC Section 199. Some states will not conform to this deduction.

(2) State Law. Some states have provisions that require that the Federal ETI Exclusion be added back.

(3) Audit Procedure. The amount of the ETI exclusion must be verified to the Federal Schedule M-1 and detail and to the Federal form 8873.

9.02(i) *Charitable Contributions*

(1) Federal Law. For federal purposes IRC Section 170 provides that the charitable contributions are limited to 10% of the federal taxable income.

(2) State Law. Most states follow the federal contribution deductions. Some states have provisions that limit the charitable contribution to 10% of the state computed income.

(3) Audit Procedure. If a state requires that the charitable contribution limitation be computed at the state level a computation schedule must be created to recompute the deduction.

9.02(j) *Depletion Adjustments.* For states that make such adjustments the auditor must review the statutes and regulations of the state and verify that the appropriate adjustments are computed.

9.02(k) *Royalty and Other Related Expense Addbacks.* For states that make such adjustments, the auditor must review the statutes and regulation of those states and make the appropriate adjustments.

9.02(l) *IRC Section 199 Domestic Production Activities Deduction Addback*

(1) Federal Law. The American Jobs Creation Act (P.L. 108-357) created a new deduction for a specified portion of “Qualified Production Activity Income.” It was enacted as IRC Section 199 effective for tax years beginning on or after January 1, 2005.

(2) State Law. Most states follow the federal law at this point. For states that do not follow the federal law there will be an addition for the amount of the deduction taken on the federal return.

(3) Audit Procedure. If a state requires that this deduction be added back the amount will be obtained from the Federal Form 8903 and/or the Federal Schedule M-1 detail.

9.02(m) *IRC Section 482 adjustments.* This provision provides that the government may distribute, apportion or allocate gross income, deductions, credits or allowances between or among such organizations, trades or businesses, if it is determined that such distribution, apportionment or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades or businesses.

The auditor must be aware of the states that can make such adjustments and request the information needed to determine if such an adjustment is required to clearly reflect income.

9.03 Deductions from Income

9.03(a) *Dividends*

(1) Federal Law. IRC Section 243 allows corporations a dividend deduction (DRD). Without getting into a lot of detail about the intricacies of the federal DRD the following general rules apply. The deduction is taken on the Federal 1120, line 29(b) and is computed on the Schedule C. In general a corporation is allowed to deduct 70% of a dividend received from a less-than-20 percent owned domestic corporation, 80% of a dividend received from a 20 percent or more owned nonaffiliated corporation, and 100 percent of a dividend received from a

corporation that is a member of an affiliated group with the corporation receiving the dividend.

A federal DRD is generally not available for dividends received from foreign corporations, including wholly owned foreign subsidiaries. The same applies to the Section 78 gross-up and Subpart F income. A 100% DRD is allowed for FSC distributions from earnings and profits attributable to foreign trade income.

IRC Code Sec. 965, which was added by American Jobs Creation Act of 2004 (P.L. 108-357; 10/22/2004), allows a temporary elective 85% dividends received deduction for cash dividends paid by CFCs to U.S. corp. shareholders. Section 965(f) provides that taxpayers may elect the application of section 965 for either the taxpayer's last taxable year which begins before October 22, 2004, or the taxpayer's first taxable year which begins during the one-year period beginning on October 22, 2004.

(2) State Law. Most states allow dividend deductions and there are a wide variety of rules for computing the dividend deductions. If a state's starting point is Federal Taxable Income (FTI), line 30 and there is no provision for an addition adjustment for the Federal dividends received deduction (DRD), that state is allowing the Federal DRD for state purposes. The state may then provide that some dividends that are not allowable deductions for federal purposes are deductible for state purposes. For instance the state may provide that foreign dividends are a deduction adjustment either in full or at a percentage such as 50% or 80%. States that start at FTI, line 28 may provide for a subtraction adjustment for the Federal DRD and in addition allow deductions for foreign dividends, or may provide for deductions for specified dividends based on ownership percentage, etc. A few states provide that dividend subtractions are only allowed if the paying company is taxed in that state. In unitary states dividends paid from one unitary group member to another are allowed as a subtraction at 100%.

(3) Audit Procedure. The dividend amounts are obtained from the Federal 1120, Schedule C. In states where dividend deductions are dependent on ownership percentages, additional information and workpapers from the taxpayer will have to be reviewed to determine what the ownership percentage of the company that paid the dividend was.

9.03(b) *Interest Income Earned on Direct Obligations of the United States*

(1) Law. U.S. Government Obligation interest is taxed for federal purposes. For states that have provisions that this interest is not taxed it is subtracted.

(2) Audit Procedure. Most states provide that only interest earned on direct obligations of the U.S. government are allowed. That means that interest earned from obligations of the FNMA, GNMA, Federal Home Loan Mortgage Corporation, or the World Bank are not allowed since these are not direct obligations of the U.S. Government.

The U.S. Government obligation interest is verified to the supporting detail to the interest income reported on the Federal 1120, line 5 and to other workpapers as necessary.

9.03(c) *Expenses not Deductible on the Federal tax Return due to the Election of Federal Tax Credits*

(1) Law. For federal tax purposes there are some expenses that are eligible for federal tax credits. The federal law provides that if a taxpayer elects to take the tax credits, the expenses are not deductible.

(2) Audit Procedure. Amounts reported as expenses not deducted on the federal return due to federal tax credits taken are verified to the Federal 1120, Schedule M-1 detail of expenses per books not deducted on the return. Examples of such amounts would be jobs credit wages, and research credit expenses.

9.03(d) *Expenses Attributable to Federally Exempt Interest Income (Municipal Interest) Taxed by the State*

(1) Law. Some states that provide that municipal interest is taxable (i.e. an addition adjustment) also provide that the related expenses that were not deductible for federal purposes are deductible. IRC Sections 265 and 291 are the provisions that provide that those expenses cannot be deducted.

(2) Audit Procedure. These expenses are found on the Federal 1120, Schedule M-1, line 5 detail.

9.03(e) *Excess Federal Capital Losses*

(1) Law. This adjustment only applies in states where the federal law is not followed. If a state does not follow IRC Section 1211(a) which limits the deduction for capital losses to the amount of capital gains, a deduction will be allowed for excess losses in the year they are generated. These excess capital losses are carryovers for federal purposes but not for purposes of a state that does not follow the federal law.

(2) Audit Procedure. The excess capital losses are verified to the Schedule D and on the Schedule M-1, line 3.

9.03(f) *Other Subtraction Adjustments*

(1) Foreign Royalties. For the states that allow a foreign royalty deduction the taxpayer will have to provide detail showing the source of all of the royalty income in order to determine the amount of foreign royalties that are allowed as a deduction.

(2) Foreign Source Income Deduction. For the states that allow a foreign source income deduction the Federal Forms 1118 are normally the source of these deductions.

9.04 IRS Audit Adjustments

All Federal RARs must be reviewed for audit adjustments that affect the state adjustments so those can be reflected on the audit schedules.

9.05 Federal Income Tax Deductions

For the states that allow federal income tax deductions the computations will be based on the particular states' form.

## 10. Business & Non-Business Income

### 10.01 General Tests to be used in Determining Nature of Income

General tests may be applied initially to determine whether any class of income (e.g., dividends, interest, royalties, and rents) is business or nonbusiness in nature. In addition, however, the auditor must monitor facts that are peculiar to each particular class.

10.01(a) The auditor should, with respect to each item of income, determine —

(1) The nature of its source and the nature of any relationship of that source to the taxpayer. For example: Was the dividend paid by a subsidiary which is in the same line of business as the parent? Was the rental income earned from property used in the taxpayer's business?

(2) The purpose behind the making of the investment. For example: Did the interest income constitute income earned on a short term investment of working capital which the taxpayer intended to use later in the unitary business? Was the dividend received from a subsidiary which supplied raw materials or important services to the unitary business?

(3) The source of the funds used to make the investment. For example: Did the taxpayer set the funds aside as self insurance for workers' compensation?

(4) The taxpayer's rationale for treating income as business or non business in nature and the consistency or inconsistency with which the taxpayer has reported such treatment to other states.

10.01(b) The purpose of investing in income producing property is controlling in most instances for the purpose of distinguishing between that income which is business income and that which is non business income. If the investment has been made for a purpose other than that of investing surplus funds which are not needed or utilized in the business of the taxpayer, the income from that investment is business income; but if the investment was made solely for the purpose of obtaining a return on such surplus funds and if the investment is unrelated to the taxpayer's business operations, the income in most instances is non-business income. In other circumstances, income from the investment would be classified as business income since it is functionally related to the taxpayer's trade or business operations.

## 10.02 Business Income Tests

The MTC regulations establish tests by which to determine whether income is business or nonbusiness in nature. The tests can help to resolve business or nonbusiness income problems:

10.02(a) *Transactional Test*. Does the property that produces the income arise from transactions or activities conducted in the course of the taxpayer's trade or business operations?

10.02(b) *Functional Test*. Is the property functionally related to the taxpayer's unitary business, i.e., was the acquisition, management and disposition of the property accomplished as an integral part of the taxpayer's business?

In short, was the acquisition of the property or its subsequent use or disposition accomplished for the purpose of furthering the taxpayer's business or did it constitute a mere investment the sole purpose of which was to produce investment income?

The taxpayer need not be engaged in a unitary business with the payor of the income for that income to be classified as business income.

10.02(c) *General Tests*. In applying phrases such as "functionally related" and "effectively connected," one may find it helpful to relate them to specific examples such as those that are included in the MTC Regulations. The business/non business income issue generally arises with respect to intangible income such as dividends; interest from sources like bonds, debentures, charge accounts and credit card operations; royalties from sources such as patents, trademarks and copyrights; and gains or losses from the disposition of intangibles such as stocks and bonds. Any large taxpayer is likely to have many intangible investments involving many items of income, and the purposes of the investments may vary, which in turn can affect the business/nonbusiness income determination.

A determination of whether each such investment is functionally related to the taxpayer's unitary business can consume more auditing effort than is justified by the potential tax liability or tax savings at issue. The taxpayer will often arbitrarily classify all investment income from intangibles as non business income for this reason. The auditor must seek to resolve the business/nonbusiness income issue without placing an undue burden on either audit resources or taxpayer resources. In order to expedite this determination, the auditor should generally assume that dividends are non business income if they are derived from stock investments which constitute less than ten percent of the ownership of the dividend payor, unless the auditor believes that significant tax consequences are at stake and sufficient functional integration exists to hold otherwise.

The auditor should look for significant individual items, such as dividends from subsidiaries and income from investments that can be lumped into specific categories. If the auditor needs to rely on sampling techniques, the auditor should work out with the taxpayer an adequate sampling approach by class of income for one year and then apply the findings to all items in each class and to all years.

#### 10.03 General Categories of Business Income

10.03(a) Income from investments which have been made in stocks, bonds and loans for the purpose of securing a source of supply or a market.

10.03(b) Income from investments of working capital, whether short term or long term in nature.

10.03(c) Income from patents, copyrights and trademarks which have been developed by the taxpayer and used in its business.

10.03(d) Income traceable to reserves for the normal cycling or fluctuations of the taxpayer's business.

10.03(e) Income from investments which were made by the taxpayer for the purpose of expanding its business, e.g., the formation of a subsidiary that engages in the same line of business.

10.03(f) Income from commonly owned and controlled corporations.

10.03(g) Income from the disposition of investments which produced business income when held by the taxpayer. Be aware that in some states, disposition of an entire business by a taxpayer will generate non-business income.

#### 10.04 General Categories of Non Business Income

10.04(a) Income from surplus funds that are not needed in the taxpayer's business and that are invested in a business which is not functionally related to that of the taxpayer.

10.04(b) Income from corporate business activities which are unrelated to the business of the taxpayer.

10.04(c) Income from the disposition of assets which produced non business income when held by the taxpayer.

## 10.05 Specific Factual Determinations

10.05(a) *Purpose of Investment.* The auditor must determine the purpose for which the taxpayer made the investment that produced the intangible income in question. If idle funds were used to invest in assets that were totally unrelated to the taxpayer's business and if there is no indication that such funds were reserves for use in that business, the reasonable inference is that the investment was made for a non business purpose. This will be so even if the income has been commingled with operating funds of the taxpayer. But, if the investment was made for a purpose associated with the taxpayer's unitary business, then the reasonable inference is that the investment was made for a business purpose.

10.05(b) *Common Facts.* Early questions should include:

(1) Why did the taxpayer classify the income in question as non business income and on what information did it rely in doing so?

(2) How has the taxpayer accounted in its books and records for the assets and the income derived therefrom?

(3) Has the taxpayer specifically allocated on returns to appropriate states that income which it has classified as non business income on the returns which are being audited?

(4) Has the taxpayer deducted from apportionable net income the expenses of producing income which it claims to be non business? If not, then how did the taxpayer determine which expenses were attributable to the claimed non business income?

(5) Did the taxpayer adjust the apportionment formula factors to exclude from them any property, payroll or sales associated with the production of the claimed non business income? If so, how did it determine those adjustments?

(6) Did the taxpayer own a controlling interest in the payor of the income in question?

(7) What business relationship, if any, other than that of a mere investor, did the taxpayer have with the payor of the income?

(8) What was the purpose of this specific investment by the taxpayer?

(9) What was the source of the capital with which the taxpayer purchased or otherwise acquired the property which gave rise to the income?

(10) What interest expense did the taxpayer deduct in computing net apportionable income? How much of it was attributable to the investment in question?

10.05(c) *Dividend Income.* Dividend income is business income if the dividends were earned in the course of activities which were directly related to or functionally integrated with the conduct of the recipient's unitary business. There is no constitutional requirement that the payor be connected to the recipient by more than 50% ownership. Specific examples of the distinction between business and non business dividend income are included in the MTC Allocation and Apportionment Regulation IV.1.(c)(4).

(1) Obtain all relevant dividend income information required to support Line 4 of Federal Form 1120.

(2) Prepare a schedule for each year under examination, detailing the dividend income by type.

(3) Present the schedule to the taxpayer with the request that it be completed for any dividend income which the taxpayer deems to be non business income. The auditor should identify on the schedule(s) any dividend income which he/she recommends to be considered as non business income.

(4) If the auditor has recommended that any dividend income be treated as non business income, he/she should prepare a schedule to determine directly related expenses, indirect expenses and dividend expenses proration.

(5) The following should be explained in the narrative —

i. the amount of dividends,

ii. the purpose of the acquisition of the stock which produced the dividends,

iii. how the stock was acquired, (For instance: From a subsidiary formed by the taxpayer? As a part of the acquisition of a going business? Other? Identify all persons, documents and communications that are relevant to the acquisition of the stock.)

iv. the percentage of the stock of the dividend payor the taxpayer owned,

v. how the taxpayer accounted for the dividend income,

vi. whether the taxpayer deducted related expenses from its apportionable income,

vii. what business, if any, the taxpayer conducted with the dividend payor,

viii. what, if anything, the taxpayer's ownership of the stock of the dividend payor contributed to the taxpayer's business,

ix. the number of transactions that took place each year in which the taxpayer acquired stock of other corporations,

x. whether the dividend payor was a part of the unitary business of the recipient,

xi. whether the dividend payor and the taxpayer engaged in the same line of business,

xii. how and to what extent did the taxpayer exercised management, supervision and/or control over the dividend payor corporations (identify all persons who participated in such activities; identify all communications that were involved; and identify all relevant documents.)

xiii. what relationships, if any, existed between the taxpayer and the dividend payors? Relate, in detail the extent to which the taxpayer: sells products to, or purchases products from, those corporations; lends monies to or borrows monies from them; or exchanges personnel with them.

xiv. the extent to which the taxpayer shares with those corporations any of the following: research and development facilities and results; trade names and trademarks; fringe benefits; personnel, especially executive personnel; training programs; technical expertise; legal services; accounting services; advertising services; or other services.

(6) Identify all persons who may have knowledge of these relationships, and identify all pertinent documents and communications, whether oral or written.

10.05(d) *Interest Income*. Interest income is business income if it has been earned on funds used in the regular conduct of the taxpayer's business regardless of how those funds were invested. Interest income earned from intangibles acquired as short term investments of capital used in the regular conduct of the taxpayer's business is also generally business income. Specific examples of the distinction between business and non business interest income are included in MTC Allocation and Apportionment Regulation IV.1.(c)(3).

(1) Obtain all interest income information required to support such income reported on the Federal Form 1120.

(2) The following should be explained in the narrative:

- i. the purpose of the purchase of the interest bearing assets,
- ii. whether the capital used to purchase or acquire these interest bearing assets derived from the business operations of the corporation,
- iii. whether this interest income was utilized in the overall operations of this corporation,
- iv. the number of transactions that have given rise to the entries into the interest bearing asset account for each of the taxable years,
- v. the number of years during which the corporation has owned interest bearing assets,
- vi. the relationships between the Creditor Company and the Debtor Company,
- vii. identify all relationships between the creditor company and the debtor company (other than the debtor creditor relationship itself),
- viii. identify all persons who have knowledge of these relationships and all pertinent documents and communications,
- ix. indicate the amount of interest income which was received from persons with whom the company or its affiliated and subsidiary corporations had no business relationships other than that of creditor,
- x. identify the sources of funds/interest income,
- xi. identify the source of the funds used to make the loans that gave rise to interest income,

- xii. identify all pertinent documents and communications,
- xiii. identify the company's characterization of the interest income, i.e. short term or long term,
- xiv. how the company accounted for its interest income on its income statements to its shareholders in its annual reports,
- xv. whether related expenses have been deducted from apportionable income in current year or previous year.
- xvi. the purpose of the investment,
- xvii. whether the money to make the investment that produced the interest income constitute part of the company's working capital.

(3) Expenses Related to Allocated Interest Income. If the auditor has recommended that any interest income be treated as non business income, he/she should prepare a schedule to determine directly related expenses, indirectly related expenses, and the interest expense proration.

10.05(e) *Rental Income from Real and Tangible Personal Property.* Rental income is business income when the rental of the property is a principal business activity of the taxpayer or when the rental of the property is related to or incidental to the taxpayer's principal business activity. Specific examples of the distinction between business and non business rental income are included in MTC Allocation and Apportionment Regulation IV.1.(c)(1).

(1) Obtain all rental income information required to support such income as reported on the Federal Form 1120. Prepare and attach to this section an indexed narrative which responds to the following questions and suggestions:

- i. Were the funds used to acquire or construct this rental income property derived from the business operations of this corporation? If not, explain.
- ii. Was the value of the property included in the property factor of the apportionment formula?
- iii. Indicate the number of years during which the corporation has owned rental income property and realized rental income.

iv. Determine whether related expenses have been deducted from apportionable income in the current year or in previous years.

(2) Present a schedule to the taxpayer with the request that it be completed for any rental income which it deems to be non business in nature. The auditor should reflect on the audit schedules any rental income for which he/she recommends treatment as non business income. The auditor should make appropriate comments in the audit narrative.

10.05(f) *Royalty Income.* Patent and copyright royalties are business income if the patent or copyright with respect to which the royalties were received arises out of or was created in the regular conduct of the taxpayer's business or if the purpose for acquiring and holding the patent or copyright was related to or incidental to such business. Specific examples of the distinction between business and non business royalty income are included in MTC Allocation and Apportionment Regulation IV.1.(c)(5).

(1) Obtain all royalty income information required to support such income as reported on the Federal Form 1120. Prepare and attach to this section an indexed narrative which responds to the following questions and suggestions:

i. Indicate the number of years this corporation has owned royalty assets and realized royalty income.

ii. Identify the sources of the inventions, patents, copyrights, trademarks, etc., which gave rise to the royalty income.

iii. Identify the entities from which the company derived royalty income; include the amounts received from each such entity.

iv. Determine the nature of the company's relationship with each of those entities. Identify all pertinent documents and communications.

v. Does the company own any trade names, trademarks, licenses, franchises, copyrights, or other patents in common with its affiliates? If so, identify their origin, the person who produced them, and all documents or communications pertaining to their use.

vi. Has the company sold to or acquired from any affiliate any trade names, trademarks, licenses, franchises, copyrights, patents, etc.? If so, identify all persons who have knowledge of such activity; and identify all pertinent documents.

vii. Identify all transactions between the company and its affiliates involving trade names, trademarks, licenses, franchises, copyrights, patents, etc., which have given rise to royalty income.

viii. Does the company make available to affiliates any trade names, trademarks, licenses, franchises, copyrights, patents, etc., which are not made available to the general public? If so, identify all persons who have knowledge of these activities, and identify all pertinent documents and communications.

ix. Determine whether related expenses have been deducted from apportionable income in the current year or in previous years.

(2) The auditor should present a schedule to the taxpayer with the request that it be completed for any royalty income which the taxpayer deems to be non business in nature. The auditor should reflect on the audit schedules any royalty income for which he/she recommends treatment as non business income. He/she should make appropriate comments in the audit narrative to support those recommendations.

10.05(g) *Gain or Loss on Sales of Assets.* Gain or loss from the disposition of property is business income if the property, while owned by the taxpayer, was used in the taxpayer's business. The gain or loss from the disposition of property is non business income if the property was utilized for non business purposes for a significant period of time before its disposition. Specific examples of the distinction between business and non business gain or loss from the disposition of property are included in MTC Allocation and Apportionment Regulation IV.1(c)(2).

(1) Obtain all information relevant to the Gains or Losses on Sale of Assets required to support income/loss as reported on the Federal Form 1120. Prepare and attach to this section an indexed narrative which responds to the following questions and suggestions:

i. Describe briefly the use of the assets which generated the net gain or loss for the taxable years under examination.

ii. Determine whether related expenses have been deducted from apportionable income in the current year or in previous years.

(2) The auditor should present a schedule to the taxpayer with the request that it be completed for any gains (losses) which the taxpayer deems to be non business in nature. The auditor should reflect on the audit schedules any gains or losses for which he/she recommends

treatment as non business income. The auditor should make appropriate comments in the audit narrative to support such recommendations.

10.05(h) *Other Income*. Obtain all information relevant to other income required to support Line 10 on the Federal Form 1120. Prepare a schedule as deemed necessary by the auditor. Allow the taxpayer the same opportunity as in the instances set forth above to demonstrate which income it deems to be non business and why. Prepare appropriate schedules and enter appropriate comments in the audit narrative to support any auditor recommendations that any income be treated as being non business in nature.

#### 10.06 Related Expenses

The auditor must make sure that expenses related to non-business income are reported as an offset to any non-business income allowed.

## 11. Apportionment

### 11.01 General Description of the Apportionment Factor

11.01(a) *Apportionment Process*. Apportionment is the process of dividing the corporation's income among the states in which it conducts business.

#### 11.01(b) *Apportionment Formula*

(1) Purpose. The purpose of using an apportionment formula is to attribute to each state its fair share of the total business net income of the taxpayer. The formula does not "source" income. Its use is based on the premise that the net income of a corporation or a unitary business is properly determined by its activities in a state as reflected by the factors in the formula.

(2) Formula and Computation. The basis for many states is the use of UDITPA. UDITPA is a three-factor formula comprised of the average of three factors: property, payroll, and sales. In recent years, many states have moved away from the equal weighted formula and have adopted formulas that are either comprised of a heavier weighted sales factor or a single sales factor.

i. Property Factor. The "property factor" is a fraction, the numerator of which is the average value of real and tangible personal property owned plus the capitalized rental real and tangible personal property used in the production of business income in-state and the denominator of which is the average value of all of the owned real and tangible personal property plus the capitalized rental property used in the production of business income during the tax period.

ii. Payroll Factor. The "payroll factor" is a fraction, the numerator of which is the in-state payroll and the denominator of which is the payroll everywhere.

iii. Sales Factor. The "sales factor" is a fraction, the numerator of which is the in-state sales and the denominator of which is the sales everywhere.

iv. Average. The three factors are added up and divided by three to get the average.

## 11.02 Property Factor

### 11.02(a) In general

(1) **Income-Producing Nature of Invested Capital.** The use of the property factor in the apportionment formula represents the income-producing nature of invested capital.

### (2) The Property Formula

i. **Definition of Property.** The property factor includes all real and tangible personal property owned or used during the tax period to produce business income. The term “real and tangible personal property” includes land, buildings, machinery, stocks of goods (inventory), equipment, and other real and tangible personal property used in connection with the production of business income but does not include coin or currency.

ii. **Average Value.** The average value of property is used. It is determined by averaging the values at the beginning and ending of the income year. If significant property is added during the latter part of the year, the averaging by monthly values may be necessary to reflect the average value for the income year properly. Significant acquisitions or dispositions of property, which can cause material fluctuation, should be accounted for by weighted-averages.

iii. **Original Cost.** Property is valued at original cost and will generally be the federal tax basis

iv. **Rented Property.** Rented property is capitalized by multiplying by 8.

(3) **Construction in Progress.** Property under construction during the income year is excluded from the factor until it is actually used in the regular course of the trade or business. If it is partially used in the regular course of the trade or business while under construction, the value of property to the extent used is included in the property factor.

### (4) Inventories

i. **Valuation.** The valuation of inventories for purposes of the property factor is generally to be derived from the valuation used for federal income tax purposes.

ii. In-Transit Inventory

In-Transit Between Locations — Property in transit between locations of the taxpayer to which it belongs is considered to be at the destination.

In-Transit Between a Buyer and Seller — Property in transit between a buyer and seller, which is included by a taxpayer in the denominator, must be included in the numerator of the state of destination.

(5) Land

i. Included at Original Cost. Land is included at original cost if used in the business. Land which is temporarily out of use and any business land held for sale are included. Non-business land is excluded. Vacant land purchased for prospective use in the business is not included in the factor until such use actually takes place.

ii. Excluded if Removed From the Business. Land permanently removed from the business is not included in the factor.

(6) Wasting Assets. Mineral deposits and oil reserves are included in the property factor at original cost. The treatment of intangible drilling costs expensed for federal tax purposes varies from state to state. Expenses capitalized for tax purposes are included in the cost. No reduction to cost is made for depletion.

(7) Items Excluded from Property Factor

i. Property Not Used to Produce Business Income. Items not available for use to produce business income.

ii. Non-Business Income Property. Property used in connection with both the production of business and nonbusiness income shall be included in the factor only to the extent that the property was used in connection with the production of business income. The method of determining that portion of the value to be included in the factor will depend upon the facts of each case.

(8) Partnership Property

i. Included to the Extent of the Partner's Interest in the Partnership. A partnership's real and tangible personal property, both owned or rented, and used during the income year in the regular course of the trade or business, is to be included in the denominator of a corporate

partner's property factor to the extent of the partner's interest in the partnership. The value of such property located in the state is to be included in the numerator of the taxpayer's property factor.

ii. Exclude inter-company partnership property. The value of property which is rented or leased by a corporate partner to the partnership or vice versa is to be excluded from the property factor to the extent of the partner's interest in the partnership.

iii. Verify Partnership Property. Obtain copies of the partnership returns to verify or determine the appropriate factors.

iv. Corporation's Capital Sharing Percentage. For purposes of the property factor, interest in the partnership property normally refers to the corporation's capital sharing percentage.

(9) Offshore Property. The value of offshore oil wells located outside the three-mile limit on the continental shelf and under federal jurisdiction is included in the denominator but not the numerator of any property factor. Any property connected with federal oil leases that lies within the three-mile limit is included in the numerator of the property factor.

#### 11.02(b) *Rents*

(1) Verify Rent Expense to Federal Return. Rental expense is obtained from the Federal 1120, line 16, Schedule A, the cost of goods sold and line 26 the schedule of other deductions.

(2) Exclude Advance Rents and similar. Advance rents, daily rents, and service charges are not included.

(3) Annual Rental Rate. The annual rental rate is the amount paid as rental for property for a 12-month period. Where property is rented for less than a 12-month period, the rent paid for the actual period of rental constitutes the "annual rental rate" for the tax period.

(4) Annualize Rents for Short Periods. In situations where a taxpayer has rented property for a term of 12 or more months and the current tax period covers a period of less than 12 months, the rent paid for the short tax period must be annualized. (Examples would be corporate reorganizations or changes of accounting period.) If the rental term is for less than 12 months, the rent is annualized, but not beyond the rental term. When the rental term is on a month-to-month basis, the rent is not annualized because the term is too uncertain.

(5) Subrents. In many states subrents of business income are not deducted in arriving at annual rent expense.

Example: The taxpayer rents a 10-story building at an annual rental rate of \$1,000,000. Taxpayer occupies two stories and sublets eight stories for \$1,000,000 a year. The net annual rental rate of the taxpayer must not be less than two-tenths of the taxpayer's annual rental rate for the entire year, or \$200,000.

(6) Rents Included in Construction in Process. Rents paid for tangible personal property used in the construction of an asset should be capitalized into cost. For example, if a taxpayer uses rented equipment in the construction of a building, the rent paid should be capitalized into the cost of the building. Since the cost of the building is not included in the property factor until it is available for use, it follows that the rent paid for the rented property used in its construction should not be reflected in the property factor because it is not "used in the business."

(7) No Rent or Nominal Rent

i. Determine Reasonable Rent. If property is used by the taxpayer at no charge or rented by the taxpayer for a nominal rate, the net annual rental rate for such property is included in the factor based on a determination of a reasonable market rental rate for such property. This type of situation occurs when a local government desires to attract new industry or when a government contractor uses U.S. government facilities for the production of a product. If necessary, the taxpayer may be required to obtain an appraisal to determine the market rental rate.

ii. U.S. Government Contracts. If a taxpayer's contract with the U.S. government specifies only that the taxpayer is to "manage, operate, and maintain the government plant" the rental value of the property is not included in the property factor. It is only included when the facilities are used in the production of a unitary product.

iii. Unusually low rent Expense. Unusually low rent expense should alert the auditor to the possibility that an adjustment may be necessary. Comments and notes to the financial statements are a good source for information about use of facilities for no rent or nominal rent.

(8) Wasting Rental Assets. Royalties paid for the use of mineral and oil tracts are economic interests in real property and are not capitalized as rents for inclusion in the property factor.

## (9) Partnership Rents

i. Profit and loss Sharing Ratio. A partner's share of the cost of rental property owned by a partnership is included in its property factor based on its interest in the partnership. The partner's share is determined by its profit and loss sharing ratio.

ii. Eliminate Inter-company rent. Inter-company rents paid between a partner and a partnership must be eliminated

iii. Verify to return. Partnership rents are verified to the partnership return.

11.02(c) *Denominator*. The denominator is the average value of all owned and rented real and tangible personal property used in the production of business income.

11.02(d) *Numerator*. The numerator is the average value of all owned and rented real and tangible personal property used in the production of business income in the state.

### 11.02(e) *Auditing the Property Factor*

(1) "All-State" Apportionment Workpapers. Obtain the taxpayer's "all-state" apportionment workpapers breaking down the property and rents for each of the years under examination.

(2) Reconcile the Workpapers to the Federal Return .  
Compare the total property and rents shown on the apportionment workpapers to the Federal 1120.

(3) Adjust for Acquisitions, Divestitures, etc. Generally, the ending balance of one year will be the beginning balance for the next year; however, adjustments may be needed for newly acquired corporations, entities sold or merged-in companies.

(4) Further Investigation may be Required. Further verification can be done if problems are found.

(5) Exclude Inter-company Transactions. Verify the exclusion of intercompany transactions in cases where combined or consolidated returns have been filed and between a partnership and its partners.

(6) Review Prior Audit Reports. Review prior audit reports and determine whether there are any carryforward adjustments to the current audit period.

### 11.03 Payroll Factor

#### 11.03(a) *In general*

(1) Income-Producing Nature of Invested Capital. The use of a payroll factor in the apportionment formula reflects the income producing nature of labor.

#### (2) Compensation

i. Compensation Defined. The term “compensation” means salaries, wages, commissions and any other form of remuneration paid to employees for personal services. Compensation also includes the value of room and board, rent, housing, lodging and other benefits and services provided to employees in return for services rendered when such amounts constitute taxable income to the employee under the Internal Revenue Code. These amounts are generally reported for unemployment compensation purposes.

ii. Payments to Independent Contractors are not Compensation. Compensation, for purposes of the payroll factor, includes only amounts paid to employees. Exclude payments to independent contractors or any other persons not properly classified as employees. Include only amounts paid directly to employees. Exclude items such as employer paid payroll taxes and pension and welfare payments.

#### (3) Partnership Payroll

i. Include Pro-Rata Share of Partnership Payroll. A corporate partner’s pro-rata share of a partnership’s payroll is included in the numerator and denominator of the factor.

ii. Verify partnership payroll. The partnership payroll must be verified to the partnership’s federal tax return form 1065 and the partnership’s “all-state” apportionment workpapers.

11.03(b) *Denominator*. Any compensation which is associated with income but is determined to be non business or to be income for a separate business must be eliminated from the payroll factor.

#### 11.03(c) *Numerator*

(1) Compensation in a State. Compensation is paid in a state if:

i. The individual's services are performed entirely within the state, or

ii. The individual's services are performed both within and without the state, but the service performed without the state is incidental to the individual's service within the state, or

iii. Some of the service is performed in the state and the base of operations, or if there is no base of operations, the place from which the service is directed or controlled is in the state, or the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in the state.

#### 11.03(d) *Special Situations*

(1) Construction of Assets. Compensation paid to employees for the construction of a fixed asset, even though it is capitalized into the cost of the fixed asset, is nevertheless included in the payroll factor.

(2) Operations of U.S. Government Plant. There are occasions when a taxpayer operates a U.S. Government owned plant for a fee. In such cases, the workers are generally the employees of the taxpayer and the compensation paid to them should be included in the payroll factor.

(3) Offshore Employees. Compensation paid to employees working offshore oil platforms outside the limits of any state is to be included in the denominator of the payroll factor but not in the numerator. The limit of state jurisdiction is three miles off the coast or adjacent islands.

#### 11.03(e) *Auditing the Payroll Factor*

(1) "All-State" Apportionment Workpapers. Obtain the taxpayer's "all-state" workpapers breaking down the payroll for each of the years under examination.

(2) Reconcile the Workpapers to the Federal Return . Compare the payroll shown on the apportionment workpapers to the Federal 1120 and/or the Federal Forms 940 or 941s.

(3) Verify In-state Payroll to state U/C returns. The in-state payroll can be verified to the state U/C returns.

(4) Further Investigation may be Required. Further verification can be done if problems are found.

(5) Exclude Inter-company Transactions. Verify the exclusion of inter-company transactions in cases where combined or consolidated returns have been filed and between a partnership and its partners.

(6) Review Prior Audit Reports. Review prior audit reports and determine whether there are any adjustments that carryforward to the current audit period.

#### 11.04 Sales Factor

##### 11.04(a) *Sales Factor in General*

(1) Income-Producing Nature of sales. The use of the sales or gross receipts factor reflects the income-producing nature of sales.

##### (2) Definition of Sales

i. General Definition of Sales. Section (1)(g) of the UDITPA states: "Sales" means all gross receipts of the taxpayer not allocated under other paragraphs of this article. In other words, receipts which are considered to be business income subject to formulary apportionment are to be included in the sales factor.

ii. All Receipts are Included. Receipts from a trade or business are included in the sales factor. Tangible property manufactured and sold or property purchased and resold is included in the sales factor at the selling price. Selling price means gross sales less returns and allowances.

##### (3) Partnerships

i. A corporate taxpayer's pro-rata share of a unitary partnership's revenues is included in the numerator and denominator of the factor.

ii. This can be obtained from the partnership's federal tax return.

iii. Inter-company transactions between the partnership and the taxpayer partner must be eliminated.

(4) Special Rules – MTC Reg. IV.18.(c)

i. Substantial Amounts from Incidental or Occasional Sales of Fixed Assets. Where substantial amounts of gross receipts arise from an incidental or occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business, exclude such gross receipts from the sales factor. For example, exclude gross receipts from the sale of a factory or plant.

ii. Insubstantial Amounts from Incidental or Occasional Sales of Fixed Assets. Insubstantial amounts of gross receipts arising from incidental or occasional transactions or activities may be excluded from the sales factor unless such exclusion would materially affect the amount of income apportioned to the state. For example, the taxpayer ordinarily may include or exclude from the sales factor gross receipts from such transactions as sales of office furniture and business automobiles.

iii. Income Producing Activity can be Readily Identified. When the income-producing activity in respect to business income from intangible personal property can be readily identified, such income is included in the denominator of the sales factor and, if the income-producing activity occurs in the state, in the numerator of the sales factor as well. For example, usually the income-producing activity can be readily identified in respect to interest income received on deferred payments on sales of tangible property and income from the sale, licensing, or other use of intangible personal property.

iv. When Business Income from Intangible Assets Cannot be Readily Identified. When business income from intangible property cannot be readily attributed to any particular income-producing activity of the taxpayer, such income cannot be assigned to the numerator of the sales factor for any state and is to be excluded from the denominator of the sales factor. For example, where business income in the form of dividends received on stock, royalties received on patents or copyrights, or interest received on bonds, debentures or government securities results from the mere holding of the intangible personal property by the taxpayer, such dividends and interest are to be excluded from the denominator of the sales factor.

11.04(b) *Numerator*

(1) In General. MTC Reg. IV.15.(c) provides the numerator of the sales factor shall include gross receipts attributable to this state and derived by the taxpayer from transactions and activity in the regular

course of its trade or business. All interest income, service charges, carrying charges, or time-price differential charges incidental to such gross receipts shall be included regardless of (1) the place where the accounting records are maintained or (2) the location of the contract or other evidence of indebtedness.

(2) Tangible Personal Property

i. MTC Reg. IV.16.(a). Gross receipts from sales of tangible personal property (except sales to the United States Government) are in this state:

if the property is delivered or shipped to a purchaser within this state regardless of the f.o.b. point or other conditions of sale; or

if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and the taxpayer is not taxable in the state of the purchaser.

ii. Property shall be deemed to be delivered or shipped to a purchaser within this state if the recipient is located in this state, even though the property is ordered from outside this state.

iii. Property is delivered or shipped to a purchaser within this state if the shipment terminates in this state, even though the property is subsequently transferred by the purchaser to another state.

iv. The term “purchaser within this state” shall include the ultimate recipient of the property if the taxpayer in this state, at the designation of the purchaser, delivers to or has the property shipped to the ultimate recipient within this state.

v. When property being shipped by a seller from the state of origin to a consignee in another state is diverted while en route to a purchaser in this state, the sales are in this state.

vi. If the taxpayer is not taxable in the state of the purchaser, the sale is attributed to this state if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state.

vii. If a taxpayer whose salesman operates from an office located in this state makes a sale to a purchaser in another state in which the taxpayer is not taxable and the property is shipped directly by a third party to the purchaser, the following rules apply:

If the taxpayer is taxable in the state from which the third party ships the property, then the sale is in that state.

If the taxpayer is not taxable in the state from which the property is shipped, then the sale is in this state

(3) Rents and Royalties from Personal Property. Rents and royalties pertaining to stationary personal property are assigned to the state in which the property is located.

(4) Royalties from Patents, Copyrights, etc. Royalties from patents, processes and copyrights which are used in fabrication and production are generally assigned to the state in which the fabrication and production takes place.

(5) U.S. Government Sales. U.S. Government Sales will be included in the numerator of the state from which shipment is made

(6) Throwback Sales. Shipments to a state in which the taxpayer is not taxable will be attributable to the state of origin.

(7) Sales other than sales of tangible personal property

i. Cost of Performance Rule. This regulation provides for the inclusion in the numerator of gross receipts from transactions other than sales of tangible personal property (including transactions with the United States Government). Gross receipts are attributed to this state if the income producing activity which gave rise to the receipts is performed wholly within this state. Also, gross receipts are attributed to this state if, with respect to a particular item of income, the income producing activity is performed within and without this state but the greater proportion of the income producing activity is performed in this state, based on costs of performance.

ii. Income Producing Activity Defined. The term “income producing activity” means the act or acts directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit. Such activity does not include transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor. Accordingly, income producing activity includes but is not limited to the following:

The rendering of personal services by employees or the utilization of tangible and intangible property by the taxpayer in performing a service.

The sale, rental, leasing, licensing, or other use of real property.

The rental, leasing, licensing, or other use of tangible personal property.

The sale, licensing or other use of intangible personal property.

iii. **Income Producing Activity—Business Situs.** The income producing activity is deemed performed at the situs of real, tangible, and intangible personal property or the place where personal services are rendered. The situs of real and tangible personal property is the commercial domicile of the taxpayer unless the property has acquired a “business situs” elsewhere. “Business situs” is the place at which intangible personal property is employed as capital, or the place where the property is located, if possession and control of the property is localized in connection with a trade or business so that substantial use or value attaches to the property. This rule shall not apply to the performance of construction contracts.

Example: Taxpayer, a corporation whose principal business activity is the manufacture and sale of hot water heaters pledges bonds in this State as security for the payment of taxes incurred or to be incurred in connection with its business activities in this state. The property has a business situs in this state; therefore, interest income derived from such bonds is attributable to this state.

iv. **Costs of Performance—Defined.** The term “costs of performance” means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer.

v. **Application.** Receipts (other than from sales of tangible personal property) which do not constitute a principal source of business income and which such receipts are included in the denominator of the receipts factor are in this state if:

the income producing activity is performed wholly within this state; or

the income producing activity is performed both in and outside this state and a greater proportion of the income producing

activity is performed in this state than in any other state, based on costs of performance.

(8) Gross Receipts from Rental, Lease, or Licensing the use of or Other use of Tangible Personal Property. Gross receipts from the rental, lease, or licensing the use of or other use of tangible personal property are in this state if the property is located in this state during the entire period of rental, lease, license or other use. If the property is within and without this state during the rental, lease or licensing period, gross receipts attributable to this state shall be measured by the ratio which the time the property was physically present or was used in this state bears to the total time or use of the property everywhere during that period.

(9) Gross receipts for the performance of personal services. Gross receipts for the performance of personal services are attributable to this state to the extent that such services are performed in this state. If services are performed partly within and partly without this state, the gross receipts from the performance of such services shall be attributable to this state based upon the ratio which the time spent in performing the services in this state bears to the total time spent in performing the services everywhere. Time spent in performing services includes the amount of time expended in the performance of a contract or other obligation which gives rise to such gross receipts. Personal service not directly connected with the performance of the contract or other obligation, as for example time expended in negotiating the contract, is excluded from the computations.

(10) Gross receipts from intangible personal property. Gross receipts from intangible personal property shall be attributed to this state based upon the ratio which the total property and payroll factors in this state bears to the total of the property and payroll factors everywhere for the tax period

11.04(c) *Denominator*. The denominator of the sales factor includes all gross receipts derived from transactions and activity in the regular course of the taxpayer's trade or business operations.

11.04(d) *Auditing the Sales Factor*

(1) Obtain the taxpayer's "all-state" workpapers breaking down each type of sale for each of the years under examination.

(2) Compare each type of sale shown on the apportionment workpapers to the Federal 1120.

- (3) Verify that all sales are appropriately assigned.
- (4) Examine treatment of throwback sales.
- (5) Verify the exclusion of nontaxable revenues from the factor.
- (6) Verify the exclusion of intercompany transactions in cases where unitary or consolidated returns have been filed.

## **12. Allocated Income and Deductions**

### 12.01 Non-Business Income

If the auditor determines that non-business income is to be excluded from apportionable income as discussed in Chapter 10, the next step is to determine how much of this income should be allocated to the participating states. This determination will vary based on the type of non-business income.

### 12.02 Allocable Partnership Income

A few participating states provide that partnership income is allocable. The templates for these states detail the computations. The auditor must examine the partnership returns and the partnership's apportionment workpapers in order to audit and compute this income.

### 12.03 Allocated Deductions

Certain participating states allocate certain deductions (e.g., a Federal Income Tax Deductions in Alabama, Missouri and North Dakota and a Dividend Received Deduction in Minnesota and Missouri. The MTC audit schedule templates for these states detail the computations of these deductions.

## 13. Net Operating Losses

### 13.01 Definition of Net Operating Loss

A net operating loss arises when the taxable income in a given year is less than zero. The Internal Revenue Code permits the carryover of net operating losses (NOLs) incurred in one taxable year to offset net income in previous and future years. The NOL deduction allows a taxpayer with an uneven pattern of income to pay an equivalent tax to the tax paid by the taxpayer who earns a similar amount of income ratably over the same period.

### 13.02 Federal Law

IRC Section 172 provides the rules for net operating losses. For federal tax purposes, a taxpayer ordinarily may carry back an NOL for two years and carry it forward for twenty years. Unless a taxpayer elects to waive carryback treatment in favor of carryforward treatment, a taxpayer generally must first carry back the NOL as far as possible with any unabsorbed loss applied to the next succeeding year until the NOL is used up.

### 13.03 State Law

The most common form of state conformity to the federal NOL rules is to allow a state NOL deduction “in the same manner” as the NOL deduction provided under the Code. Whether a federal NOL deduction is allowed for a taxable year is irrelevant to whether a state NOL deduction may be allowed for that year. Most of the states that currently participate in the MTC Audit Program follow this approach.

The existence and amount of a state NOL that is subject to carryover is not in any way tied to the federal NOL. Rather, a state NOL arises if the taxable income for state purposes is less than zero. This state NOL can then be carried over, under rules similar to those applicable to NOLs under the Code, to offset state taxable income in other years.

In most of the participating states, computation of state taxable income generally begins with line 28 of the federal Form 1120—federal taxable income *before* NOL and other special deductions. State addition and subtraction modifications are then made to determine state income or loss for the taxable year. That figure is then multiplied by the apportionment factor to determine the state apportioned loss to which any income allocable to the state is added. Any loss at this point is then a state NOL and may be carried over to other taxable years. If the figure is greater than zero, the taxpayer's state NOLs from other years may be used to offset this amount.

There are some differences in rules in the member states. For instance, some states do not allow NOL carrybacks. All of the member states provide for NOL

carryforwards, although there are differences in the number of years that the NOLs can be carried forward. The auditor must apply the law of each participating state to its NOLs and the MTC audit schedule templates for each state have schedules set up for these computations.

#### 13.04 State level application of separate return limitation year (SRLY) principles for corporations joining in consolidated return at federal level

For federal income tax purposes, a group of affiliated corporations filing a consolidated income tax return may deduct from the group's income the NOL carryover that one of its members sustained in a "separate return year" (i.e., a year in which the corporation filed a separate return). However, there are limitations on the use of the NOL under the separate return limitation year (SRLY) rules set forth in the federal regulations. In general, the NOL is deductible if it was sustained during a year in which the corporation was a member of the affiliated group, and therefore could have joined in a consolidated return, even though it filed a separate return. On the other hand, if the loss was sustained during a year in which the corporation was *not* a member of the affiliated group, and therefore could not have joined in a consolidated return, then the affiliated group may use the NOL in the year's current consolidated return only to the extent that the member contributes taxable income to the affiliated group for the year in question.

#### 13.05 State Tax Treatment of NOL Carryovers Following Changes in Ownership

The Internal Revenue Code imposes certain restrictions on the post-acquisition use of NOLs. Under Section 269, a taxpayer that acquires control of another corporation for the principal purpose of securing the benefit of specified tax attributes, including NOLs, cannot use them. Under Section 382, a corporation's use of its NOLs is restricted if in general more than 50 percent of its stock is acquired by new shareholders. The NOLs are not extinguished, but the income each year against which the NOLs can be applied after the acquisition is limited, in substance, to the use that the loss company could have made of them if the acquisition had not occurred.

Unlike federal law, many state tax statutes do not provide for the transfer of NOL carryovers from one corporation to another in an acquisition. These statutes typically provide that NOLs can be carried forward by a "taxpayer" and may be applied against the taxpayer's income over a specified period of years. But they say nothing about the use of NOLs against the income of any other taxpayer. The courts have had to address the question of the extent to which an acquiring corporation in a merger or other acquisition should be treated as the same "taxpayer" as the target corporation for purposes of these provisions. The courts have been divided on this issue.

### 13.06 State Statutory Provisions Relating to the Transfer of NOLs in Corporate Acquisitions

Many states allow the transfer of NOLs from one corporation to another in certain circumstances in the same manner as the federal tax law allows a transfer of NOLs. Some state statutes expressly adopt Sections 381 and 382 of the Code. Other states adopt Sections 381 and 382 implicitly under their federal state conformity provision because they provide no express exception for Sections 381 and 382. Other states, however, have no provision for the transfer of NOLs in corporate acquisitions. These statutes typically provide that a “taxpayer” may apply NOLs from one year against the income of another year, but provide no mechanism for the transfer of an NOL from one corporation to another in an acquisition, even if the acquisition is a statutory merger or other form of tax-free reorganization.

### 13.07 Audit Procedures for NOLs

The first step in auditing NOLs claimed will be the review of any NOL schedules provided by the taxpayer. Most participating states have instructed the MTC auditors to verify the NOL amounts detailed on these schedules to the actual tax returns for the loss years. The auditor must verify that these NOL figures have been properly adjusted for any amended returns that have been filed. The auditor must also determine that the states’ laws regarding the numbers of years allowed for carrybacks and carryforwards have been properly applied and that the state’s laws relating to the transfer of NOLs in corporate acquisitions and carryovers following changes of ownership have been properly applied. For combined return states the auditor must verify the validity of the filing method in the year of the loss being carried forward. The auditor must also recompute the NOLs to determine that any separate return limitations are properly computed and, for those states that apply intrastate apportionment, that the NOLs are tracked by company. The MTC audit schedule templates have schedules set up to make these computations.

## **14. Computation of Proposed Tax Changes**

14.01 Review the tax computations for the individual states to determine that:

14.01(a) The proper tax rate has been applied. (Pay particular attention to surtax rates and rate changes from one year to another.)

14.01(b) Taxes previously assessed are properly reflected.

14.01(c) All tax credits have been properly recognized.

When tax computations for individual entities included in a combined report are required, intra-state apportionment will be necessary.

## 15. Narrative

As part of every MTC audit, a narrative report will be included with the audit recommendations. A narrative report is a written synopsis/summary of the audit recommendations to the participating jurisdictions.

Unlike the audit workpapers, the narrative reports are not to be submitted to the taxpayer. The completed narrative report is the property of each participating jurisdiction. If a taxpayer requests a copy of the narrative report from the MTC auditor, the auditor should advise the taxpayer to contact a participating jurisdiction to request a copy.

Complete Narrative Reports in the sequence below:

General Narrative – This portion of the narrative will be common for the participating jurisdictions. The auditor may modify the General Narrative for particular circumstances in a state.

State Specific Portion – See Section 15.04 for the details of the make-up of the state specific narrative. This portion will vary from state to state.

### 15.01 General Narrative

#### *Scope of Audit.*

Include the following statement in each narrative:

“The Multistate Tax Commission has audited the books and records of [Insert Taxpayer’s Name] and its subsidiaries and affiliates to determine whether the income tax liability as reported to your state is accurate. In addition, we have tested the operations of said Taxpayer corporation(s) to determine whether or not those operations are unitary in nature. We have conducted the audit in accordance with uniform audit procedures for all states in accordance with the Multistate Tax Commission directives.”

Detail any variations from these procedures which have been followed.

15.01(a) *Lead Auditor and Commission Office.* Include the MTC Office, address, telephone number and the e-mail of the MTC auditor.

15.01(b) *Audit Years.* In block form, note the years audited for each state.

15.01(c) *Reporting Entities.* In block form, detail the parent company, the subsidiaries and affiliates (if they have filed separate returns), and the

federal and state identification numbers. If the listing is voluminous, provide a listing as part of an exhibit to the audit report.

15.01(d) *Earliest Statute*. For each state, list the date of the earliest expiration of waivers. Indicate whether the S.O.L. dates are the normal statutes or whether state waivers were secured.

15.01(e) *Federal Audit Status*. Enter the status of the federal audit for the audit years and the dates of the existing federal waivers. If the Federal Audit was completed, indicate whether the taxpayer filed the federal RARs with the states or whether the Federal RARs are incorporated into the MTC recommendations.

#### 15.02 General Narrative – Taxpayer’s General Business Operations

15.02(a) *General History*. Give a brief history of the company from original date of incorporation to date. The length should be a minimum of one paragraph, a maximum of one page.

15.02(b) *Business Type and General Activity*. Detail the products (in general) of the corporation and its subsidiaries and affiliates, both domestic and worldwide. This information can be obtained from the Annual Reports and/or SEC 10-Ks and should be limited to a few paragraphs.

15.02(c) *Parent, Subsidiaries, and Affiliates*. For each major corporate entity and partnership, especially those corporations that file in many of the states, briefly describe their business activities. Exhibit a complete listing of Domestic and Foreign affiliates, which can be from Federal Forms 851 and/or 7004 for U. S. affiliates and Forms 5471 for foreign affiliates.

15.02(d) *Mergers, Acquisitions, and Divestitures*. If the parent acquired, merged with or changed or disposed of part or all of its interests in any subsidiary or affiliate during the years under examination, include details. If no such activities took place, say so.

#### 15.03 Unitary Nature of Operations

The unitary nature of the operations of the taxpayer may require substantial efforts to establish evidence within the course of the audit program. The results of those efforts should be stated here with reference to supporting documentation in Chapter 7 of this manual.

If the taxpayer has elected to execute an agreement letter on unity and on business or non-business income, reference it in the narrative, specifically mentioning:

15.03(a) Circumstances of the offer of the agreement letter;

15.03(b) Comments and agreement of the MTC Legal Staff

Include a copy of the agreement letter as an exhibit and state that the agreement letter is the reason why no further evidence was sought to substantiate unity or to ascertain the distinction of business or non-business income.

Although unity usually is not an issue for separate entity states, the unitary information provided can be useful in subsequent years (i.e. a sale of a unitary operation reported as nonbusiness for a separate entity state in the audit period or subsequent years).

#### 15.04 State Specific Portion

**NOTE: The following items should be specifically detailed as they apply to each state participating in the audit. Prepare a separate statement for each state.**

15.04(a) *Reporting Entities; Method of Reporting.* In a separate paragraph for each reporting entity: identify the entity and its Federal and State I.D. numbers; indicate the method which the taxpayer used in filing its return in this state (e.g. worldwide combination, domestic combination, lines of business combination, consolidated filing, separate entity or separate accounting) and indicate whether it has treated any income as nonbusiness income on its returns.

15.04 (b) *No Change Recommendations* – List the filers that were examined resulting in a “no tax change” recommendation and explain the reasons for the auditor’s recommendation in Section 15.12 (Auditor’s Recommendations) of the narrative report.

15.04 (c) *Surveyed Returns* – List the filers that are being surveyed and explain the reasons for the auditor’s decision to survey in Section 15.12 (Auditor’s Recommendations) of the narrative report.

15.04 (d) *Nonfiling Entities*

List corporations that have not filed in a particular state that nexus will be recommended.

#### 15.04 (e) *Nexus Recommendations*

In the event that the primary authorization for a given state was for a nexus investigation, narrate the procedures used to make the determination that nexus does or does not exist for each entity in question. Refer to Index 2200 materials. State the taxpayer's position for each entity.

#### 15.05 *In-State Activities - Operations in State of [Participating State Name]*

List the companies and affiliates doing business in the state and briefly describe their instate operations. Also, describe the instate operations of the non filing entities where nexus will be recommended. Cross reference to Sections 1504 (d) and (e).

For each entity where tax change is being recommended, the following format should be followed for each filer. For separate entity states, there can be several entities where tax changes will be recommended. For unitary states where 1 unitary group combination is recommended, the format will only have to be listed once.

#### 15.06 Income

Describe how the income before state adjustments was determined, referring to the applicable schedule. Comment on any major differences between audited and reported income.

#### 15.07 State Adjustments

Refer to the State Adjustment Summary Index (see Schedule 1100 for each state). Highlight any State Adjustments with which the taxpayer is not in agreement.

#### 15.08 Business or Non-Business Income

The narrative in this area is most crucial to the audit; the Index 1300 Schedules should be complete and detailed. Make appropriate comments to support recommendations.

In the event that the taxpayer has elected to execute an agreement letter on business income, reference it in the narrative and refer to the letter in the Schedules, and include a copy of the letter as an exhibit if the letter is in reference only to business or non-business income. If the agreement encompasses unitary combined filing as well, it will already have been included as an Index 2100 exhibit (See paragraph Section 15.03).

### 15.09 Apportionment Formula

Write a brief narrative of the apportionment formula methodology as presented in Index 1400. Each of the three factors, both numerators and denominators, should be discussed. Verification procedures and recommended changes should be annotated in the narrative. Comment on any major differences between audited and reported factors.

### 15.10 Allocated Income and Deductions

Discuss particular items of income and deductions that are typically allocated to states after the apportionment of income and are not part of apportionable income. Some common allocated items are nonbusiness income/losses, partnership income/losses for some states, dividend deductions and net operating losses.

### 15.11 Tax Credits

Discuss whether the examination of state specific tax credits was within the scope of the MTC audit and the verification procedures utilized.

### 15.12 Taxpayer's Position

The auditor should state the taxpayer's comments and position after the taxpayer has reviewed the audit workpapers. Emphasize agreement, non-agreement and expressed protest areas, directing detailed comment to non-agreement and protest areas.

### 15.13 Auditor's Recommendations

Summarize the audit findings. Schedule (in block form) recommended additional tax/refund by year. Also, complete and attach to the narrative (Tax Change Analysis) to summarize the major reasons for tax changes.

Auditor should also annotate returns examined that are accepted as filed and detail the rationale for accepting the returns as filed. Indicate that the audit workpapers were provided to the taxpayer and are included in the audit report to the states.

## 16. Assembly of Audit Report

16.01 The assembly of each state's package, top to bottom, is to be in the following sequence:

### INDEX

#### NARRATIVE

AUDIT SCHEDULE INDEX	0700	MTC Exhibit 0700A
COMPUTATION OF INCOME & TAX	0800	_____
ANALYSIS OF TAX CHANGE	0900	_____
INCOME	1000	_____
STATE ADJUSTMENT SUMMARY	1100	_____
STATE ADJUSTMENT DETAIL	1200	_____
NON-BUSINESS INCOME	1300	_____
APPORTIONMENT FORMULA	1400	Summary #1400 Detail (1410, 1420, etc.)
PROPERTY	1500	_____
PAYROLL	1600	_____
RECEIPTS	1700	_____
ALLOCATED INCOME/DEDUCTIONS	1800	_____
TAX COMPUTATIONS/TAX CREDITS	1900	_____
TAXES PREVIOUSLY PAID	2000	_____
UNITARY	2100	_____
NEXUS	2200	If applicable
EXHIBITS, if applicable		
AUTHORIZATION (300-C)		

WAIVERS, STATE RETURNS, OTHER

- (1) Pages 1-4 of the federal consolidated return
- (2) By-company spreadsheets of income and expenses
- (3) By-company spreadsheets of balance sheets

See MTC Exhibit 0700-A for the Scheduling sequence for each participating state.

## **17. Review & Transmittal of Completed Audit**

### 17.01 Internal Audit Review

17.01(a) A review of the completed audit (much of which may have been done during the course of the audit) is to be made by the Field Audit Supervisor. This review has the following objectives:

- (1) To determine the appropriateness of the audit conclusions;
- (2) To make sure that the audit has been conducted in a professional and accurate manner;
- (3) To control the efficiency of the audit program and to identify timing delays and other significant factors which affected the audit; and
- (4) To ensure that the audit has been performed in compliance with MTC Procedures, that the report is complete, and that it is of high quality.

17.01(b) The overall objective of the review is to ensure that the documentation, exhibits, narrative and schedules are sufficient to support the findings in the event of a taxpayer protest or of derivative litigation. Pay particular attention to those areas as to which the taxpayer has indicated that he/she does not agree or that a protest will be filed.

17.01(c) The reviewer should begin with the final recommendations and work backward to each supporting document and narrative. The reviewer must pay particular attention to those areas of the narrative which pertain to unity, state adjustments, business vs. non business income and the recommendations; and should make sure that the auditor has attached applicable taxpayer source documents as exhibits or has identified them for further reference.

17.01(d) The reviewer and the Auditor in Charge will cooperate to make any additions, deletions or modifications which will improve the quality of the audit.

### 17.02 Taxpayer Review.

At the conclusion of the audit review, the Auditor in Charge will submit a complete hardcopy set of audit schedules to the taxpayer along with a cover letter explaining the audit adjustments. The narrative and electronic copies of the audit are not to be sent to the taxpayer in accordance with the Commission's policy. The Auditor in Charge will make any changes, corrections, or adjustments in the workpapers which he or

she may consider desirable on the basis of requests or information submitted by the taxpayer, provided that the reviewer agrees that they should be made.

#### 17.03 Distribution to States.

The auditor with support from the audit program administrative assistant will arrange for the preparation, for each state, of a report which contains complete recommendations plus supporting materials, including copies of all supporting documents; and will then transmit the report to the state. This distribution will include a hard and electronic record of the schedules and narrative.

#### 17.04 Retention of Master Copy of Audit Report.

The MTC audit offices will retain an electronic Master Copy of the audit report. Hard copies of the report and supporting documents will be destroyed in accordance with the commission's policy.

#### 17.05 Responsibility of the States.

Upon receipt of the audit report, a state will be responsible to review the audit and the recommendations and to issue whatever assessments it deems to be appropriate. It should at that time prepare and then send to the MTC's Audit Division headquarters office an Audit Evaluation (Exhibit 2400 C). The state will issue any final assessments or refunds to the company. The state will be responsible thenceforth for obtaining any waivers of applicable statutes of limitations.

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