



MEMORANDUM

To: Robynn Wilson, Chairperson,
Income and Franchise Tax Uniformity Subcommittee

From: Bruce Fort, MTC Counsel

Date: August 26, 2011

Re: Study Suggestions for Possible Amendments to the Model Allocation and Apportionment Regulations IV.3.(a), (b) and (c) Applicable to the "Taxable in Another State" Provisions in Multistate Tax Compact Article IV.3.

In July of 2011 the Income and Franchise Tax Subcommittee voted to proceed with a project to study possible amendments to the model regulations addressing the "taxable in another state" provision of the Multistate Tax Compact, Article IV.3. A memorandum outlining the general topic dated July 14, 2011 was briefly discussed by the Subcommittee; this memorandum is intended as a follow-up to the July 14 document.

Compact Article IV.3 provides in its entirety:

For purposes of allocation and apportionment of income under this Article, a taxpayer is taxable in another State if (1) in that State he 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, or (2) that State has *jurisdiction* to subject the taxpayer to a net income tax regardless of whether, in fact, the State does or does not do so.

The subcommittee's July 2011 discussion focused on the application of Article IV.3 to the "throw-back" rule for sourcing receipts from sales of tangible personal property under Article IV.16.(b), which provides that receipts should be sourced to the state from which a shipment originated if "the taxpayer is not taxable in the State of the purchaser." The throw-back provision of UDITPA has taken on more significance as states move to single-sales factor or heavily-weighted sales factor formulas.

The memo previously provided to the subcommittee addressed two issues: (1) whether the model regulations should be amended to clarify the instances in which a taxpayer will be considered "subject to" net income taxes, franchise taxes or corporate

stock taxes; and (2) which state's laws should control the determination of whether a taxpayer is "taxable" in the destination state. The prior memorandum suggested that the subcommittee should focus its attention on the first issue since the states are generally uniform in their income tax nexus positions and application of P.L. 86-272 to particular fact-patterns. The July 14 memorandum finally summarized some recent cases in which the "subject to tax" provisions of UDITPA were applied with varying results.

The following is a list of issues and topics that the subcommittee may wish to consider further, either with the benefit of a drafting or study group or through direction to staff.

1. Should Existing Regulations be Amended to Ensure that Payment of Minimal Franchise Tax or Capital Stock Taxes Does Not Create "No-Where" Income?

Currently, some 26 states have a sales-throw-back provision, and the majority of states have apportionment formulas heavily weighted towards the sales factor. In addition, some sixteen states have some form of franchise or capital stock tax which may be payable even though a taxpayer in those states is protected from income tax liability under P.L. 86-272. Currently, the model regulations provide three criteria to prevent a taxpayer from avoiding throw-back from the payment of a relatively minor amount of franchise or capital stock tax: (a) the voluntary payment of either of these tax types does not qualify as being "subject to" taxation; (b) where the taxpayer's activities are insufficient to create income tax nexus and the franchise or capital stock tax "bears no relationship to the extent of business activity" conducted in the state, and (c) the franchise or capital stock tax must "be considered basically revenue raising rather than regulatory measures." Regulation IV.3.(b)(1) & (2).

Appended to this memorandum is a CCH "Smart-Chart" describing franchise and capital stock taxes in the states. The nature of these taxes and the amount of revenue generated by them varies considerably among the states, especially since some states have imposed both floors and caps on the amount of tax due. Two states, Connecticut and Massachusetts, also use these taxes in the determination of overall income tax liabilities. It may be difficult under existing regulatory guidance to determine in all instances whether any of these taxes qualifies as "basically revenue-raising" or "basically regulatory" in nature. The subcommittee may wish to consider:

- (a) What factors which might be identified in determining whether being "subject to" these taxes precludes throw-back?
 1. Does the state also have an income tax?
 2. What percentage of state revenues is raised by such taxes?
 3. What other characteristics of "regulatory" taxes might be identified?
 4. Is the tax apportioned based on business presence or is it a flat tax?
 5. Is the tax dedicated to particular programs?
 6. Who collects and administers the tax?

- (b) How should the regulations treat statutory minimums and “alternative minimum tax” liabilities in the context of income, franchise and bank stock taxes?
- (c) Could the payment of franchise or stock taxes be subject to a proportionality test related to the amount of sales throw-back at issue or some other criteria?
- (d) Should the subcommittee consider a regulation classifying other tax types, such as Washington’s B&O tax, as qualifying franchise taxes?
- (e) Should the subcommittee consider creation of a 51-state “throw-back matrix” to provide concrete guidance to taxpayers and auditors on when sales from various origins to various destinations should be thrown back if certain taxes are paid?

(2) Should Model Regulation IV.3.(b)(1) be Amended to Specify that a Taxpayer Can Only Claim to Have Been “Subject to” the Destination State’s Income Tax by Demonstrating it Filed Income Tax Returns in the Destination State?

Section (b)(1) of the model regulation provides that a taxpayer must provide evidence to support the claim of taxability upon request, and that such request for proof can include tax returns and evidence of payment. Failure to provide returns or payment information “may be taken into account” in determining whether the taxpayer was “subject to tax.”

Some states have gone further than the model regulation and provided that failure to provide returns is fatal to the claim of being subject to the destination state’s tax (assuming the destination state actually imposes that type of tax).¹ The previous memorandum described two cases in which taxpayers successfully argued they were subject to other states’ income or franchise/stock value taxes even though no returns were filed in those states. See *Knauf Fiber Glass GMBH, Inc. v. Alabama Dept. of Revenue, Corp.* Docket No. 05-970, 2006 WL 3587185 Ala. Admin. Hrg. (11/30/05), <http://216.226.178.107/aljrules/05-970-2.pdf>.; *Colgate Palmolive Company v. Commissioner of Revenue*, Mass. Appellate Tax Board No.C255116 (4/23/03), 2003 WL 1787975, <http://www.mass.gov/?pageID=afsearchlanding&sid=Eoaf&q=colgate-palmolive&collectorName=EOANFxDECISIONSx>. See also, *Goldberg v. State Tax Commission*, 618 S.W.2d 635, 642 (Mo. 1981)(failure to file return immaterial to issue of whether taxpayer subject to tax in destination state); *Indiana D.O.R. v. Continental Steel Corp.*, 399 N.E.2d 754, 758 (Ind. App. 1980)(same).

¹ See *Dover Corp. v. Dept. of Revenue*, 648 N.E.2d 1089 (Ill. 1995) (failure to file returns precludes argument that taxpayer subject to tax in destination state); *In re Appeal of Galvatech, Inc.*, 2006 WL 29531 (Cal. SBE 2006)(failure to demonstrate that taxes were paid precluded claim that taxpayer was subject to tax in foreign jurisdictions)

The subcommittee may wish to consider whether the administrative concerns for taxpayers in providing copies of returns filed in other states is outweighed by the certainty and consistency which would be achieved by adoption of a policy based on return requirements.

APPENDIX A

(CCH “SmartChart” Describing Current Franchise Tax and Stock Value Taxes)

State	2011 Tax Year	Comments	Citation	CCH ¶
Alabama	Business privilege tax imposed at following graduated rates based on taxable net worth: \$0-\$0.999: \$0.25 per \$1,000 net worth \$1-\$199,999: \$1.00 per \$1,000 net worth \$200,000-\$499,999: \$1.25 per \$1,000 \$500,000-\$2,499,999: \$1.50 per \$1,000		Alabama Code §40-14A-22	5-101, 5-301, 5-401
Alaska	No entity-level tax measured by net worth/capital value.			
Arizona	No entity-level tax measured by net worth/capital value.			
Arkansas	0.3% of ordinary stock corporation's outstanding capital stock apportioned to state, but not less than minimum tax of \$150.		Ark. Code. Ann. §26-54-102, Ark. Code. Ann. §26-54-104(a)(6)	5-101, 5-301, 5-401
California	No entity-level tax measured by net worth/capital value.			
Colorado	No entity-level tax measured by net worth/capital value.			
Connecticut	Capital stock tax is part of overall corporation business tax calculation that is based on the greater of the net income basis, the capital stock basis, or the minimum tax.	Rate of tax, including minimum tax, is covered in charts under the topic Tax Rates and AMT-Corporation Income Tax.		
Delaware	<u>Authorized shares method</u> <ul style="list-style-type: none"> • 5,000 shares or less: \$75 • 5,001-10,000 shares: \$150 • 10,000 or more shares: \$150 plus \$75 for each additional 10,000 shares or fractional shares <u>Assumed capital value method</u> <ul style="list-style-type: none"> • \$500,000 or less of assumed no-par capital: \$75 • \$500,001-\$1,000,000 of assumed no-par capital: \$150 • \$1,000,000 or more of assumed no-par capital: \$150 plus \$75 of each additional \$1,000,000 or fraction of assumed no-par capital 	Maximum tax: \$180,000 (\$165,000 for tax years prior to 2009). Minimum tax: \$75 for authorized shares method; \$350 for assumed capital value method (\$75 for tax years prior to 2010).	Del. Code Ann. tit. 8, §501, Del. Code Ann. tit. 8, §503	6-050

	Assumed no-par capital is determined by multiplying number of authorized shares of capital stock without par value by \$100. Tax for assumed par value capital is \$350 (\$250 in tax years prior to 2009) for each \$1,000,000, or fractional part, in excess of \$1,000,000. If assumed par value capital is less than \$1,000,000, the tax is calculated by dividing the assumed par value capital by \$1,000,000 then multiplying that result by \$350. The tax liability of a corporation with both par-value and no-par-value shares is the sum of each category.			
District of Columbia	No entity-level tax measured by net worth/capital value.			
Florida	No entity-level tax measured by net worth/capital value.			
Georgia	Graduated tax from minimum of \$10 to maximum of \$5,000 based on net worth.		Ga. Code Ann. §48-13-72 , Ga. Code Ann. §48-13-73	5-105 , 5-305 , 5-405
Hawaii	No entity-level tax measured by net worth/capital value.			
Idaho	No entity-level tax measured by net worth/capital value.			
Illinois	Initial tax is \$1.50 per \$1,000 of paid in capital; annual tax is \$1.00 per \$1,000 of paid in capital.		805 ILCS 5/15.35 , 805 ILCS 5/15.45 , 805 ILCS 15.65 , 805 ILCS 15.75	5-020 , 5-200
Indiana	No entity-level tax measured by net worth/capital value.			
Iowa	No entity-level tax measured by net worth/capital value.			
Kansas	Franchise tax is repealed for tax years after 2010.		Kan. Stat. Ann. §79-5401(g)(1)	5-101 , 5-401
Kentucky	No entity-level tax measured by net worth/capital value.	For tax years prior to 2006, license tax imposed on greater of \$30 or \$2.10 per \$1,000 of capital employed in the state.		
Louisiana	\$1.50 per \$1,000 of first \$300,000 and \$3.00 per \$1,000 of amount which exceeds \$300,000 of corporation's issued and outstanding capital stock, surplus, undivided profits, and borrowed capital. \$10 minimum tax.			5-110 , 5-301 , 5-405
Maine	No entity-level tax measured by net worth/capital value.			
Maryland	No entity-level tax measured by net worth/capital value.			
Massachusetts	Taxable net worth or tangible property is part of overall excise tax calculation that is based on the greater of the net worth or tangible property basis, the income tax basis, or the minimum tax.	Rate of tax, including minimum tax, is covered in charts under the topic Tax Rates and AMT-Corporation Income Tax.	Mass. Gen. Laws ch. 63, §32 , Mass. Gen. Laws ch. 63, §39	

Michigan	No entity-level tax measured by net worth/capital value.			
Minnesota	No entity-level tax measured by net worth/capital value.			
Mississippi	\$2.50 per \$1,000 of capital used, invested, or employed, but not less than the minimum tax of \$25.		Miss. Code. Ann. §27-13-5(1), Miss. Code. Ann. §27-13-7(1)	5-101, 5-301, 5-401
Missouri	Until 2012, 1/30 of 1% (\$30 per \$1,000) of the corporation's outstanding shares and surplus if the outstanding shares and surplus exceed \$10 million.	For 2012, 1/37 of 1%. For 2013, 1/50 of 1%. For 2014, 1/75 of 1%. For 2015, 1/150 of 1%. For 2016 and thereafter, no tax imposed. Also, for taxable years beginning after 2010, liabilities capped at amount of each corporation's tax liability for the 2010 tax year. If a corporation had no corporate franchise tax liability in 2010 because the corporation was not doing business in the state or did not exist, the corporation's tax liability would be limited to the amount of its tax liability for its first full taxable year of existence.	Mo. Rev. Stat. §147.010(1)	6-050
Montana	No entity-level tax measured by net worth/capital value.			
Nebraska	Graduated tax from minimum of \$26 to maximum of \$23,990 based on paid-up capital stock.	Imposed biennially each even-numbered calendar year.	Neb. Rev. Stat. §21-303	5-105, 5-205, 5-210
New Hampshire	No entity-level tax measured by net worth/capital value.			
New Jersey	No entity-level tax measured by net worth/capital value.			
New Mexico	\$50 per tax year.		N.M. Stat. Ann. §7-2A-3(B), N.M. Stat. Ann. §7-2A-5.1, FYI-350	5-105, 5-110
New York	Capital value tax is part of overall franchise tax calculation that is based on the greater of the net income base, the alternative minimum tax base, the capital tax base, or the minimum tax.	Rate of tax, including minimum tax, is covered in charts under the topic Tax Rates and AMT-Corporation Income Tax.		
North Carolina	\$1.50 per \$1,000 of greatest of capital stock, surplus and undivided profits; actual investment in tangible property; or 55% of appraised value of real/tangible property. Minimum tax of \$35.		N.C. Gen. Stat. §105-122, N.C. Admin. Code §17:05B.0104	5-105, 5-305

North Dakota	No entity-level tax measured by net worth/capital value.			
Ohio	Franchise tax phased out for most taxpayers and replaced by the Commercial Activities Tax (CAT).	For tax years 2006, 2007, 2008, 2009, and 2010 franchise taxpayers pay 80%, 60%, 40%, 20%, and 0%, respectively, of franchise tax after nonrefundable credits that would otherwise have been due without phase-out.	Ohio R.C. §5733.01	10-380
Oklahoma	\$1.25 for each \$1,000 of capital used, invested, or employed in the state, but no less than \$250 or more than \$20,000.	The franchise tax is suspended for taxable periods beginning July 1, 2010, and ending before July 1, 2013. For 2010-2012 tax years, franchise tax is replaced by business activities tax (BAT) equal to franchise tax paid or required to be paid in 2010, or minimum annual tax of \$25. BAT is scheduled to expire after 2012 tax year, unless it is enacted into law, in which case the BAT will be imposed at rate of 1% on net revenue allocated to the state.	Okla. Stat. tit. 68, §1203, Okla. Stat. tit. 68, §1204, Okla. Stat. tit. 68, §1205, Okla. Stat. tit. 68, §1212.1, Okla. Stat. tit. 68, §1218	5-101, 5-301, 5-401
Oregon	No entity-level tax measured by net worth/capital value.			
Pennsylvania	2.89 mills of the value of capital stock computed as the product of one-half times the sum of the average book income capitalized at the rate of 9.5% plus 75% of net worth minus \$160,000. 1.89 mills for tax year after 2011.	3.89 mills for tax year prior to 2008. 4.89 mills for tax year prior to 2007. 5.99 mills for tax year prior to 2006.	72 P.S. §7601, 72 P.S. §7602	5-250, 5-305, 6-025
Rhode Island	Capital stock tax is part of overall business corporation tax calculation that is based on the greater of the apportioned net income basis, the capital stock basis, or the minimum tax.	Rate of tax, including minimum tax, is covered in charts under the topic Tax Rates and AMT-Corporation Income Tax.	R.I. Gen. Laws §44-12-1	
South Carolina	1 mill on the total capital and paid-in surplus plus \$15, but no less than \$25.		S.C. Code Ann. §12-20-50	5-101, 5-301, 5-401
Tennessee	\$0.25 for each \$100 of net worth or actual value of tangible property, whichever is greater, but no less than \$100.		Tenn. Code Ann. §67-4-2105, Tenn. Code Ann. §67-4-2106, Tenn. Code Ann. §67-4-2119	5-101, 5-301, 5-401
Texas	Revised franchise tax, otherwise known as margin tax, on total revenues.	Rate of tax is covered in charts under the topic Tax Rates and AMT-Corporation Income Tax.	Tex. Tax Code Ann. §171.001(a)(1), Tex. Tax Code Ann. §171.0011, Tex. Tax Code Ann. §171.002, Tex. Tax	10-380

			Code Ann. §171.0021	
Utah	No entity-level tax measured by net worth/capital value.			
Vermont	No entity-level tax measured by net worth/capital value.			
Virginia	No entity-level tax measured by net worth/capital value.			
West Virginia	34¢ per \$100 of taxable capital (.34% or 0.0034) with a minimum tax of \$50.	<p>Future years Rate is reduced in subsequent tax years prior to repeal of tax beginning after 2014, as follows:</p> <ul style="list-style-type: none"> • 27¢ per \$100 of taxable capital (.27% or 0.0027) for tax years after 2011; • 21¢ per \$100 of taxable capital (.21% or 0.0021) for tax years after 2012; and • 10¢ per \$100 of taxable capital (.10% or 0.0010) for tax years after 2013. <p>Minimum tax remains unchanged at \$50.</p> <p>Prior years</p> <ul style="list-style-type: none"> • 41¢ per \$100 of taxable capital (.41% or 0.0041) with a minimum tax of \$50 for 2010; • 48¢ per \$100 of taxable capital (.48% or 0.0048) with a minimum tax of \$50 for 2009; • 55¢ per \$100 of taxable capital (.55% or 0.0055) with a minimum tax of \$50 for 2007 and 2008; and • 70¢ per \$100 of taxable capital (.70% or 0.0070) with a minimum tax of \$50 prior to 2007. 	W. Va. Code §11-23-6	5-215

APPENDIX B

MTC Regulations IV.3.(a), (b) and (c)

•• **Reg. IV.3.(a). Taxable in Another State: In General.** Under Article IV.2. the taxpayer is subject to the allocation and apportionment provisions of Article IV if it has income from business activity that is taxable both within and without this state. A taxpayer's income from business activity is taxable without this state if the taxpayer, by reason of such business activity (i.e., the transactions and activity occurring in the regular course of a particular trade or business), is taxable in another state within the meaning of Article IV.3.

(1)Applicable tests. A taxpayer is taxable within another state if it meets either one of two tests: (1) By reason of business activity in another state, the taxpayer is subject to one of the types of taxes specified in Article IV.3.(1), namely: 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; or (2) By reason of such business activity, another state has jurisdiction to subject the taxpayer to a net income tax, regardless of whether or not the state imposes such a tax on the taxpayer.

(2)Producing nonbusiness income. A taxpayer is not taxable in another state with respect to a particular trade or business merely because the taxpayer conducts activities in that other state pertaining to the production of nonbusiness income or business activities relating to a separate trade or business.

•• **Reg. IV.3.(b).Taxable in Another State: When a Corporation Is "Subject to" a Tax under Article IV.3.(1).**

(1) A taxpayer is "subject to" one of the taxes specified in Article IV.3.(1) if it carries on business activities in a state and the state imposes such a tax thereon. Any taxpayer which asserts that it is subject to one of the taxes specified in Article IV.3.(1) in another state shall furnish to the [tax administrator] of this state upon his/her request evidence to support that assertion. The [tax administrator] of this state may request that such evidence include proof that the taxpayer has filed the requisite tax return in the other state and has paid any taxes imposed under the law of the other state; the taxpayer's failure to produce such proof may be taken into account in determining whether the taxpayer in fact is subject to one of the taxes specified in Article IV.3.(1) in the other state.

Voluntary tax payment. If the taxpayer voluntarily files and pays one or more of such taxes when not required to do so by the laws of that state or pays a minimal fee for qualification, organization or for the privilege of doing business in that state, but (A) does not actually engage in business activity in that state, or (B) does actually engage in some business activity not sufficient for nexus and the minimum tax bears no relationship to the taxpayer's business activity within such state, the taxpayer is not "subject to" one of the taxes specified within the meaning of Article

IV.3.(1).

Example: State A has a corporation franchise tax measured by net income for the privilege of doing business in that state. Corporation X files a return and pays the \$50 minimum tax, although it carries on no business activity in State A. Corporation X is not taxable in State A.

(2) The concept of taxability in another state is based upon the premise that every state in which the taxpayer is engaged in business activity may impose an income tax even though every state does not do so. In states which do not, other types of taxes may be imposed as a substitute for an income tax. Therefore, only those taxes enumerated in Article IV.3.(1) which may be considered as basically revenue raising rather than regulatory measures shall be considered in determining whether the taxpayer is "subject to" one of the taxes specified in Article IV.3.(1) in another state.

Example (i): State A requires all nonresident corporations which qualify or register in State A to pay to the Secretary of State an annual license fee or tax for the privilege of doing business in the state regardless of whether the privilege is in fact exercised. The amount paid is determined according to the total authorized capital stock of the corporation; the rates are progressively higher by bracketed amounts. The statute sets a minimum fee of \$50 and a maximum fee of \$500. Failure to pay the tax bars a corporation from utilizing the state courts for enforcement of its rights. State A also imposes a corporation income tax. Nonresident Corporation X is qualified in State A and pays the required fee to the Secretary of State but does not carry on any business activity in State A (although it may utilize the courts of State A). Corporation X is not "taxable" in State A.

Example (ii): Same facts as Example (i) except that Corporation X is subject to and pays the corporation income tax. Payment is prima facie evidence that Corporation X is "subject to" the net income tax of State A and is "taxable" in State A.

Example (iii): State B requires all nonresident corporations qualified or registered in State B to pay to the Secretary of State an annual permit fee or tax for doing business in the state. The base of the fee or tax is the sum of (1) outstanding capital stock, and (2) surplus and undivided profits. The fee or tax base attributable to State B is determined by a three factor apportionment formula. Nonresident Corporation X which operates a plant in State B, pays the required fee or tax to the Secretary of State. Corporation X is "taxable" in State B.

Example (iv): State A has a corporation franchise tax measured by net income for the privilege of doing business in that state. Corporation X files a return based upon its business activity in the state but the amount of computed liability is less than the minimum tax. Corporation X pays the minimum tax. Corporation X is subject to State A's corporation franchise tax.

••• Reg. IV.3.(c). Taxable in Another State: When a State Has Jurisdiction to Subject a Taxpayer to a Net Income Tax. The second test, that of Article IV.3.(2), applies if the taxpayer's business activity is sufficient to give the state jurisdiction to impose a net income tax by reason of such business activity under the Constitution and statutes of the United States. Jurisdiction to tax is not present where the state is prohibited from imposing the tax by reason of the provisions of Public Law 86-272, 15 U.S.C.A. §§ 381-385. In the case of any "state" as defined in Article IV.1.(h), other than a state of the United States or political subdivision thereof, the determination of whether the "state" has jurisdiction to subject the taxpayer to a net income tax shall be made as though the jurisdictional standards applicable to a state of the United States applied in that "state." If jurisdiction is otherwise present, that "state" is not considered as being without jurisdiction by reason of the provisions of a treaty between that "state" and the United States.

Example: Corporation X is actively engaged in manufacturing farm equipment in State A and in foreign country B. Both State A and foreign country B impose a net income tax but foreign country B exempts corporations engaged in manufacturing farm equipment. Corporation X is subject to the jurisdiction of State A and foreign country B.