



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**

### ***01. MTC Joint Audit Program.***

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

### ***02. Income & Franchise Tax Audit Manual.***

This Income & Franchise Tax Audit Manual (“manual”) sets forth the procedures that MTC 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.

### ***03. Changes in Substantive Law.***

The information provided in the manual 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.

### ***04. Purpose of the Manual.***

The sole purpose of this manual is to provide general guidance to the MTC’s Joint Audit Program staff for the performance of joint audits on behalf of program states. It is the nature of tax audits that particular audit procedures are necessitated by particular provisions of the tax law (e.g., verifying that the filing group meets the legal requirements for inclusion/exclusion). While the manual may generally reference typical state law requirements in describing certain procedures, the manual is not intended to replace applicable law or specific guidance of the states on substantive issues, nor can it be cited for that purpose. The manual does not constitute a uniform law or regulation under the Multistate Tax Compact Art. VII, but it has been approved by the MTC Audit Committee. The MTC has made this manual available to the public in order to provide general information on the joint audit process.

### ***05. Suggestions and Corrections.***

Any suggestions or corrections are welcomed and should be communicated to the MTC’s Joint Audit Program Director (“audit director”).

## **2. Definitions**

### ***01. Introduction.***

This section lists terms and general definitions use extensively in multistate audits. In many cases, the terms are also 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.

### ***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.

### ***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. (See also Interstate Apportionment, below.)

### ***04. Apportionment Formula.***

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

### ***05. Business Activity.***

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

### ***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.

### ***07. Combined Reporting.***

A method of measuring the tax liability of a corporation or group of corporations. An apportionment formula is applied to the combined unitary income of the corporation and its affiliates.

## Section 2 - Definitions

### ***08. Combined Report or Combined Return.***

A combined report or combined return computes the business income and apportionment factor(s) of a unitary group of corporations.

### ***09. Commercial Domicile.***

The principal place from which the trade or business of the taxpayer is directed or managed.

### ***10. Compensation.***

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

### ***11. Consolidated Returns.***

Under federal law, a filing method which allows certain related corporations (with at least 80 percent common ownership) the convenience of filing a single tax return and paying one tax amount. (See also Sec. 8.02(c) and the discussion of nexus consolidated filing.)

### ***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.

### ***13. Foreign Corporation.***

For federal purposes, and in the context of this manual, a corporation organized in a foreign country. (In other contexts, it may also refer to a domestic corporation organized under the laws of another state.)

### ***14. Intrastate Apportionment.***

The process of determining the combined income apportioned and allocated to the state and to each member of a combined group, or for the group as a whole. 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, state minimum tax, graduated rates, and tax credits.

### ***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.

### ***16. Nonbusiness (non-apportionable) income.***

Generally, nonbusiness income is all income which is not business income (e.g., the income does not arise from the taxpayer's regular business activities).

## Section 2 - Definitions

### ***17. PL 86-272.***

Public Law 86-272 (15 USC § 381) is a federal law 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, orders for which are accepted outside the state and delivery of property is made from outside the state. A combined filing state may follow the Finnigan or the Joyce approach to applying P.L. 86-272.

### ***18. Sales (Receipts).***

All gross receipts of the taxpayer subject to apportionment.

### ***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, "State" may also include any foreign country or political subdivision thereof.

### ***20. Statute of limitations.***

State law that sets the time limits within which an action must be taken. States have statutes of limitations that set deadlines for the valid assessment of taxes by the tax authority and claiming a tax refund by a taxpayer.

### ***21. Taxable in another state.***

For purposes of apportionment and allocation of income, the general rule is that the taxpayer is taxable in another state if either of two conditions exist: (1) a taxpayer is taxable in another state if 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 in that state; or (2) 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.

### ***22. Taxpayer.***

A taxpayer is any person subject to the tax imposed under each state's tax laws. In this manual, the term "taxpayer" generally refers to a corporation or group of corporations subject to tax in particular states. In addition, depending on the context, the term "taxpayer" may refer to the person or persons designated by the taxpayer to handle the audit and respond to the auditor.

### ***23. Throwback sales (receipts).***

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 may be assigned to the state from which the goods were shipped (the state of origin). Sales subject to this exception to the general rule

## Section 2 - Definitions

of assigning sales to the destination state are referred to as throwback sales. As with P.L. 86-272, a combined filing state may follow the Finnigan or Joyce approach with respect to determining when sales are thrown back.

### ***24. UDITPA.***

The Uniform Division of Income for Tax Purposes Act (UDITPA), also Article IV of the Multistate Tax Compact prior to the amendment of the Compact in 2015. UDITPA was drafted by the National Conference of Commissioners on Uniform State Laws (now the Uniform Laws Commission) in 1957 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. NOTE: The MTC has recommended amendments to UDITPA (which is part of the MTC's Compact, Art. IV.) Those changes mainly affect the computation of the sales (receipts) factor for sales other than sales of tangible personal property.

### ***25. Unitary Business.***

Generally, a corporation or group of business entities or parts of entities engaged in business activities which constitute a single trade or business.

### ***26. Waiver.***

An agreement between a taxpayer and a state to extend the statute of limitations.

### **3. Pre-Audit Procedures**

#### ***01. Introduction.***

This section explains: (1) how the MTC's auditors should prepare to conduct an audit under the Joint Audit Program; (2) how an audit is assigned and the time frames for responses from the states in the Joint Audit Program; (3) what sources auditors should use to investigate the taxpayers' activities, and (4) how auditors determines the audit period, develop an audit plan, and organize the audit file.

#### ***02. Audit assignments.***

The MTC will keep an inventory of selected audits and will report to the Audit Committee when those audits are assigned to an auditor.

#### ***03. Request for audit authorizations from the states and determination of audit period.***

Following a vote by the Audit Committee to initiate an audit of a taxpayer, the supervisor or an administrative assistant will send audit authorization requests to the states in the Joint Audit Program agreeing to participate in the income tax audit along with an income tax checklist. The audit authorization will also include the audit period as determined by the audit supervisor. The supervisor 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 at least one year before the earliest statute of limitations expires.

#### ***04. Authorization deadline for the states.***

The states should return the signed authorizations within 45 days. The lead auditor will verify that that the states correctly completed the authorization request. At the expiration of the authorization deadline, the lead auditor will inform the supervisor of the names of the states that have indicated their intention to participate. The supervisor or an administrative assistant 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 audit director.

#### ***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 the annual report and SEC Forms 10-K or 20-F. The auditor should make use of the internet to explore the taxpayer's website and other information regarding the company.

***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.

***07. Workload review and audit activity update form.***

The auditor will set up a workload review and audit activity form which will be used throughout the audit. These forms will be updated monthly and given to the supervisor at the end of each month. This will enable the supervisor to keep abreast of any activity on the audit.

***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 MTC's file back-up guidelines and follow them.

***09. Scope of the audit.***

The auditor will review all information received. The auditor will look for any material issues that may be present. The issues may include, but are not limited to, such items as the composition of the filing group, exclusion of expenses related to non-unitary or non-business income, calculation of the sales (receipts) factor, nexus issues, apportionment problems, business/nonbusiness items, compliance with add-back statutes, transactions involving intangible property royalties or similar fees, inter-company transactions and expenses, including management or procurement fees, interest expense calculations, net operating and capital loss carryforward or carryback deduction claims, treatment of GILTI, Subpart F and inclusion of foreign source income where appropriate, transactions with related parties such as captive insurance companies, and any transactions or activities suggesting tax avoidance.

***10. Audit plan.***

The auditor will establish an initial audit plan and get approval of that plan from their supervisor. The plan should be discussed with the taxpayer during the initial audit appointment. The audit plan may include the order in which information will be reviewed and may also include the order in which state audits are completed. The auditor has the flexibility to determine how to proceed on the audit. The auditor may also decide to start with specific audit issues. The initial audit plan may be adjusted during the audit if so desired and the auditor may want to make the taxpayer aware of the plan and any adjustments. The auditor must be flexible in working with the taxpayer to adjust the audit plan, if needed.

## 4. Statutes of Limitation & Waivers

### *01. Timely Completion of Audit; Extension of Statute of Limitations.*

As indicated in section 3.09, an auditor should endeavor to begin the audit field work at least one year before the earliest statute of limitations expires.

Once the audit has begun, the auditor must allow time for the taxpayer to provide needed documents and information. After the auditor has obtained that information and has prepared the audit findings, the taxpayer will generally be given time to review those findings prior to their submission to the state. As a result of that review, adjustments may be requested and will have to be considered by the auditor. Also, once the audit report is submitted to the state, the state will need time to review the findings, and may also need time to request adjustments before the audit is completed and any assessment is issued.

An auditor must make sure the audit can be completed and any assessment issued before the expiration of statutes of limitations, including any waivers of those statutes of limitations. If needed, the auditor should request waivers from the taxpayer a minimum of nine months before the earliest expiring statute or any waiver applicable to the audit.

An exception to this nine-month rule may be made where the taxpayer has provided all the requested information needed for the auditor to complete the audit findings and allow sufficient time for both the taxpayer and the states to review those findings before the statute or current waiver expires.

The auditor will attempt to minimize the number of times a waiver has to be requested. And, because a taxpayer is not required to sign any waiver of the statute of limitations, the auditor must address this issue as part of the initial discussions or at the initial audit appointment and determine if the taxpayer is willing to sign a waiver, if needed.

### *02. Statute of Limitations Control Procedure.*

The following control procedure will apply:

- (a) *Discuss Waiver Policy with Taxpayer.* As part of the initial discussions or at the initial audit appointment, the auditor will provide the taxpayer with a copy of the MTC's Waiver Policy and ask for the taxpayer to sign it. The auditor will also discuss the taxpayer's own policy for signing waivers of statutes of limitations, if any, with the taxpayer.
- (b) *Responsibility of Auditor in Charge.* Each auditor is responsible for ensuring that no statute of limitation expires without the auditor forewarning the affected states. The auditor will warn the affected states with sufficient time remaining before the expiration of any statute of limitations to enable those states to take necessary

- steps to, including expedited review of audit recommendations or issuance of provisional assessments if appropriate.
- (c) *Requesting a Waiver.* As noted above, the auditor should make every effort to complete the audit before the expiration of the current state statute of limitations. Consequently, auditors should endeavor to begin audit field work at least one year prior to the expiration of the earliest state statute of limitations. Whenever a state's statute of limitations is due to expire in nine months or less, the auditor will request a waiver from the taxpayer. The only exception is where the auditor has all the information necessary to complete the audit findings and is confident that those findings can be finished in time to provide an opportunity for the taxpayer and the state to review those findings.
  - (d) *Form of Waiver of Statute of Limitations.* The auditor should prepare one MTC Waiver Form (Exhibit D) for all states in the audit except for states where a separate waiver form is required for each taxpayer that filed returns in the state.
  - (e) *Sufficiency of Extension.* To allow both the taxpayer and participating states enough time to review the MTC audit recommendations, the auditor should establish an expiration date at least nine months after the estimated completion date of the audit.
  - (f) *Completeness of Waivers.* The auditor should ensure that a waiver is completed for all participating states with respect to the taxpayer and all affiliates, subsidiaries, and parent companies of the taxpayer which are included in the audit. The form of the waiver shall contain a statement that the signature on the waiver is prima facie evidence that the individual signing the waiver is authorized to sign on behalf of the taxpayer.
  - (g) *Preparation of Statute Control Checklist.* The auditor will prepare the statute control checklist identifying all the returns that are being audited. When a waiver is signed, the waiver expiration dates as per the waiver will be entered. This control checklist will be updated as new waivers are signed. See Exhibit B.
  - (h) *Supervisor Review of Waivers.* The supervisor will determine whether to review waivers and the auditor's statute control checklist is required prior to sending 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 supervisor must maintain copies of these waivers.

**03. Where Taxpayer Declines to Sign Waivers of Statutes of Limitations.**

If a taxpayer declines to sign a waiver, generally within 30 days of the request, or only agrees to sign a waiver that does not provide enough time for the MTC to timely and

## Section 5 – Working with Taxpayers – Conducting the Audit

accurately complete the audit, the auditor will immediately consult with the supervisor, audit director, and general counsel. Based on these discussions the audit may be completed to the best of the auditor's ability based on available information. Alternatively, to facilitate the timely completion of the audit, the MTC or a participating state may issue a subpoena to compel production of documents and information necessary for the joint audit. See Sec. 5.

## **5. Working with Taxpayers – Conducting the Audit**

### ***01. Introduction.***

NOTE: In this section, the term “taxpayer” may refer both to the business being audited as well as to the taxpayer contact.

The MTC serves as a representative of the member states participating in the Joint Audit Program. The MTC Joint Audit Program must conduct its audits in a professional and timely manner. The audit staff endeavors to adhere to the state’s laws and regulations. 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 states’ request to have the MTC conduct the audit on their behalf.
- Extend professional courtesy to the MTC audit staff.
- Supply the information requested to conduct the audit in a timely manner.
- Sign reasonable waiver requests in accordance with the MTC Waiver Policy – Exhibit C.
- Notify the MTC auditor of any contact the taxpayer has with the states pertaining to the audit while the audit is being conducted.
- Provide the MTC auditor with any amended returns filed while the MTC audit is being conducted.
- Inform the MTC of any IRS audits completed during the audit.

### ***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 conversations with the taxpayer will

## Section 5 – Working with Taxpayers – Conducting the Audit

involve audit-related scheduling and logistical questions, at first, and then more detailed questions. The following matters will be discussed (see also Sec. 5.05 below):

- (a) The auditor will obtain the appropriate point of contact for the audit. The auditor should work with the person or persons designated by the taxpayer to handle the audit, unless the auditor believes that this person is unable or unwilling to respond to reasonable requests. In that case, the auditor should consult with the supervisor as to whether to contact some other taxpayer representative.
- (b) The auditor will inform the taxpayer that member states have authorized the MTC to conduct an audit.
- (c) The auditor will inform the taxpayer which states are participating in the joint audit and the states that may potentially join.
- (d) *Scheduling Field Work.* The auditor will discuss audit appointment dates with the taxpayer. If the auditor cannot secure a timely appointment, then the auditor will discuss the MTC Waiver Policy (See Exhibit C) with the taxpayer and attempt to secure waivers. See Section 5.05 below. Once dates have been agreed upon, the assigned auditor will record those dates in the workload review given to his or her supervisor each month, and in their own personal calendar. These dates will be identified in the engagement letter written for the taxpayer (See Exhibit A).
- (e) *General Information on Joint Audits.* The assigned auditor can describe the basic operations of the MTC and the Joint Audit Program and direct the taxpayer to the MTC Website for more information.
- (f) *Plan for Initial Meeting.* The assigned auditor will inform the taxpayer that an audit plan will be discussed at the initial meeting.

### **03. Procedures for a Non-Responsive Taxpayer.**

If a taxpayer does not respond in a timely or acceptable manner to repeated attempts to make contact (either by letter, phone, or email), the assigned auditor will send a certified letter to the taxpayer giving the taxpayer seven days 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.

### **04. Engagement Letter to Taxpayer.**

After the initial telephone conversation with the taxpayer, the auditor will send the taxpayer an engagement letter (See Exhibit A). The engagement letter can be modified to fit the situation with the individual taxpayer. Copies of signed audit authorizations and the audit brochure are also typically sent with the engagement letter. An initial document request may be included or attached to the engagement letter.

**05. Initial Meeting.**

The following should be discussed at the initial meeting with the taxpayer (if not already discussed):

- (a) The MTC Waiver Policy and the taxpayer's waiver policy.
- (b) The audit plan.
- (c) The form, timing, and general expectations for information & document requests (IDRs).
- (d) The MTC Information and Document Request (IDR) Enforcement Compliance Procedure (see 5.06(b)).
- (e) Steps of the audit process generally.
- (f) MTC personnel that can be involved in the audit (auditor(s), supervisor, audit director, and legal counsel).
- (g) Taxpayer personnel including personnel or representatives outside of tax department (attorneys, accountants, or consultants) who will be communicating with the MTC auditor throughout the audit. Power of Attorney forms will be required from outside representatives in order for the auditor to speak with those representatives without the taxpayer present.
- (h) The taxpayer policy relating to corresponding via email and copies of documents.
- (i) Safeguarding taxpayer's documents at the taxpayer's location.
- (j) Secure Communications. It is the general practice of the MTC to communicate with audited taxpayers by phone and email, unless the taxpayer requests otherwise. Communications by email will generally be done in a way that will secure the information being communicated to avoid any disclosure of confidential information. If the taxpayer requests or agrees to communicate through email without additional security, the auditor should obtain a written waiver of this policy from the taxpayer and keep this as a record of this request or agreement in the audit files.
- (k) The MTC does not issue assessments, refund requests, or any other adjustments to taxpayer liability. The MTC only issues recommendations to participating states as to assessments, refunds, and other adjustments to taxpayer liability as requested by states. Protests and any resolution of audit results will be handled directly by each individual state participating in the audit.

**06. Conducting the Audit.**

MTC auditors should adhere to the following procedures while conducting audits.

## Section 5 – Working with Taxpayers – Conducting the Audit

(a) *Information & Document Requests (IDRs) – Response Dates.* The MTC has authority to request information pursuant to the Multistate Tax Compact in compact member states, and as an authorized representative of non-compact member states. The MTC will seek such information and documents as are necessary to complete an accurate and appropriately verified income tax audit in the participating states.

- (1) Major issues should be addressed in separate IDRs or, if multiple issues are addressed in a single IDR, the major issues should be addressed in separate sections of the IDR to the extent possible. IDRs should be numbered sequentially. All IDRs should include a response date on the face of the document.
- (2) Response dates will generally be 30 days from the day the IDR is sent, although additional time may be granted where the IDR is extensive or the taxpayer has indicated that more time will be needed and this does not pose a problem for completing the audit in a timely fashion. See section 06.(b)(1) below.
  - a. If the taxpayer representative requests an extended response date, the auditor should make reasonable accommodations, consistent with the auditor's extension authority (see below) given the available time under existing statutes of limitations or waivers. The auditor will not agree to extend the response date if doing so would jeopardize timely completion of the audit.
  - b. If the auditor determines that an IDR response date should be less than 30 days from the date the IDR is issued, the auditor will notify the taxpayer on the face of the IDR of the response date and by email or phone.
- (3) The auditor should communicate with the taxpayer's representative prior to the IDR response date to determine the status of the taxpayer's responses to the IDR. The auditor should also communicate with the taxpayer when the response to an IDR is complete and sufficient.

(b) *IDR Compliance Enforcement Procedure.*

It is important for the auditor and the taxpayer to establish communications on IDRs so that the auditor is aware of any problems or issues the taxpayer may have in responding to IDRs. Even where there is sufficient time to complete the audit, an auditor should follow up on IDRs where the taxpayer has failed to provide information by the deadline.

## Section 5 – Working with Taxpayers – Conducting the Audit

(1) *Taxpayer Refusal to Provide Information.* If at any point during the audit, the taxpayer states that they are not willing to provide information for any reason, the auditor should attempt to confirm this in writing with the taxpayer and promptly contact their supervisor, audit director, and general counsel to make them aware of the taxpayer's refusal.

(2) *Extension Authority.*

a. In general, the auditor may grant an extension from the original IDR response date before the Enforcement Process begins. That extension will be no more than 30 days, unless the taxpayer has signed a waiver extending the statute of limitations so that there will be sufficient time to complete the audit, and the auditor obtains approval from the supervisor, audit director, or general counsel. If the taxpayer's representative requests a longer or an additional extension, the auditor should discuss with the supervisor.

b. *Taxpayer Failure to Respond.* If a taxpayer fails to respond to an IDR by the response date, or fails to respond to particular requests, the auditor should contact the taxpayer's representative as soon as possible to determine the cause of the taxpayer's failure to respond and decide whether an extension should be granted.

c. *Taxpayer Provides Insufficient or Inaccurate Response.* If the auditor determines that the taxpayer's response to an IDR is insufficient or inaccurate, the auditor should contact the taxpayer's representative as soon as possible to explain why the auditor believes the information is insufficient or inaccurate and to determine the reason and decide whether an extension should be granted to provide additional information.

(3) *IDR Enforcement Process – Timing*

a. The auditor should monitor whether information is being received in an appropriate time to complete the audit and allow appropriate review within the statutes of limitations or waiver deadlines. In some cases where the taxpayer is willing to sign waivers extending the assessment/refund statute of limitations, it may be possible to grant the taxpayer additional extensions to provide necessary information. But the taxpayer's willingness to sign waivers, alone, does not permit indefinitely delaying the completion of the audit. Extensions should be based on the taxpayer's commitment to

comply by the extended deadline or on unexpected events that are beyond the taxpayer's control.

- b. If a taxpayer provides additional information after receiving an extension for providing an incomplete response, the auditor should promptly review the additional information to determine whether the requirements of the IDR have been satisfied. If the auditor determines that the taxpayer's response is still incomplete, the enforcement process begins on the date that the auditor communicates to the taxpayer that the information is incomplete.
- c. If an IDR extension has been granted, but the taxpayer fails to provide a response by the extended due date, the enforcement process generally begins on the extended response date. If the taxpayer does not respond by the IDR due date or provides an insufficient response, and no extension is granted for additional time to respond, the IDR enforcement process begins on the date the auditor communicates to the taxpayer's representative that an extension has not been granted.

(4) No later than 8 months prior to the expiration of the earliest statute of limitations, the auditor should notify their supervisor, audit director, and general counsel about any taxpayer noncompliance. At this point, the MTC may determine that the IDR enforcement process should begin. *IDR Enforcement Process*

- a. Once the IDR enforcement process is triggered, the auditor should immediately notify their supervisor, the audit director, and/or the general counsel and together they will prepare a plan for how to protect the interests of the states and ensure the timely completion of the audit within the statutes of limitation. The plan may include some or all of the following steps depending on the overall stage of the audit and specific facts applicable to the audit.
- b. After consulting with the supervisor, the audit director, and the general counsel, and unless instructed otherwise, the auditor will send the taxpayer a Delinquency Notice, which will identify the information previously requested which has not yet been provided and will set a timeframe with deadlines for when that information must be provided to avoid the issuance of a Demand Letter.
- c. If the taxpayer fails to produce the information requested in the Delinquency Notice within by the deadline established in that notice, the auditor should notify their supervisor, the audit director,

and the general counsel to discuss whether a formal Demand Letter should be sent.

- d. If a decision is made to issue a formal Demand Letter, the auditor will send taxpayer the Demand Letter requiring production of the previously requested documents by a deadline or deadlines that will enable the audit to be completed timely.
- e. If the taxpayer fails to produce the information requested in the Demand Letter within the timeframe established in the Demand Letter, the MTC legal staff and/or one of the states participating in the audit may commence a legal process to compel the production of records, including the issuance of an administrative subpoena to compel production of documents containing the requested information. The auditor, supervisor, director, and legal staff will work together through the legal process.

***07. Complex/Significant Issues.***

When a complex or particularly significant issue arises, the auditor should —

- (a) Encourage the taxpayer to provide a statement that supports its position.
- (b) Inform the supervisor and the state liaison, if necessary, to determine the direction the state wishes to take regarding that issue.

***08. Provide Taxpayer with Preliminary Schedules.***

The auditor should provide the taxpayer with preliminary audit schedules. The auditor should also allow the taxpayer time to review and respond to the preliminary audit schedules. The execution of a waiver may be required to allow sufficient time for taxpayer review.

***09. Concluding the Audit.***

- (a) The auditor should make necessary adjustments to the preliminary schedules.
- (b) If time permits, the auditor should allow the taxpayer an opportunity to provide a written response to the positions taken in the audit and to have that response included in the audit report.
- (c) The auditor should offer the taxpayer a closing conference. If the taxpayer declines, the auditor should ensure that all recommendations are conveyed and explained to the taxpayer. The auditor should seek to obtain the taxpayer's position regarding the recommendations and should note those positions in the audit report as appropriate.

## Section 5 – Working with Taxpayers – Conducting the Audit

- (d) Auditors must direct taxpayers who request audit workpapers, narratives, and similar materials to the relevant state tax agency. This is in accordance with Article VII, paragraph 6, of the Multistate Tax Compact (Interstate Audits), which states in relevant part: “Information obtained by any audit . . . shall be confidential and available only for tax purposes to party States, their subdivisions or the United States. Availability of information shall be in accordance with the laws of the States or subdivisions on whose account the Commission performs the audit and only through the appropriate agencies or officers of such States or subdivisions.”
- (e) The auditor will inform the taxpayer that assessments, actions on refunds, adjustments to liability, protests, and similar official actions will be handled directly by each state; the MTC only recommends actions to the states based upon its audit findings.
- (f) MTC audit findings are subject to the review and approval of the state for which they are prepared. The auditor may assist the states during the protest process at their request and may communicate with taxpayers following submission of an audit recommendation only with the state’s permission.

## 6. Nexus

### *01. Introduction.*

Nexus refers to the connection between a state and the person, activity, or property within a state sufficient to allow the state to impose its tax. Once a taxpayer has established sufficient nexus, it may be subject to tax by that state.

New auditors will be expected to participate in one or more of the MTC's nexus training programs and courses as soon as practical. The auditor will receive nexus training materials and should refer to them when investigating nexus issues for income tax purposes.

### *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 tax returns and financial statements to determine if there are any affiliates that have not filed in those states as separate entities, or as member of a combined or consolidated filing group. For combined filing states using the Joyce methodology, the auditor should determine whether the affiliate has in-state sales that were excluded from the sale factor numerator for that state.

For any non-filing affiliates, the auditor should endeavor to understand the affiliates' 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 (receipts) of affiliates to determine whether there are sufficient activities in a particular participating state to warrant further 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 taxpayer 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 (receipts) factor rules will need to be carefully considered in order to determine whether nexus within a particular state will have a significant tax effect. Without factor representation to assign income to a particular state, the establishment of nexus may not result in any more than the minimum tax.

### *03. Use of MTC Nexus Questionnaire.*

Initially, the auditor may wish to 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 E). Alternatively, the auditor may design a customized questionnaire for the particular audit.

- (a) **Follow-up Investigation.** After receiving the completed MTC Nexus Questionnaire, the auditor should compare the responses to the questionnaire with information previously obtained regarding the affiliate’s business activity within the state. To verify the accuracy of the responses, the auditor may, if necessary, seek additional information from the taxpayer and others. In the context of an investigation into whether an affiliate is immune from income taxation under P.L. 86-272, such additional investigation may include, for example: Review of procedural and instructional manuals for sales representatives and supervisors
- 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 affiliates.
- (b) *Document Requests for Nexus Audits.* While not an all-inclusive list, the following documents may be requested while conducting a nexus audit (note that the first three items pertain to any income tax audits):
- (1) Annual Report & 10-K. This information will give significant information regarding the operations of the company and most major operating affiliates.
  - (2) Federal Consolidated 1120 Return. This information will give information concerning affiliates in the corporate group with 80% or more common ownership and control, together with some minimal information regarding the business activity of each of the affiliates. The affiliates will be found on MTC Audit Schedule 851. Note that certain affiliates including some insurance companies, REITs, RICs and foreign affiliates will not be included on the consolidated return. In addition, partnerships operating within the state will not be listed on the return.
  - (3) State Apportionment Factors. This information, usually requested as a “51 state spreadsheet,” should provide 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 Sales Personnel. This information may describe the activities and perhaps sales territories for sales personnel. Close inspection should be made to see if duties of salespeople go beyond the protection of Public Law 86-272.

- (5) Expense Reports for Sales Staff. Expense reports are very important to discover what the sales staff are actually doing. It is important to get the description of their daily activities when obtaining the expense reports.
  - (6) Warranty and Extended Warranty Contracts. It is important to determine how warranty and extended 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 and determine if the independent contractor creates nexus for the company.
  - (8) Wholesaler and Retailer Agreements with Manufacturers and Distributors. Many out of state manufacturers and distributors rely on agreements (sometimes called incentive agreements) to address issues such as returns, excess inventory, product placement and displays, customer relations, trademark use and displays, signage, uniforms, promotional activities and warranty work. These agreements may indicate the taxpayer has exceeded P.L. 86-272 protections through the activities of these representatives.
  - (9) Company Policy or Procedure Manuals. These are important documents to discover how the company operates.
  - (10) Delivery and Back-hauling Records. These records will help determine if products and shipping containers are delivered or back-hauled by company-owned vehicles, which may create nexus in a state.
  - (11) In House Publications or Newsletters. Often these documents may contain information that may be helpful in determining nexus.
  - (12) Financial Audit Consolidating Workpapers. The company may be required to provide for potential state tax liabilities. These are often detailed in the Tax Provision Account. The companies are often reluctant to release this information.
- (c) *Determination of Nexus.* After completing the nexus investigation, the auditor should contact his or her supervisor 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 may include consultation with the MTC's legal

staff.

If needed, the auditor or legal staff should discuss the findings with the applicable state(s) to obtain their feedback regarding whether the taxpayer would be considered to have nexus based on that state’s laws, statutes, regulations and policies.

- (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.

#### **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 that are approved and filled from outside the state (15 U.S.C. §381). NOTE: the immunity granted under P.L. 86-272 only applies to taxes based on or measured by net income. Thus, most franchise taxes and gross receipts taxes are not covered by the statute.

The immunity provided by Public Law 86-272 is expressly limited to interstate commerce. No such immunity, therefore, applies with respect to foreign commerce but some states apply P.L. 86-272 when determining whether a taxpayer is “subject to tax” in a foreign country.

For sellers who are not protected by P.L. 86-272 (e.g., because their sales are not sales of tangible personal property), the due process and commerce clauses 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. States may have their own statutory standards limiting their imposition of income taxes.

NOTE: The Commission has adopted a Statement of Information Concerning Practices of the Multistate Tax Commission and Signatory States Under P.L. 86-272. Auditors should reference that statement for the most current position of the MTC and adopting states on the application of P.L. 86-272. (That Statement is available on the MTC website under the Uniformity tab, and the Adopted Uniformity Recommendations page.) The Statement includes the following policy and legal guidelines:

- (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.

- (b) *General Limitations on P.L. 86-272 Protection.* 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.
- (c) *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 —
    - a. Repair shop;
    - b. Parts department;
    - c. Purchasing office;
    - d. Employment office;
    - e. Warehouse;
    - f. Meeting place for directors, officers, or employees;
    - g. Stock of goods;
    - h. Telephone answering service;
    - i. Mobile stores, e.g. trucks with driver salespeople; or
    - j. 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.
- (d) *Activities Protected by P.L. 86-272.* The following in-state activities are protected by P.L. 86-272, which means 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 salespeople;
  - (4) Forwarding of inquiries and complaints to the home office;
  - (5) Incidental and minor advertising, e.g., notice in a newspaper that a salesperson 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.
- (e) *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.
  - (4) 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 to the taxing jurisdiction of the state.
- (f) *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.
- (1) 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.”
  - (2) 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.
  - (3) 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.

***05. Economic Presence Nexus.***

The U.S. Supreme Court has long held that a state may constitutionally impose an income tax on 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 MTC'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 nexus through economic presence exists with the state for income tax purposes. (For example, see the MTC's Factor Presence Nexus Standard.) Other states assert economic presence nexus based on the existence of specific types of activity that occur within the state regardless of the amount.

***06. Nexus through an Agency or Representative Relationship***

Activities performed within a state may establish nexus even if the activities are performed by an agent or representative of the taxpayer, rather than the taxpayer itself. Whether the agent or representative also performs activities for other principals may not be relevant (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, and in particular whether the taxpayer has engaged in such activities on a systematic basis intended to exploit the taxing state's market, regardless of whether those activities are performed directly by the taxpayer or by an agent or representative on the taxpayer's behalf. In addition, having personnel or property in the state on a permanent basis, even if that property or those employees are not furthering the market for the taxpayer's good or services, may be sufficient to establish nexus for income tax purposes.

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 corporation entities and partnerships will often act as agents or representatives for other affiliates engaged in the same unitary business.

## 7. Unitary Investigation

### *01. Applying the Unitary Business Principle through Combination*

- (a) *Preliminary Unitary Consideration.* In states that require or allow taxpayers to file on a unitary combined basis, the audit may involve an investigation of which affiliates or operations are part of the unitary business. The unitary business principle has been developed over the years and has been accepted by the U.S. Supreme Court. Many states have codified a definition of a unitary business based on Supreme Court precedent. The MTC has adopted a model definition of what constitutes a unitary business in its *General Allocation and Apportionment Regulation*, also incorporated into its model combined filing statutes. A unitary business generally always involves common ownership or control.
- (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, an auditor 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 or return may be required to accurately capture the amount of income earned by a particular legal entity operating within the state. A majority of states now require combined returns or reports; even in separate-entity reporting states, a combined return may be required in certain circumstances.
  - (2) *The Net Income of the Unitary Business* — After an auditor has ascertained the contours of the unitary business, the auditor must then determine the apportionable 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. See the Computation of Income manual section of for further detail.
  - (3) *The Expenses Related to the Non-Apportionable Net Income* — Expenses that were not related to the generation of apportionable net income must be deducted in determining the amount of net income from the unitary business. See the Computation of Income manual section for further detail.

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- (4) **The Formulary Percentage of the Unitary Business** — The property, payroll, and sales (receipts) associated with the production of the apportionable 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 (or included in the combined return) for both numerator and denominator purposes. The resulting apportionment percentage is then applied to the apportionable net income. See Section 7, Apportionment, for further detail.
- (c) *The Nature and Purpose of a Combined Report or Return.* A state may require the filing of a combined report or a combined return. A combined report is generally 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 or combined return 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 some states, the individual members of the group are assessed, whereas in other states the group is assessed as a single taxpayer. 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.
- (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.
- (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

## Section 7 – Unitary Investigation

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, between the members of the affiliated group, there are transfers of value 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).

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

- (1) 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 functional integration and economies of scale. For example,

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commonly owned or separately incorporated grocery stores will usually be engaged in a unitary trade or business.

- (2) 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.
- (3) 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 policy for each corporation's primary business activities and when central offices perform such functions as accounting, financing, advertising, researching, or purchasing. Truly independent corporations would perform such functions themselves.

### ***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 should consider in conducting a unitary investigation.

- (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.
- (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.
- (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 taxpayer's 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.
- (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.

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- (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 may request from the taxpayer a letter conceding unity.
- (f) Prepare test checks for combination for each participating state in order to assess the significance of the unitary issue.
- (g) Discuss the unitary issue with the taxpayer and determine what its position is.
- (h) If the taxpayer did not file combined returns in a state but agrees that it is unitary and agrees that a unitary investigation will not be conducted, the taxpayer will be required to sign a letter conceding unity.
- (i) Issue a general Unitary Questionnaire (Exhibit F) or a unitary questionnaire tailored to the taxpayer. In states that have unique requirements a questionnaire specific to that state should be issued in addition to the general questionnaire.
- (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.
- (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.

### ***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 applies 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.

- (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.
- (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

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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.

- (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.
- (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 chair, 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.
- (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 principal 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,

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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.
- (f) *Intercompany Sales.* Sales may 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. Also indicate the general category or categories of products or services involved in these sales if the parent produces several different types of products or services.
  - (2) For the parent as to its purchases from subsidiaries, the name of each selling subsidiary, the separate amount and type of products or services 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 or services 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 or service sold to it, and the selling subsidiary's total sales to all buyers.
  - (5) Obtain copies of intercompany sales, licensing and services agreements, and transfer pricing studies, if any, relating to those agreements.

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### (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.

### (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 (h)(1).
- (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 and/or do not involve royalty payments.
- (4) Obtain copies of related party licensing agreements.

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### (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 (h)(1) 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.

### (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 and/or were not involved in each of the programs or schools identified in item (3) above.

### (k) *Computer and Information Technology Services*

- (1) Obtain a list of each location at which the parent corporation maintains computer facilities and/or information technology staff. Explain which

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general type of usage (such as production data, sales data, accounting data, etc.) is managed 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 and/or information technology staff. 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-tie in with the parent's facilities.

- (1) *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.

### (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.

### (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.

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- (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.

### (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.

### (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.

### (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,

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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.

### (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.

### (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 and/or of any of its subsidiaries.

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- (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.

### (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.

#### ***04. Lines of Business***

The activities of many large corporate businesses are very complex. The organizational structures of these 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. For example, combining (a) a management company receiving royalties from affiliates with (b) a regional company selling tangible personal property at retail could result in a dilution of the income generated by the management company in certain states. Other examples where combination could result in distortion of income in some states include combining a retail line with a financial line, combining a manufacturing line with a retail credit line, a railroad with an oil company, an airline with a hotel chain, or a tobacco distributorship with a restaurant chain.

In such instances, it may be necessary to apply different apportionment formulas to different business lines, employ separate accounting, or make other adjustments to ensure that the taxpayer's business presence and profits are fairly reflected in each of the states in which the taxpayer operates. 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. The holding company may invest temporarily excess operating funds for the two lines on a short-term basis pending an operational 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, what is known as “asset” unity will be present, and combination with the subsidiaries will be appropriate, but so-called “enterprise” or “operational” unity may not be present. While some early court decisions held that combination was not appropriate, the weight of authority from more recent cases recognize that combination is required in such circumstances. 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 or more

unitary businesses in which the conglomerate engages, the second being that of managing and controlling its diversified subsidiaries.

***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.

- (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 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.

- (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.
- (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
- (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 ensure 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.
- (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,

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management comment letters, financial statements by entity, SEC, Regulatory and Government filings, and tax return workpapers.

- (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 search of our subscription services, 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 taken: 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.
- (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.
- (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.
- (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.
- (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.
- (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

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

- (l) *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.)
- (m) *Taxpayer Website.* The internet is a valuable tool in gathering information, particularly, the taxpayer's website is valuable source of information about its operations. Such as lines of business, services the taxpayer offers to their customers, etc.

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

### *01. Starting Point Used for Computing State Taxable Income*

- (a) Most states conform to the federal law with regard to basic definitions of gross income. Some states have “rolling” conformity, meaning they conform to the IRC unless the legislature decouples from some provision. Some states have “static” conformity, meaning they conform to the IRC at a particular date.
- (b) Most states start with Federal Taxable Income from the federal Form 1120. This will be either Line 28 or Line 30. Line 28 of Form 1120 is federal taxable income before net operating losses and special deductions; line 30 is federal taxable income after net operating losses and the federal special deduction for dividends.
- (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.

### *02. Reporting Methods*

- (a) *Separate Company (Single Entity) Returns.* Each company that has nexus in the state is required to file an income tax return.
- (b) *Combined Reporting.* The members of an entire group of corporations engaged in a unitary business may be required or allowed to file a combined report to compute the combined income of all members of the group. The reporting companies may be only the companies that have nexus in the state or may be all companies in the unitary group.
  - (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 greater than 50% as opposed to the 80% requirement to file a federal consolidated return.
  - (3) Types of Combination —
    - a. *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.

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- b. 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 including domestic and certain foreign entities, depending upon the state's rules, 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. A state that has a tax-haven provision may also include income and factors of foreign entities.
- (c) *Consolidated Reporting*. Some states that require corporations to file combined or 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 member's 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.

### ***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.

### ***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. Companies owned more than 50% but less than 80%). Any nonunitary domestic companies that have been included in the consolidated federal 1120 return will be subtracted. Review intercompany transactions to see if Federal 1120

## Section 8 – Computation of Income

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.

### ***05. Computation of Worldwide Combined Income***

- (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., Dividends Received Deduction) are allowable for a given state, they will be state adjustments.
- (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-3 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.
- (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.
  - (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.

## Section 8 – Computation of Income

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.

***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. SEC Form 20-F may also be used to determine worldwide income.

***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.

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-3 of the consolidated Federal Form 1120. Line 1 of Schedule M-3 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-3 to the income of the consolidated domestic subsidiaries.

## Section 8 – Computation of Income

The result of accumulating book income and the federal tax provision per the Schedules M-3 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 —

- (a) Consolidating adjustments.
- (b) Differences in the taxpayer's method of accounting for book purposes versus tax purposes.
- (c) Omission of income for one or more entities.
- (d) Under reporting of income per the Federal Forms 5471.
- (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.

### ***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;

## Section 8 – Computation of Income

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.

### ***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.

### ***10. Information Included in Consolidated Statement***

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

- (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.
- (b) Currency translation gains and losses.
- (c) Income and financial position on an individual company basis.
- (d) Differences in accounting methods used by the various members of the group.
- (e) Differences in accounting periods.

### ***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:

- (a) Profit and loss statement for the accounting period.
- (b) Balance sheet as of the end of the accounting period.

## Section 8 – Computation of Income

(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.

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

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

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

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

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

(i) Income taxes paid to foreign countries.

### ***12. Foreign Book Income***

Of the states in the MTC Joint Audit Program that require or permit worldwide reporting, some states require the use of book income of the foreign subsidiaries and other 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.

### ***13. IRS Revenue Agent Report - Federal Adjustments***

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

## 9. State Adjustments

### *01. Conformity.*

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.

### *02. Additions to Income*

#### *(a) Taxes*

- (1) Federal Law. State, local, and foreign income/franchise 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.

#### *(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. Municipal interest is included for book purposes but not for tax purposes.
- (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 Federal Exempt Interest (Municipal Interest) is listed on the Federal 1120, Schedule K and should also be reported on Form 8916-A. The amount of municipal interest is included on the Federal

## Section 9 – State Adjustments

1120, Schedule M-3, but is not separately stated on this form. Also note that taxpayers are required to report investments in municipal obligations on the balance sheet, Federal 1120, Schedule L. 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.

### *(c) Depreciation Adjustments*

- (1) Federal Law. Federal law generally provides that taxpayers are not allowed to expense the cost of assets that are considered capital in nature, unless specifically provided for in the IRC. Instead, an annual depreciation deduction (cost recovery) is allowed. See IRC §§167 and 168 for the general federal rules including bonus depreciation.
- (2) State Law. While many states follow the federal depreciation methods, some states do not and provide that federal depreciation must be added back to income and a state depreciation adjustment computed. As federal rules change (e.g. the Tax Cuts and Jobs Act, etc.), auditors should check whether states have conformed or decoupled from depreciation rules.
- (3) Audit Procedure. If the taxpayer has made no depreciation adjustment, the auditor must determine if one is required by state law and 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. The auditor may need to review prior year depreciation expense computations.

### *(d) Federal Capital Loss Carryover/Carryback 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. IRC Section 1212 provides that, in general, a net capital loss should be used to offset net capital gains first in the 3 preceding tax years and then carried forward to offset net capital gains in the subsequent 5 years. Special rules and limitations apply.
- (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.

## Section 9 – State Adjustments

This amount will be an addition adjustment for states that do not follow the federal rules. Separate-entity reporting states may follow the federal law, but capital loss/gain should be calculated for each entity separately and adjustments may apply.

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

- (1) Law. Most state statutes contain provisions allowing for the addition of expenses back to taxable net income that are related to income of the taxpayer 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. The taxpayer may net the income and expense, rather than separately state these items, and the expense adjustment will not be necessary.

### *(f) Federal Dividend Received Deduction (DRD), Special Deductions, NOL Deductions 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 and Special Deductions 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). The amount on line 29(b) includes amounts from the 1120 Schedule C which, after the Tax Cuts and Jobs Act, also includes Global Intangible Low Taxed Income (GILTI) and the related Sec. 250 deduction.

### *(g) Charitable Contributions*

- (1) Federal Law. For federal purposes IRC Section 170 provides that the charitable contributions may be limited. The limit as of 2020 is 25% 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 the same percentage of the state computed income.

## Section 9 – State Adjustments

- (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. Separate-entity reporting states may follow the federal law, but the charitable deduction limitation should be calculated for each entity separately and adjustments may apply.
- (h) 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.
- (i) Related Party Expense: Addback Adjustments.*
  - (1) Many separate-entity and some waters-edge combined states require an addback for otherwise deductible expenses and costs paid to a related party (most common are intangible expenses and interest expenses). For states that make such adjustments, the auditor must review the statutes and regulation of those states and make the appropriate adjustments.
  - (2) **Audit Procedure.** In reviewing related party expense addbacks, the auditor should examine Federal Form 1120, Other Deductions Schedule, Cost of Goods Sold Schedules, particularly Other Costs Schedule and Other Income. For determining interest expenses paid to a related party, the auditor should review Federal Form 8916-A. Related party expenses may be embedded in larger income and expense items such as Cost of Goods Sold Purchases.
- (j) IRC Section 199 Domestic Production Activities Deduction Addback*
  - (1) **Federal Law.** Repealed for tax years beginning after December 31, 2017. The American Jobs Creation Act (P.L. 108-357) created a 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. Section 199 allows the taxpayer to take a deduction for domestic production activities in addition to other expenses.
  - (2) **State Law.** Many states follow the federal law. For tax years preceding the repeal, an addition is required for states that did not conform to federal law allowing a Section 199 deduction.
  - (3) **Audit Procedure.** If a state requires that this deduction be added back the amount will be obtained from the Federal Form 1120, Line 25. The auditor may also review the Federal Form 8903 and/or the Federal Schedule M-3 detail. Separate-entity reporting states may follow the federal law, but the Section 199 deduction should be calculated for each entity separately and adjustments may apply.

*(k) IRC Section 482 adjustments.*

- (1) Federal Law. 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.
- (2) State Law. Most states have enacted similar authority for use in their states but may also have implicit authority based on the state's adoption of Federal Taxable Income in calculation of taxable income in their state.
- (3) First, examine the Federal Form 1120 and request the taxpayer representative to identify significant intercompany transactions. The auditor should request intercompany agreements and transfer pricing studies that document the pricing of intercompany transactions. 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.

*(l) IRC Section 163(j) adjustments.*

- (1) Federal Law. Interest Expense Limit. The Tax Cuts and Jobs Act amended IRC Sec. 163(j) to impose a limit on the amount of interest expense that is deductible in any year beginning in 2018. Interest expense deductions are limited to the sum of interest income plus 30% of the taxpayers adjusted taxable income plus certain "floor plan" interest. The IRS is developing regulations for how this limitation applies on a consolidated filing basis. States that have conformed to this federal provision will need to determine how the limit applies in the context of the filing group (or if the state is a separate filing state, how it applies on a separate entity basis).
- (2) State Law. Some states have decoupled, or are considering decoupling, from this limitation. Audit Procedures. If a state requires that the interest expense limitation be computed at the state level, a computation schedule must be created to recompute the deduction. Separate-entity reporting states may follow the federal law, but the interest expense limitation should be calculated for each entity separately and adjustments may apply.

**03. Deductions from Income**

**(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

## Section 9 – State Adjustments

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.

Prior to 2018, 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. The Tax Cuts and Jobs Act now excludes foreign dividends.

- (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, prior to the Tax Cuts and Jobs Act, 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 have provided 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.

### *(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.

## Section 9 – State Adjustments

- (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.

### (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-3 detail of expenses per books not deducted on the return. Examples of such amounts would be jobs credit wages, and research credit expenses.

### (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-3, line 5 detail.

### (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 carrybacks/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-3.

### (f) *Charitable Contribution Carryover.*

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If a state requires that the charitable contribution limitation be computed at the state level, carryovers may be available for a deduction. See 9.02(g).

(g) Interest Deduction carryover IRC Section 163(j).

If a state requires that the interest expense limitation be computed at the state level, carryovers may be available for a deduction. See 9.02(l).

(h) *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. This deduction should be computed net of expenses.

### ***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.

### ***05. Federal Income Tax Deductions***

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

### ***06. Apportionment Factor***

Some additions and deductions from income will affect the taxpayer's sales/receipts factor. The auditor should consider whether an adjustment to the sales/receipts factor is necessary.

## **10. Business & Nonbusiness (Apportionable & Non-Apportionable) Income**

### ***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.

- (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 nonbusiness in nature and the consistency or inconsistency with which the taxpayer has reported such treatment to other states.
- (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 nonbusiness 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 likely 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 nonbusiness 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.

## ***02. Business Income Tests***

The MTC's model General Allocation and Apportionment Regulations Section IV.1. 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:

- (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?
- (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?
- (c) 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?
- (d) 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.
- (e) *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 model General Allocation and Apportionment Regulations. The business/nonbusiness 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 nonbusiness 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 nonbusiness 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.

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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.

### **03. General Categories of Business Income**

- (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.
- (b) Income from investments of working capital, whether short term or long term in nature.
- (c) Income from patents, copyrights and trademarks which have been developed by the taxpayer and used in its business.
- (d) Income traceable to reserves for the normal cycling or fluctuations of the taxpayer's business.
- (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.
- (f) Income from commonly owned and controlled corporations.
- (g) Income from the disposition of investments which produced business income when held by the taxpayer.

### **04. General Categories of Nonbusiness Income**

- (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.
- (b) Income from corporate business activities which are unrelated to the unitary business of the taxpayer conducted in the taxing state.
- (c) Income from the disposition of assets which produced nonbusiness income when held by the taxpayer.

### **05. Specific Factual Determinations**

- (a) *Purpose of Investment.* The auditor must determine the purpose for which the taxpayer made the investment that produced the 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 nonbusiness 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

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with the taxpayer's unitary business, then the reasonable inference is that the investment was made for a business purpose.

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

- (1) Why did the taxpayer classify the income in question as nonbusiness 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 nonbusiness 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 nonbusiness? If not, then how did the taxpayer determine which expenses were attributable to the claimed nonbusiness 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 nonbusiness 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?

(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 nonbusiness dividend income are included in the MTC model General Allocation and Apportionment Regulation IV.1.(c)(4).

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- (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 nonbusiness income. The auditor should identify on the schedule(s) any dividend income which he/she recommends be considered as nonbusiness income.
- (4) If the auditor has recommended that any dividend income be treated as nonbusiness 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,

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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.

(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 nonbusiness 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,

## Section 10 – Business & Nonbusiness (Apportionable & Non-apportionable) Income

- 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 nonbusiness income, he/she should prepare a schedule to determine directly related expenses, indirectly related expenses, and the interest expense proration.

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(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 nonbusiness 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.

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

(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 nonbusiness 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:

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- 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 nonbusiness in nature. The auditor should reflect on the audit schedules any royalty income for which he/she recommends treatment as nonbusiness income. He/she should make appropriate comments in the audit narrative to support those recommendations.
- (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

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nonbusiness income if the property was utilized for nonbusiness purposes for a significant period of time before its disposition. Specific examples of the distinction between business and nonbusiness 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 nonbusiness in nature. The auditor should reflect on the audit schedules any gains or losses for which he/she recommends treatment as nonbusiness income. The auditor should make appropriate comments in the audit narrative to support such recommendations.
- (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 nonbusiness 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 nonbusiness in nature.

### ***06. Related Expenses***

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

### ***07. Apportionment Factor***

If the auditor determines that an item of income should be reclassified as business/nonbusiness income, the auditor should also consider the effect on the taxpayer's apportionment factor and make appropriate adjustments.

## 11. Apportionment

### 01. General Description of the Apportionment Factor

- (a) *Apportionment Process - Introduction.* Apportionment is the process of dividing the corporation's business income among the states in which it conducts business through the use of a formula. Every state has adopted a formula by statute. In addition, many states have adopted special industry apportionment rules (e.g. financial institutions, transportation, etc.) and other regulations to implement the apportionment formula—including defining key terms. Auditors should make sure they understand the state's apportionment formula and the rules for that formula.

The information in this section reflects common rules for state apportionment and is generally consistent with current MTC recommended apportionment regulations. This section refers to the inclusion of a share of the partnership factors in the apportionment factor of the corporate partner, which is the generally accepted approach to the treatment of unitary partnerships with apportionable business income. But state rule may differ on the approach to inclusion of partnership factors.

#### (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 traditionally a three-factor formula comprised of the average of three factors: property, payroll, and sales (receipts). 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.
- a. *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.

- b. *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.
- c. *Sales (or Receipts) 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.
- d. *Combined Factor*. Traditionally, the three factors are added up and divided by three to get the average. As noted above, most states now put a heavier weight on the sales (receipts) factor or use a single sales factor.

**02. Property Factor.**

(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*.

- a. *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.
- b. *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.
- c. *Original Cost*. Property is valued at original cost and will generally be the federal tax basis

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d. *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.*

a. *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.

b. *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.*

a. *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. Nonbusiness land is excluded. Vacant land purchased for prospective use in the business is not included in the factor until such use actually takes place.

b. *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.*

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

b. *Nonbusiness 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.*

- a. *Included to the Extent of the Partner's Interest in the Partnership.* In general, 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 proportionately to the distributive share of income from that property. The value of such property located in the state is to be included in the numerator of the taxpayer's property factor.
- b. *Exclude Intercompany 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.
- c. *Verify Partnership Property.* Obtain copies of the federal and state partnership returns, including the partner's Schedule K-1s to verify or determine the appropriate factors.
- d. *Corporation's Capital Sharing Percentage.* For purposes of the property factor, interest in the partnership property normally refers to the corporation's distributive share of income derived from that property or the partner's interest in that property.

(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.

(b) *Rents*

- (1) *Verify Rent Expense to Federal Return.* Rental expense is obtained from the Federal 1120, line 16, the cost of goods sold detail and line 26 the schedule of other deductions.
- (2) *Exclude Advance Rents and Similar.* Advance rents, daily rents, and service charges are not included.

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- (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 dispositions, acquisitions, 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.
- (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.*
  - a. *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.
  - b. *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.



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- (5) *Exclude Intercompany Transactions.* Verify the exclusion of intercompany transactions in cases where combined or federal-style consolidated returns have been filed and between a partnership and its partners. Some states allow a kind of consolidated return where apportionment factors are calculated independently for each corporate member and intercompany transactions are not eliminated.
- (6) *Review Prior Audit Reports.* Review prior audit reports and determine whether there are any prior period adjustments applicable to the current audit period.

### **03. Payroll Factor**

#### (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.*
  - a. *Compensation Defined.* The term “compensation” has commonly been defined to include 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.
  - b. *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.
  - c. *Payments to Leased Employees.* Some states include compensation paid to leased employees. In particular for separate entity states, related party leased employees can create distortion in the payroll factor if excluded.
- (3) *Partnership Payroll.*

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- a. *Include Pro-Rata Share of Partnership Payroll.* In general, corporate partner's share of a partnership's payroll, based on the partner's distributive share of income derived from that payroll, is included in the numerator and denominator of the factor.
  - b. *Verify Partnership Payroll.* The partnership payroll must be verified to the partnership's federal tax return form 1065, Schedule K-1, and the partnership's "all-state" apportionment workpapers.
- (b) *Denominator.* Any compensation which is associated with income but is determined to be nonbusiness or to be income for a separate business must be eliminated from the payroll factor.
- (c) *Numerator.*
  - (1) *Compensation in a State.* Compensation is paid in a state if:
    - a. The individual's services are performed entirely within the state, or
    - b. 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
    - c. 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.
- (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.
- (e) *Auditing the Payroll Factor*

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- (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 issues are identified.
- (5) *Exclude Intercompany Transactions.* Verify the exclusion of intercompany transactions in cases where combined or consolidated returns have been filed and between a partnership and its partners. Some states allow consolidated returns where apportionment factors are calculated independently for each corporate member and intercompany transactions are not eliminated.
- (6) *Review Prior Audit Reports.* Review prior audit reports and determine whether there are any prior period adjustments that are applicable to the current audit period.

### **04. Sales (Receipts) Factor.**

#### (a) Sales (Receipts) 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 (Receipts).*
  - a. *General Definition of Sales.* Section (1)(g) of UDITPA traditionally provided that “Sales” means “all gross receipts of the taxpayer not allocated under other paragraphs of this article.” The MTC has recommended states adopt a revised term – “receipts,” and a somewhat narrower definition, which means “all gross receipts of the taxpayer that are not allocated . . . and that are received from transactions and activity in the regular course of the taxpayer’s trade or business.”
  - b. *All Receipts from Business Operations are Included.* Some states may have adopted a narrower definition of “receipts” or have excluded particular receipts. Receipts from a trade or business are included in the sales factor.

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- i. Gross receipts from sale of 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. If it will not cause distortion, receipts from sale of tangible personal property may also include incidental receipts such as service charges, interest, and related fees that would not be charged were it not for the sale of the tangible personal property.

### (3) *Partnerships.*

- a. In general, a corporate partner's share of the partnership's revenues, based on the taxpayer's distributive share of the partnership income, is included in the numerator and denominator of the factor.
- b. This information can be obtained from the partnership's federal and state tax return, including the corporate partner's Schedule K-1. Receipts from intercompany transactions between the partnership and the taxpayer partner must be eliminated.

### (4) *Special Rules – MTC General Allocation and Apportionment Reg.*

#### *IV.18.(c).*

- a. *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 unless this would lead to the taxpayer having no sales factor. In that event, refer to the state's apportionment rules or to the MTC special apportionment rules under Art. IV, Sec. 18. (For example, exclude gross receipts from the sale of a factory or plant.)
- b. *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.
- c. *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.

d. *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. (NOTE: This is different from a case where sales from services or sales or licenses of intangibles to customers cannot be sourced on a market basis looking to delivery or use and, therefore, may be sourced based on some reasonable approximation.)

(b) *Numerator.*

(1) *In General.* MTC Reg. IV.15.(c) provides the numerator of the sales factor shall include gross receipts attributable to a 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.

a. *Joyce States.* States that allow or require combined filing and follow Joyce will exclude from the sales factor numerator of the group or of the member the receipts from sales into the state by a member that lacks constitutional nexus in the state or is protected by P.L. 86-272. Whether a state follows Joyce also affects whether it will throw back receipts made from a member from that state to another state. States that follow Joyce (and follow UDITPA's throw-back

rule, Section 16) will throw back sales made by a member of a group from the state to another state if the member lacks nexus or is protected by P.L. 86-272 in the destination state, even if other members of the unitary group are taxable in the destination state.

b. *Finnigan States*. States that allow or require combined filing and follow Finnigan will not exclude from the sales factor numerator of the group or of the member the receipts from sales into the state by a member that lacks constitutional nexus in the state or is protected by P.L. 86-272. States that follow Finnigan will not throw back sales made by a member of a group from the state to another state if the member lacks nexus or is protected by P.L. 86-272 in the destination state, provided that other members of the unitary group are taxable in the destination state.

(2) *Sourcing Receipts from Sales of Tangible Personal Property*.

- a. *MTC Reg. IV.16.(a)*. Gross receipts from sales of tangible personal property (except sales to the United States Government) are typically sourced to a state:
- i. if the property is delivered or shipped to a purchaser within the state regardless of the f.o.b. point or other conditions of sale; or
  - ii. if the property is shipped from an office, store, warehouse, factory, or other place of storage in the state and the taxpayer is not taxable in the state of the purchaser.
- b. Property shall generally be deemed to be delivered or shipped to a purchaser within the state if the recipient is located in the state, even though the property is ordered from outside the state.
- c. Property is generally deemed delivered or shipped to a purchaser within the state if the shipment terminates in the state, even though the property is subsequently transferred by the purchaser to another state.
- d. The term “purchaser within this state” shall include the ultimate recipient of the property if the taxpayer in the state, at the designation of the purchaser, delivers to or has the property shipped to the ultimate recipient within the state.
- e. 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 a state, the sales are in the state of the purchaser.

## Section 11 - Apportionment

- f. If the taxpayer is not taxable in the state of the purchaser, the sale is attributed to the state if the property is shipped from an office, store, warehouse, factory, or other place of storage in that state.
  - g. Assuming the state has a throwback rule, if a taxpayer, whose salesman operates from an office located in that 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:
    - i. If the taxpayer is taxable in the state from which the third party ships the property, then the sale is in that state.
    - ii. If the taxpayer is not taxable in the state from which the property is shipped, then the sale is in the origin 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) **Sourcing 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.** Receipts from shipments to a state in which the taxpayer is not “taxable” will be attributable to the state of origin. In this context, not “taxable” means that the taxpayer has no nexus in or is protected from tax under P.L. 86-272. For states requiring a unitary combined report, auditors should consider if the state follows Joyce or Finnigan approach.
- (7) **Sourcing Receipts from Transactions Other than Sales of Tangible Personal Property.** There are two main rules for sourcing receipts from transactions other than sales of tangible personal property. The first is the traditional cost of performance rule. The second is market sourcing. Each of these is discussed below. In addition, the following are generally sourced as described:
- a. **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.
  - b. **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.

(8) *Traditional UDITPA Sec. 17 Rule.*

- a. *Income Producing Activity Performed Entirely in the State.* The location of the income producing activity for transactions involving the sale of services or intangibles may be performed entirely in the state where the service customer is. In that case, the receipts from the transactions would be sourced to that state.
- b. *Income Producing Activity Performed Inside and Outside the State. Cost of Performance Rule - Generally.* Under the original Sec. 17 of UDITPA, if the income producing activity is performed inside and outside a state, then gross receipts are attributed to the state which has the greatest proportion of the income producing activity, based on costs of performance.
- c. *Income Producing Activity Defined.* The term “income producing activity” has commonly been defined as 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:
  - i. The rendering of personal services by employees or the utilization of tangible and intangible property by the taxpayer in performing a service.
  - ii. The sale, rental, leasing, licensing, or other use of real property.
  - iii. The rental, leasing, licensing, or other use of tangible personal property.
  - iv. The sale, licensing, or other use of intangible personal property.
- d. *Income Producing Activity—Definition and Business Situs.* Income producing activity is commonly defined as that activity that gives direct rise to revenue, typically from the business’s customers. It is often critical to properly determine the scope of the activities that are “income producing activity.” Also, when it comes to defining “income producing activity,” whether the state focuses on the

activity as a whole or on specific transactions may make a difference.

The income producing activity from the lease or license to use property is deemed performed at the situs of real, tangible, and intangible personal property. The income producing property related to personal services is typically deemed to be 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.

Example: Taxpayer, a corporation whose principal business activity as the manufacture and sale of hot water heaters pledges bonds in the 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 the state; therefore, interest income derived from such bonds is attributable to the state.

- e. *Costs of Performance—Defined.* The term “costs of performance” has commonly been defined as the direct costs of the income producing activity 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.
- f. *Gross Receipts from Rental, Lease, or Licensing the Use of or Other Use of Movable Tangible Personal Property.* Gross receipts from the rental, lease, or licensing the use of or other use of tangible personal property are typically included in the numerator of a state’s sales factor if the property is located in the state during the entire period of rental, lease, license or other use. If the property is within and without the state during the rental, lease or licensing period, gross receipts attributable to the state shall be measured by the ratio which the time the property was physically present or was used in the state bears to the total time or use of the property everywhere during that period.

g. *Gross Receipts for the Performance of Personal and Other Services.* Gross receipts for the performance of personal services are attributable to the state to the extent that such services are performed in the state. If services are performed partly within and partly without the state, the gross receipts from the performance of such services shall be attributable to the state based upon the ratio which the time spent in performing the services in the 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.

Other services, including business services, are sourced to the state to the extent the predominant cost of performance of the income producing activity is in the state. As noted above, the sourcing result for a particular type of service or business activity may depend on how the state interprets the income producing activity and whether it focusses on that activity, as a whole, or on a transactional basis.

h. *Gross Receipts from Intangible Personal Property.* Gross receipts from intangible personal property shall be attributed to the state based upon the ratio which the total property and payroll factors in the state bears to the total of the property and payroll factors everywhere for the tax period

(9) *Market Sourcing.* Many states now source receipts from transactions other than sales of tangible personal property on a market basis, rather than looking to the predominant cost of the income producing activity. States have taken different approaches to this issue in their laws. Some states look to the location of delivery to the customer or to the receipt by the customer of the service or intangible product. Other states look to the location where the benefit of the service or intangible is realized or received.

Despite the differences in the general approaches used by states, the results from many types of sales of services or intangibles will be the same sourcing to the location of the customer. The cases in which the result may differ include business-to-business transactions and sales involving an intermediary. In these cases, the question is often whether the state will

“look through,” past the initial delivery or initial customer, to the ultimate use by the customer or customer’s customer.

The MTC has developed detailed model regulations on market sourcing and some states have adopted substantial portions of those regulations. Other states with market sourcing have adopted similar, but slightly different, regulations. This section provides general guidance on market sourcing and references the MTC model rules as examples.

(10) *General Principles.* A taxpayer’s assignment of receipts from sales of other than tangible personal property must generally be consistent with the following principles (which are taken from the MTC general allocation and apportionment regulations on the Compact Art. IV (UDITPA), Sec. 17 (with MTC recommended market sourcing changes):

- a. A taxpayer should apply the rules based on objective criteria and consider all sources of information reasonably available to the taxpayer at the time of its tax filing including, without limitation, the taxpayer’s books and records kept in the normal course of business.
- b. A taxpayer should determine its method of assigning receipts in good faith and apply it consistently with respect to similar transactions and year to year.
- c. A taxpayer should retain contemporaneous records that explain the determination and application of its method of assigning its receipts, including its underlying assumptions, and should provide those records to the auditor.
- d. Some market sourcing rules apply sequentially in a hierarchy. For each sale to which a hierarchical rule applies, a taxpayer must make a reasonable effort to apply the primary rule applicable to the sale before seeking to apply the next rule in the hierarchy.
- e. A taxpayer’s method of assigning its receipts, including the use of a method of approximation, where applicable, must reflect an attempt to obtain the most accurate assignment of receipts consistent with the state’s law.
- f. There may be times when it is necessary to use a method of reasonable approximation to source receipts. If a taxpayer can ascertain the state or states of assignment of a substantial portion of its receipts from sales of substantially similar services (“assigned receipts”), but not all of those sales, and the taxpayer

## Section 11 - Apportionment

reasonably believes, based on all available information, that the geographic distribution of some or all of the remainder of those sales generally tracks that of the assigned receipts, it should include receipts from those sales which it believes tracks the geographic distribution of the assigned receipts in its receipts factor in the same proportion as its assigned receipts. This rule also applies in the context of licenses and sales of intangible property where the substance of the transaction resembles a sale of goods or services.

- g. Where a taxpayer has receipts subject to MTC Reg. IV.17 from transactions with a related-party customer, information that the customer has that is relevant to the sourcing of receipts from these transactions is imputed to the taxpayer.

(11) *In-Person Services*. In general, in-person services are services that are physically provided in person by the taxpayer, where the customer or the customer's real or tangible property upon which the services are performed is in the same location as the service provider at the time the services are performed. These services are generally sourced to where the service is received (which is also the place where the service is performed).

(12) *Services Delivered to the Customer or on Behalf of the Customer, or Delivered Electronically Through the Customer*. The MTC model regulations distinguish a group of services that are not either personal services or professional services delivered directly to the customer. In this case, the type of the service and the availability of information by the taxpayer to source that service will often determine the result.

(13) *Professional Services*. There is some overlap between in-person and professional services. In general, professional services are services that require specialized knowledge and, in some cases, require a professional certification, license or degree. These services include the performance of technical services that require the application of specialized knowledge. Professional services include, without limitation, management services, bank and financial services, financial custodial services, investment and brokerage services, fiduciary services, tax preparation, payroll and accounting services, lending services, credit card services (including credit card processing services), data processing services, legal services, consulting services, video production services, graphic and other design services, engineering services, and architectural services.

(14) *Certain Intangibles.* The MTC model general allocation and apportionment regulations treat market sourcing of receipts from transactions involving these types of intangibles slightly differently depending on the category:

- a. Marketing intangible – sourced to the ultimate customer
- b. Production intangible – sourced to the state where the intangible is used
- c. Mixed marketing and production intangible – sourced based on the separate statement, if any, made by the seller or otherwise sourced as a marketing intangible
- d. Licensing of intangible property that resembles a sale of goods or services – sourced as the sale of goods or services that the transaction resembles
- e. Software – prewritten software is generally sourced as tangible personal property, and other software is assigned based on the nature of the software (whether it is a marketing intangible, a production intangible, or resembles the sale of goods or services)

(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. Certain receipts may be excluded from the denominator per state rules or if income is not taxable or the state of assignment cannot be determined. These are commonly referred to as "throw-out" sales.

(d) *Auditing the Sales (Receipts) Factor*

- (1) Obtain the taxpayer's "all-state" workpapers breaking down each type of sale for each of the years under examination.
- (2) Identify each revenue stream. The auditor should determine if revenue streams have been combined on the taxpayer workpapers. The auditor should determine the sourcing methodology used to assign each type of receipt in calculating the sales (receipts) factor.
- (3) Compare each type of sale shown on the apportionment workpapers to the Federal 1120.
- (4) Verify that all sales/receipts are appropriately assigned.
- (5) Examine the treatment of throwback/throw-out sales. For more information, see the MTC Model General Allocation and Apportionment Regulations relating to Section 17 and Section 18.

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- (6) Verify the exclusion of nontaxable revenues from the factor.
- (7) Verify the exclusion of intercompany transactions in cases where unitary or consolidated returns have been filed. Some states allow consolidated returns where apportionment factors are calculated independently for each corporate member and intercompany transactions are not eliminated.

## **12. Allocated Income or Loss**

### ***01. Nonbusiness (Non-apportioned) Income or Loss***

If net nonbusiness income or loss is to be excluded from apportionable income per MTC Audit Schedule 1300, prepare schedules allocating appropriate portions of such income or loss among participating states.

### ***02. Other Allocated Income or Loss.***

Some states require certain items of income to be allocated rather than apportioned even when otherwise considered business income. The auditor should review specific state audit law or authority to determine income that should be properly allocated.

## **13. Net Operating Loss**

### ***01. Definition of Net Operating Loss***

A net operating loss arises when the taxable income in a given year is less than zero. The IRC 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 the same amount of income ratably over the same period.

### ***02. Federal Law***

IRC Section 172 provides the rules for net operating losses.

For federal tax purposes, for NOLs arising in tax years that end after 2017, there is no carryback period except for farming losses and NOLs of non-life insurance companies. These types of losses have a two-year carryback period unless an election to waive the carryback period is made. The carryforward period is unlimited for NOLs arising in tax years that end after 2017. Such NOLs are deducted until used up. However, for NOLs that arise in tax years that begin after 2017, an NOL carryback or carryforward may only offset 80 percent of taxable income.

Prior Law:

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.

### ***03. State Law***

- (a) Similar to federal law, states allow a NOL to be deducted in another tax period.
- (b) The presence of a federal NOL deduction for a taxable year is irrelevant in determining a state NOL deduction for that tax year. Rather, a state NOL arises if the state's taxable income is less than zero. This NOL can then be carried over, or carried back, pursuant to state law. While most states allow a NOL to be carried forward, only a few states allow a NOL to be carried back.
- (c) For most states, computation of state taxable income 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 applied to calculate apportionable state income or loss for the taxable year. This amount is then multiplied by the apportionment factor to determine the state apportioned income or loss. Any allocable income/loss is then applied. If this amount is a net

## Section 13 – Net Operating Loss

loss, then it becomes a state NOL and may be used to offset state taxable income in other tax years.

- (d) Some states begin the computation of state taxable income with Line 30 of the Federal Form 1120 and add back the federal NOL deduction before continuing the calculation as discussed in paragraph (3).
- (e) Generally, in states requiring a unitary combined return, the NOL is limited to the income of each taxable member. The NOL will be calculated and tracked separately for each taxable member.
- (f) *Application of separate return limitation year (SRLY) principles.*

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.

- (g) *Treatment of NOL Carryovers Following Changes in Ownership*

- (1) Federal law imposes certain restrictions on the post-acquisition use of NOLs. Under IRC 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 IRC 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.
- (2) Unlike federal law, many state 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. State courts have addressed but are divided on

the question of whether 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.

(h) *State Statutory Provisions Relating to the Transfer of NOLs in Corporate Acquisitions.*

- (1) Federal law allows the transfers of NOLs from one corporation to another pursuant to IRC Sections 381 and 382.
- (2) Some state statutes expressly adopt these provisions while other states adopt IRC Sections 381 and 382 implicitly under their federal conformity provision.
- (3) Some states have no provision for the transfer of NOLs in corporate acquisitions. For these states even if the acquisition is a statutory merger or other form of tax-free reorganization, there is no mechanism to transfer the NOL to the new entity and the NOL is extinguished.

**04. Audit Procedures**

- (a) Review the support for an NOL carryover, including the state and federal prior years’ tax returns and workpapers to verify the amounts on the taxpayer’s NOL schedule are correct.
- (b) The auditor should be aware that audit adjustments are allowed for prior year periods to the extent that they affect the NOL carryover. The statute may be closed for making an assessment, but adjustments can be made to reduce or eliminate the loss. The auditor should also consider if the filing method was appropriate in prior years and determine if current year adjustment should be applied to prior years.
- (c) Review all federal and state audit adjustments that impact the NOL calculated in prior tax years.
- (d) Verify that the NOLs claimed from prior tax years have not expired.
- (e) Verify application of SRLY and IRC Section 382 limitations and ensure that limitations are computed correctly in accordance with state law.
- (f) In states that allow NOLs to be shared in a consolidated or combined return and a company has departed the group, the auditor should verify that the NOL has been allocated appropriately to each member of the group.
- (g) When practical, the auditor should review, in detail, the entities that reported NOLs to determine the correct NOLs.

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

### ***01. Review the tax computations for the individual states (MTC Audit Schedule 0800 series) to determine that:***

- (a) The proper tax rate has been applied. (Pay particular attention to surtax rates, minimum tax, and rate changes from one year to another.)
- (b) Taxes previously assessed are properly reflected.
- (c) All tax credits have been properly recognized.
- (d) The apportionment factor methodology is correct for each year of the audit.  
Example: three-factor, weighted factor, single receipts factor, specialized industry factor

### ***02. Combined report.***

When tax computations for individual entities included in a combined report are required, intra-state apportionment will be necessary. Audit templates should automatically apply this computation when applicable.

## 15. Narrative Reports

### ***01. Complete Narrative Reports in the Sequence Below:***

#### ***02. 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 the affiliates and subsidiaries [or change to affiliates, subsidiaries and parent companies (if applicable)]of [Insert Taxpayer’s Name] 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.

- (a) Include auditor name and contact information.
- (b) Include taxpayer representative and contact information.
- (c) In block form, note the tax years audited for each state.
- (d) In block form, detail the parent company, the subsidiaries and affiliates (if they have filed separate returns), and the federal and state identification numbers.
- (e) For each state, list the date of the earliest expiration of statutes of limitations or waivers.
- (f) Note the status of any federal audit.

#### ***03. General Narrative***

- (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.
- (b) *Business Type and General Activity.* Detail the products (in general) of the corporation and its subsidiaries and affiliates, both domestic and worldwide.
- (c) *Parent, Subsidiaries, and Affiliates of the Taxpayer*
- (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.

#### ***04. 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 Joint Audit Program. The results of those efforts should be stated here with reference to supporting documentation in Section 10 of this manual.

If the taxpayer has elected to execute an agreement letter on unity and on business or nonbusiness income, state that in the narrative, specifically mentioning:

- (a) Circumstances of the offer of the agreement letter;
- (b) Comments and agreement of the MTC general counsel; and
- (c) Include a copy of the agreement letter as an audit report 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 nonbusiness income.

**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.**

#### ***05. Operations in State of [Participating State Name]***

- (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).
- (b) *In-State Activities.* List the companies and affiliates doing business in the state.
- (c) *Nexus.* For any nexus recommendations, narrate the procedures used to make the determination that nexus does or does not exist for each entity in question. State the taxpayer's position as to each such entity.

#### ***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.

#### ***07. State Adjustments***

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

#### ***08. Business or Nonbusiness Income***

The narrative in this area is most crucial to the audit; the MTC Audit Schedule 1300 series 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, state that in the narrative and refer to the letter in the MTC Audit Schedules, and include a copy of the letter as an audit report exhibit if the letter is in reference only to business or nonbusiness income.

***09. Apportionment Formula***

Write a brief narrative of the apportionment formula methodology as presented in MTC Audit Schedule 1400 series. Detail schedules for the apportionment factor calculations can be found in MTC Audit Schedules 1500 series, 1600 series, and 1700 series.

***10. Allocated Income or Loss***

These items can be nonbusiness income/loss or other allocable items of income/loss as determined by state law.

***11. Net Operating Loss (NOL) Deductions***

Explain adjustments to state NOL deductions.

***12. Taxpayer Comments***

Explain the taxpayer's 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.

***13. Recommendations***

Summarize the audit findings. Schedule (in block form) recommended additional assessments by year.

***14. Availability of Needed Documents or Other Information***

If, during the audit, documentation or information necessary for the examination of any issue was requested by the auditor but not provided by the taxpayer, the narrative should include a description of the information requested and what the auditor did in light of the taxpayer's failure to provide that information. The narrative should also include the auditor's understanding of whether the taxpayer claimed not to have the information. This information should be discussed in the appropriate location in the narrative.

## 16. Assembly of Audit Report

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

NARRATIVE (including all issues – e.g. unitary entities, nexus, etc.)

AUDIT SCHEDULE INDEX

COMPUTATION OF INCOME & TAX

ANALYSIS OF TAX CHANGES

INCOME (All schedules applicable for given state)

STATE ADJUSTMENT SUMMARY

STATE ADJUSTMENT DETAIL (All applicable schedules)

NONBUSINESS INCOME

APPORTIONMENT FORMULA

PROPERTY (All applicable schedules)

PAYROLL (All applicable schedules)

RECEIPTS (All applicable schedules)

ALLOCATED INCOME & DEDUCTIONS (All applicable schedules)

STATE NET OPERATING LOSS DEDUCTION

TAX COMPUTATIONS/TAX CREDITS (If applicable for given state)

TAXES PREVIOUSLY PAID

TRANSCRIPT OF FILED RETURNS

AUDIT REPORT EXHIBITS (If applicable)

AUTHORIZATIONS

WAIVERS,

FEDERAL CONSOLIDATED RETURN,

(1) Pages 1-5 of the federal consolidated return

(2) By company spreadsheets of income and expenses

(3) List of affiliated companies (Federal Schedule 851)

INFORMATION/DOCUMENT REQUEST LOG

OTHER (AS NEEDED)

## **17. Review**

### ***01. Audit Review***

- (a) The audit review is to be made by the 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 Joint 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.
- (b) The overall objective of the review is to ensure that the documentation, audit report 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.
- (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. nonbusiness income, apportionment factor, and the recommendations; and should make sure that the auditor has attached applicable taxpayer source documents or has identified them for further reference.

### ***02. Taxpayer Review.***

- (a) At the conclusion of the audit review, the Auditor in Charge will submit a complete set of audit schedules and accompanying explanations of audit recommendations to the taxpayer along with a cover letter. The Auditor in Charge will make any changes, corrections, or adjustments in the workpapers which he/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.
- (b) When all state audit reports have been submitted to the participating states, the supervisor will send an Audit Satisfaction Survey to the taxpayer representative.

### ***03. Retention of Master Copy of Audit Report.***

The retention of audit files is coordinated with the Network Administrator and will be done consistent with the MTC's document retention policy.

## **18. Transmittal to Participating States**

### ***01. Audit Report Preparation***

Upon completion of review, the auditor or the supervisor will submit the audit reports to each state. The auditor or supervisor will also submit audit summary to the audit director.

### ***02. Transmittal.***

The auditor will then send to each participating state (copying the supervisor and audit director):

- (a) The Audit Report, complete with all documents and exhibits
- (b) A Transmittal Letter
- (c) The auditor should confirm receipt of the audit report by the state.

### ***03. Subsequent Responsibilities of the States.***

Each state will then be responsible to do the following:

- (a) Confirm receipt of the audit report;
- (b) Review the audit report and recommendations;
- (c) Issue tax notices or assessments as it deems appropriate;
- (d) Complete the Audit Evaluation provided and submit the evaluation to the audit director;
- (e) Obtain any waivers of any applicable statute of limitations which it may find necessary to protect its right to issue assessments.

## **19. Exhibits**

- A. Engagement Letter
- B. Statute Control Checklist
- C. Waiver Policy
- D. MTC Waiver Form
- E. Nexus Questionnaire
- F. Unitary Questionnaire
- G. Audit Evaluation Form
- H. Audit Satisfaction Survey

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## Exhibit A. Engagement Letter

Page 1 of 2



**MULTISTATE TAX COMMISSION**

444 North Capitol Street N.W.,  
Suite 425  
Washington, DC 20001  
Telephone: (202) 650-0300

**[www.mtc.gov](http://www.mtc.gov)**

{Enter Date}

Sent via email to {enter email address}

(insert taxpayers name and address)

Re: MTC Income Tax Audit of (insert taxpayers name here)  
Tax Years 12/31/xxxx through 12/31/xxxx

Dear (Insert name here):

Thank you for speaking with me on (insert date). As we discussed, the Multistate Tax Commission has been directed by the joint audit program member states to conduct an income tax audit of your business. This letter summarizes our conversation and provides additional information about the audit.

Enclosed is a document that further explains the MTC Joint Audit Program and the audit process. As we discussed, there are (insert # of states) states participating in the audit. {Auditor might want to list the states here}. Enclosed with this letter is copy of each state's signed audit authorization. {If the auditor is still waiting for a response from any states that will be stated in a sentence here. Sample sentence is: It is possible that additional state(s) may choose to join the audit prior to our initial fieldwork. If this happens, I will notify you as soon as possible.} Also enclosed is an Information/Document Request (IDR) No. 1. Please note that the standard IDR response time is 30 days.

{Auditor: if fieldwork has been scheduled you can say this:} We have scheduled the initial conference and audit fieldwork for the week of (Insert week here). We have also scheduled xx more week(s) of fieldwork for the weeks of (insert weeks here).

{Summarize any other item of importance that were discussed on the phone call in a paragraph here.}

If you have any questions, please call me.

Sincerely,

**Engagement Letter Page 2**

XXXXXXXXXX  
MTC Income Tax Auditor  
{Contact information – email address, address, phone #}

Enclosures

## Exhibit B. Statute Control Checklist

Page 1 of 5

RETURN AND STATUTE CONTROL LIST  
 TAXPAYER: XYZ CORP. AND SUBS. - {enter #} STATES PARTICIPATING  
 Audit Period: {ENTER YEARS HERE}

### SAMPLE

| #  | State    | Basic Statute of Limitations | Company Name       | FEIN (and State ID if appl) | Audit Years                            | Date Filed | Original SOL Date | Extended SOL Date |
|----|----------|------------------------------|--------------------|-----------------------------|----------------------------------------|------------|-------------------|-------------------|
| 1. | ALABAMA  | 3 YEARS                      | XYZ CORP           | 11-1111111                  | 12/31/20XX<br>12/31/20XX<br>12/31/20XX |            |                   |                   |
|    |          |                              | ABC CORP           | 22-2222222                  | 12/31/20XX<br>12/31/20XX<br>12/31/20XX |            |                   |                   |
| 2. | ALASKA   | 3 YEARS<br>FED WAIVER        | XYZ CORP AND SUBS. | 11-1111111                  | 12/31/20XX<br>12/31/20XX<br>12/31/20XX |            |                   |                   |
| 3. | ARKANSAS | 3 YEARS                      | XYZ CORP           | 11-1111111                  | 12/31/20XX<br>12/31/20XX<br>12/31/20XX |            |                   |                   |
|    |          |                              | ABC CORP           | 22-2222222                  | 12/31/20XX<br>12/31/20XX<br>12/31/20XX |            |                   |                   |
| 4. | COLORADO | 4 YEARS<br>FED WAIVER        | XYZ CORP AND SUBS. | 11-1111111                  | 12/31/20XX<br>12/31/20XX<br>12/31/20XX |            |                   |                   |
| 5. | DELAWARE | 3 YEARS                      | XYZ CORP           | 11-1111111                  | 12/31/20XX<br>12/31/20XX<br>12/31/20XX |            |                   |                   |
|    |          |                              | ABC CORP           | 22-2222222                  | 12/31/20XX<br>12/31/20XX<br>12/31/20XX |            |                   |                   |
| 6. | D.C.     | 3 YEARS                      | XYZ CORP AND SUBS. | 11-1111111                  | 12/31/20XX                             |            |                   |                   |

RETURN AND STATUTE CONTROL LIST  
 TAXPAYER: XYZ CORP. AND SUBS. - {enter #} STATES PARTICIPATING  
 Audit Period: {ENTER YEARS HERE}

SAMPLE

| #   | State     | Basic Statute of Limitations | Company Name       | FEIN (and State ID if appl) | Audit Years | Date Filed | Original SOL Date | Extended SOL Date                      |
|-----|-----------|------------------------------|--------------------|-----------------------------|-------------|------------|-------------------|----------------------------------------|
|     |           |                              |                    |                             |             |            |                   | 12/31/20XX<br>12/31/20XX               |
| 7.  | HAWAII    | 3 YEARS                      | XYZ CORP AND SUBS. | 11-1111111                  |             |            |                   | 12/31/20XX<br>12/31/20XX<br>12/31/20XX |
| 8.  | IDAHO     | 3 YEARS                      | XYZ CORP AND SUBS. | 11-1111111                  |             |            |                   | 12/31/20XX<br>12/31/20XX<br>12/31/20XX |
| 9.  | IOWA      | 3 YEARS                      | XYZ CORP           | 11-1111111                  |             |            |                   | 12/31/20XX<br>12/31/20XX<br>12/31/20XX |
|     |           |                              | ABC CORP           | 22-2222222                  |             |            |                   | 12/31/20XX<br>12/31/20XX<br>12/31/20XX |
| 10. | KANSAS    | 3 YEARS                      | XYZ CORP AND SUBS. | 11-1111111                  |             |            |                   | 12/31/20XX<br>12/31/20XX<br>12/31/20XX |
| 11. | KENTUCKY  | 4 YEARS                      | XYZ CORP           | 11-1111111                  |             |            |                   | 12/31/20XX<br>12/31/20XX<br>12/31/20XX |
|     |           |                              | ABC CORP           | 22-2222222                  |             |            |                   | 12/31/20XX<br>12/31/20XX<br>12/31/20XX |
| 12. | LOUISIANA | 3 YEARS                      | XYZ CORP AND SUBS. | 11-1111111                  |             |            |                   | 12/31/20XX<br>12/31/20XX<br>12/31/20XX |

RETURN AND STATUTE CONTROL LIST  
 TAXPAYER: XYZ CORP. AND SUBS. - {enter #} STATES PARTICIPATING  
 Audit Period: {ENTER YEARS HERE}

SAMPLE

| #   | State         | Basic Statute of Limitations                     | Company Name       | FEIN (and State ID if appl) | Audit Years | Date Filed | Original SOL Date | Extended SOL Date |
|-----|---------------|--------------------------------------------------|--------------------|-----------------------------|-------------|------------|-------------------|-------------------|
| 13. | MISSOURI      | 3 YEARS                                          | XYZ CORP           | 11-1111111                  | 12/31/20XX  |            |                   |                   |
|     |               |                                                  | ABC CORP           | 22-2222222                  | 12/31/20XX  |            |                   |                   |
| 14. | MONTANA       | 3 YEARS<br>FED WAIVER                            | XYZ CORP AND SUBS. | 11-1111111                  | 12/31/20XX  |            |                   |                   |
|     |               |                                                  |                    |                             | 12/31/20XX  |            |                   |                   |
| 15. | NEBRASKA      | 3 YEARS<br>FED WAIVER                            | XYZ CORP AND SUBS. | 11-1111111                  | 12/31/20XX  |            |                   |                   |
|     |               |                                                  |                    |                             | 12/31/20XX  |            |                   |                   |
| 16. | NEW HAMPSHIRE | 3 YEARS                                          | XYZ CORP AND SUBS. | 11-1111111                  | 12/31/20XX  |            |                   |                   |
|     |               |                                                  |                    |                             | 12/31/20XX  |            |                   |                   |
| 17. | NEW JERSEY    | 4 YEARS                                          | XYZ CORP           | 11-1111111                  | 12/31/20XX  |            |                   |                   |
|     |               |                                                  | ABC CORP           | 22-2222222                  | 12/31/20XX  |            |                   |                   |
| 18. | NEW MEXICO    | 3 YEARS FROM XYZ CORP<br>CALENDAR YR<br>PYMT DUE | XYZ CORP           | 11-1111111                  | 12/31/20XX  |            |                   |                   |
|     |               |                                                  | ABC CORP           | 22-2222222                  | 12/31/20XX  |            |                   |                   |

RETURN AND STATUTE CONTROL LIST  
 TAXPAYER: XYZ CORP. AND SUBS. - {enter #} STATES PARTICIPATING  
 Audit Period: {ENTER YEARS HERE}

SAMPLE

| #   | State        | Basic Statute of Limitations | Company Name       | FEIN (and State ID if appl) | Audit Years | Date Filed | Original SOL Date | Extended SOL Date |
|-----|--------------|------------------------------|--------------------|-----------------------------|-------------|------------|-------------------|-------------------|
|     |              |                              |                    |                             |             |            |                   |                   |
|     |              |                              |                    |                             |             |            |                   |                   |
|     |              |                              |                    |                             |             |            |                   |                   |
| 19. | NORTH DAKOTA | 3 YEARS                      | XYZ CORP AND SUBS. | 11-1111111                  | 12/31/20XX  |            |                   |                   |
|     |              |                              |                    |                             | 12/31/20XX  |            |                   |                   |
|     |              |                              |                    |                             | 12/31/20XX  |            |                   |                   |
| 20. | OREGON       | 3 YEARS<br>FED WAIVER        | XYZ CORP AND SUBS. | 11-1111111                  | 12/31/20XX  |            |                   |                   |
|     |              |                              |                    |                             | 12/31/20XX  |            |                   |                   |
|     |              |                              |                    |                             | 12/31/20XX  |            |                   |                   |
| 21. | PENNSYLVANIA | 3 YEARS                      | XYZ CORP           | 11-1111111                  | 12/31/20XX  |            |                   |                   |
|     |              |                              |                    |                             | 12/31/20XX  |            |                   |                   |
|     |              |                              |                    |                             | 12/31/20XX  |            |                   |                   |
|     |              |                              | ABC CORP           | 22-2222222                  | 12/31/20XX  |            |                   |                   |
|     |              |                              |                    |                             | 12/31/20XX  |            |                   |                   |
|     |              |                              |                    |                             | 12/31/20XX  |            |                   |                   |
| 22. | RHODE ISLAND | 3 YEARS                      | XYZ CORP AND SUBS. | 11-1111111                  | 12/31/20XX  |            |                   |                   |
|     |              |                              |                    |                             | 12/31/20XX  |            |                   |                   |
|     |              |                              |                    |                             | 12/31/20XX  |            |                   |                   |
| 23. | TENNESSEE    | 3 YEARS                      | XYZ CORP           | 11-1111111                  | 12/31/20XX  |            |                   |                   |
|     |              |                              |                    |                             | 12/31/20XX  |            |                   |                   |
|     |              |                              |                    |                             | 12/31/20XX  |            |                   |                   |
|     |              |                              | ABC CORP           | 22-2222222                  | 12/31/20XX  |            |                   |                   |
|     |              |                              |                    |                             | 12/31/20XX  |            |                   |                   |
|     |              |                              |                    |                             | 12/31/20XX  |            |                   |                   |
| 24. | UTAH         | 3 YEARS<br>FED WAIVER        | XYZ CORP AND SUBS. | 11-1111111                  | 12/31/20XX  |            |                   |                   |
|     |              |                              |                    |                             | 12/31/20XX  |            |                   |                   |
|     |              |                              |                    |                             | 12/31/20XX  |            |                   |                   |

RETURN AND STATUTE CONTROL LIST  
 TAXPAYER: XYZ CORP. AND SUBS. - {enter #} STATES PARTICIPATING  
 Audit Period: {ENTER YEARS HERE}

SAMPLE

| #   | State         | Basic Statute of<br>Limitations | Company<br>Name    | FEIN (and<br>State ID if appl) | Audit<br>Years                         | Date<br>Filed | Original<br>SOL Date | Extended<br>SOL Date |
|-----|---------------|---------------------------------|--------------------|--------------------------------|----------------------------------------|---------------|----------------------|----------------------|
| 25. | WEST VIRGINIA | 3 YEARS                         | XYZ CORP AND SUBS. | 11-1111111                     | 12/31/20XX<br>12/31/20XX<br>12/31/20XX |               |                      |                      |
| 26. | WISCONSIN     | 4 YEARS                         | XYZ CORP AND SUBS. | 11-1111111                     | 12/31/20XX<br>12/31/20XX<br>12/31/20XX |               |                      |                      |

## Exhibit C. Waiver Policy

Page 1 of 2



MULTISTATE TAX COMMISSION

### Waiver Policy – Joint Corporate Income Tax Audits

Statutes of limitation 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. Multistate Tax Commission (“MTC”) audits are unique because multiple states simultaneously participate in the audit. MTC auditors are responsible for ensuring that no statute of limitation expires without sufficiently notifying the affected states. As a result, MTC auditors often request a waiver to facilitate a more accurate and complete audit.

*Requesting a Waiver.* MTC auditors will make every effort to complete the audit in a timely manner after the beginning of the audit. Various circumstances, however, including the complexity of the issues, the need for information, and the taxpayer’s availability, commonly necessitate that the states’ statutes of limitations be extended by waiver of the taxpayer in order to fully address all the audit issues. If the auditor determines that the audit cannot be completed at least nine months before the expiration of a state’s statute of limitations, the auditor will request a waiver from the taxpayer. An exception to this nine-month rule may be made where the taxpayer has provided all the requested information needed for the auditor to complete the audit findings and allow sufficient time for both the taxpayer and the states to review those findings before the statute or current waiver expires.

*Discuss Waiver Policy with Taxpayer.* At the initial audit appointment, the auditor will provide the taxpayer with a copy of this waiver policy. The auditor will also request a copy of the taxpayer’s written waiver policy. If the taxpayer does not have a written waiver policy, the auditor will discuss the taxpayer’s waiver policy with the taxpayer representative.

*Form of Waiver.* Unless a state requires that its own waiver form be used, the auditor will prepare one MTC Waiver Form for all states in the audit except for states where a separate waiver form is required for each taxpayer that filed returns in the state. The waiver contains a statement that the signature on the waiver is *prima facie* evidence that the individual signing the waiver is authorized to sign on behalf of the taxpayer.

*Sufficiency of Extension.* To allow participating states enough time to review the MTC audit recommendations, the waiver will extend the audit period at least nine months after the estimated completion date of the audit.

*Completeness of Waiver.* The auditor will ensure that a waiver is completed for all participating states with respect to the taxpayer and all affiliates, subsidiaries, and parent companies, as applicable, that are included in the audit.

*Taxpayer Refusal to Sign Waivers.* If a taxpayer does not sign a waiver within 30 days of the request, the auditor will immediately consult with the audit supervisor and MTC legal staff. Based on these discussions:

- the audit may be completed to the best of the auditor’s ability based on available information;
- an assessment based on the best available information may be issued by the state; or
- to facilitate the timely completion of the audit, the MTC or a participating state may issue a subpoena to compel production of documents and information.

By signing below, you certify that you have been provided a copy of the MTC Waiver Policy and have been given an opportunity to discuss the policy with the MTC auditor for all entities included in the audit.

\_\_\_\_\_  
Printed Name of Authorized Employee or Agent of Taxpayer

\_\_\_\_\_  
Signature of Authorized Employee or Agent of Taxpayer

\_\_\_\_\_  
Title

\_\_\_\_\_  
Date

# Exhibit D. MTC Waiver Form



## Multistate Tax Commission Corporate Income Tax Waiver and Extension of Statute of Limitations

|                         |                                                                                   |
|-------------------------|-----------------------------------------------------------------------------------|
| <b>Taxpayer</b>         | <b>Tax Categories:</b>                                                            |
| <b>Address</b>          | <input type="checkbox"/> <b>Income and/or Franchise Tax</b>                       |
| <b>City, State, Zip</b> | <input type="checkbox"/> <b>Financial Institution or Bank Tax / Privilege Tax</b> |
|                         | <input type="checkbox"/> <b>TN and/or OR Excise Tax</b>                           |
|                         | <input type="checkbox"/> <b>KY Limited Liability Entity Tax</b>                   |

**A. States Adopting this Form**

The following states have adopted and approved the provisions of this form:

- |                      |               |               |
|----------------------|---------------|---------------|
| Alabama              | Kansas        | North Dakota  |
| Alaska               | Kentucky      | Oregon        |
| Arkansas             | Maryland      | Pennsylvania  |
| Colorado             | Missouri      | Rhode Island  |
| Delaware             | Montana       | Tennessee     |
| District of Columbia | Nebraska      | Utah          |
| Hawaii               | New Hampshire | West Virginia |
| Idaho                | New Jersey    | Wisconsin     |
| Iowa                 | New Mexico    |               |

Louisiana provides and signs its own waiver form.

**B. Terms and Conditions; Entities and Periods Covered**

1. In order to permit the States identified in Section A. to perform audits of Taxpayer through the Multistate Tax Commission ("MTC"), acting as agent or independent contractor as applicable, and to make all appropriate deficiency determinations or assessments regarding the tax liability of Taxpayer and all affiliates, subsidiaries, and parent companies of Taxpayer, including applicable interest and/or penalties, Taxpayer agrees to waive the applicable statutes of limitations for the states and periods identified below.

Taxpayer Authorized Employee or Agent Initials \_\_\_\_\_

MTC Authorized Employee Initials \_\_\_\_\_

2. If Taxpayer filed combined or consolidated returns during the audit period, this waiver will apply to all affiliates, subsidiaries, and parent companies of Taxpayer. If Taxpayer filed separate entity returns during the audit period, even in a state where unitary groups are required to file on a combined or consolidated basis, the waiver will identify and apply to each separate entity filer.
3. The extension periods agreed to in this waiver will not shorten the statute of limitations for any tax periods within the audit that remain unexpired as of the date this waiver is signed by Taxpayer.
4. Taxpayer agrees to retain for audit purposes all records and supporting data pertaining to the taxable periods covered by this waiver.
5. By signing and initialing this waiver Taxpayer agrees to extend the statute of limitations for any amended returns that are accepted by the States for any of the audit periods identified.

| State         | Taxpayer Name | FEIN and/or State ID Number | Entire Audit Period | Period Extended Through |
|---------------|---------------|-----------------------------|---------------------|-------------------------|
| Alabama       |               |                             |                     |                         |
| Alaska        |               |                             |                     |                         |
| Arkansas      |               |                             |                     |                         |
| Colorado      |               |                             |                     |                         |
| Delaware      |               |                             |                     |                         |
| D.C.          |               |                             |                     |                         |
| Hawaii        |               |                             |                     |                         |
| Idaho         |               |                             |                     |                         |
| Iowa          |               |                             |                     |                         |
| Kansas        |               |                             |                     |                         |
| Kentucky      |               |                             |                     |                         |
| Maryland      |               |                             |                     |                         |
| Missouri      |               |                             |                     |                         |
| Montana       |               |                             |                     |                         |
| Nebraska      |               |                             |                     |                         |
| New Hampshire |               |                             |                     |                         |
| New Jersey    |               |                             |                     |                         |
| New Mexico    |               |                             |                     |                         |
| North Dakota  |               |                             |                     |                         |
| Oregon        |               |                             |                     |                         |
| Pennsylvania  |               |                             |                     |                         |
| Rhode Island  |               |                             |                     |                         |
| Tennessee     |               |                             |                     |                         |
| Utah          |               |                             |                     |                         |
| West Virginia |               |                             |                     |                         |
| Wisconsin     |               |                             |                     |                         |

Taxpayer Authorized Employee or Agent Initials \_\_\_\_\_

MTC Authorized Employee Initials \_\_\_\_\_

**C. Refunds**

1. Except for the States noted in 2., 3., and 4., of this section, the States identified in section A. agree that the signing, initialing, and filing of this waiver also extends the statutory periods identified in section B., for the States listed in Section B., during which Taxpayer may file a claim for refund if the statutory periods have not already expired prior to the signing, initialing, and filing of this waiver to the extent permitted by the laws of each State. The filing of this waiver constitutes the filing of a refund claim for the extended periods as to amounts determined by the States to be due and owing the Taxpayer if the statutory periods for filing refund claims have not already expired prior to the filing of this waiver.
2. The laws of Missouri, New Mexico, Nebraska, North Dakota, Tennessee and Wisconsin do not provide that the signing of this waiver constitutes the filing of a refund claim, but do provide that signing this waiver extends the period of time a taxpayer has to file a refund claim.
3. The law of Alabama requires a written petition for refund be filed in accordance with § 40-2A-7(c), Code of Alabama 1975. However, in some instances the Alabama Department of Revenue may issue an automatic refund in accordance with § 40-29-71. For additional information, contact the Alabama Department of Revenue.
4. In Pennsylvania, the limitations for filing a refund claim are governed by section 3003.1 of the Tax Reform Code of 1971 (72 P.S. § 10003.1). The signing of this waiver does not constitute the filing of a refund claim.

**D. Missouri Protest Rights** - By signing this waiver Taxpayer does not waive its protest rights under Chapter 143, RSMo.

[This Space Intentionally Left Blank]

**E. Signatures and Filing**

1. This waiver must be signed and initialed by an authorized employee or agent of Taxpayer. The signature will be *prima facie* evidence that the individual is authorized to sign this waiver on behalf of Taxpayer. If signed by a Taxpayer's agent, this waiver must be accompanied by a power of attorney authorizing the signature.
2. The authorized employee or agent of Taxpayer and the MTC must both sign and initial any attachments to this waiver.
3. This waiver will be deemed filed on the date it is signed and initialed by the authorized employee or agent of Taxpayer and the MTC.

\_\_\_\_\_  
**Printed Name of Authorized Employee or Agent of Taxpayer**

\_\_\_\_\_  
**Signature of Authorized Employee or Agent of Taxpayer**

\_\_\_\_\_  
**Title**

\_\_\_\_\_  
**Date**

\_\_\_\_\_  
**Printed Name of Authorized Employee of Multistate Tax Commission**

\_\_\_\_\_  
**Signature of Authorized Employee of Multistate Tax Commission**

\_\_\_\_\_  
**Title**

\_\_\_\_\_  
**Date**

# Exhibit E. Nexus Questionnaire

Page 1 of 3

## NEXUS QUESTIONNAIRE REGARDING ACTIVITIES OF EMPLOYEES PERFORMING SALES ACTIVITIES

States of:  
For Taxable Years:

NAME OF COMPANY:

ADDRESS:

1. Have you had employees or other representatives performing services within this state? (If you had employees whose base of operations was in another state, but whose duties include occasional calls upon customers or clients within this state, answer this question "yes".) Y/N

2. If "Yes",

(a) In what year did your employees or other representatives begin performance of these services within this state?

\_\_\_\_\_

Have these services been performed within this state by your employees or other representatives in every year since then?

\_\_\_\_\_

(b) Identification of employees or representatives: (a separate sheet may be used if additional space is needed).

| NAME  | ADDRESS | TERRITORY COVERED FOR YOUR COMPANY | DESIGNATE IF EMPLOYEE OR INDEPENDENT CONTRACTOR |
|-------|---------|------------------------------------|-------------------------------------------------|
| _____ | _____   | _____                              | _____                                           |
| _____ | _____   | _____                              | _____                                           |
| _____ | _____   | _____                              | _____                                           |
| _____ | _____   | _____                              | _____                                           |

(c) Do any of these employees or representatives:

|                                                                                              |     |
|----------------------------------------------------------------------------------------------|-----|
| (1) Call upon customers in this state to collect on delinquent accounts?                     | Y/N |
| (2) Make adjustments for returned or damaged merchandise?                                    | Y/N |
| (3) Investigate or authorize credit of existing or potential customers in this state?        | Y/N |
| (4) Investigate, handle, or otherwise assist in resolving customer complaints in this state? | Y/N |

NEXUS QUESTIONNAIRE PAGE 2

- If "Yes", is it more than mediating direct customer complaints when the sole purpose of such mediation is to ingratiate the sales personnel with the customer? Y/N
- (5) Receive purchase orders when calling upon a customer in this state? Y/N
- If "Yes", do they have authority to approve or reject the order? Y/N
- (6) Make "on the spot" sales to customers in this state of any items carried by them? Y/N
- (7) Inspect or have the right to inspect the marketing of your products or any use of your trademarks or trade names? Y/N
- (8) Assist your customers or their customers in this state in any of the following ways:
- (a) Train their employees or their customers in the sales, use or servicing of your products? Y/N  
 If yes, where does this take place?  
 \_\_\_\_\_  
 \_\_\_\_\_
- (b) Inspect inventories to insure adequacy? Y/N
- (9) Supervise or inspect the installation of products sold in this state? Y/N
- (10) Provide your customers in this state with technical information or advice? Y/N
- (11) Collect installments and/or delinquent accounts? Y/N
- (12) Repossess the company's products? Y/N
- (13) Investigate, recommend, or appoint potential dealers? Y/N
- (14) Conduct training courses or schools for your customers or dealers? Y/N
- (15) Maintain a sample or display room in excess of 14 days at any one location during any one year? Y/N
- (16) Maintain an office or place of business (in-home or otherwise) that is paid for directly or indirectly by the company and that is formally attributed to the company? Y/N
- (17) If the salesman's or representative's duties have not been fully covered in the items above, please add sufficient further description as to give a comprehensive description of the services performed.  
 \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_

NEXUS QUESTIONNAIRE PAGE 3

- (18) Provide a job description for each employee or representative listed in question 2(b) above.
- (19) Do any of your affiliated companies engage in any activities in this state that are listed in this questionnaire? Y/N

If so, indicate each company's name and address and explain the company's activities in this state in each of the seven most recent years.

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Signature and Verification

I declare that the information furnished in response to this questionnaire is to the best of my knowledge and belief, true, correct, and complete.

\_\_\_\_\_  
Date                      Signature of Corporate Officer                      \_\_\_\_\_  
Title

OR

I declare that, although I am not an officer of the corporation, I have prepared this report upon the basis of all information of which I have knowledge.

\_\_\_\_\_  
Date                      Signature                      \_\_\_\_\_  
Title

## Exhibit F. Unitary Questionnaire

Page 1 of 4

**MULTISTATE TAX COMMISSION**  
**UNITARY QUESTIONNAIRE FOR USE IN THE DETERMINATION OF UNITY**  
{ENTER NAME OF PARENT CORP. }  
Tax Years: {Enter Years}

**NOTE – THIS IS A SAMPLE AND SHOULD BE REVISED AS NEEDED FOR YOUR AUDIT**

1. Provide the corporate minutes and minutes of all committees of the board of directors for the entire audit period.
2. Provide a corporate organization chart.
3. For each subsidiary owned over 50% by your company and any other corporation within the worldwide consolidated group provide the following:
  - A. A list of all Officers and Directors. This list should provide the name and title of each person and should include each year under audit.
  - B. A list of all committees of the Board of Directors for each subsidiary and the names of each person on the committee.
  - C. The date and country of incorporation. In addition, indicate whether the subsidiary was incorporated by a member of the consolidated group or purchased.
  - D. The local address of each company's headquarters office.
  - E. The address of all sales offices, service centers, distribution centers, etc.
  - F. A description of its each company's activity. This description should include the types of products and/or services provided and the type of customers the product or service is provided to.
4. Please describe the reporting procedures that are required of each subsidiary.
  - A. List the types and/or names of the reports that the subsidiaries provide to the parent company or to any other member of the consolidated group.
  - B. For each report that is required list how often the report is required.
5. Does the parent corporation place controls on the subsidiaries regarding the acquisition of capital assets, purchase commitments, lease commitments or other expenditure of funds?
  - A. Describe what controls are placed on the subsidiaries for what type of transaction.
  - B. If approval is needed above a certain dollar amount, please provide the name, title and location of the person whose approval is needed.

Page 1 of 4

6. When funds are needed from outside sources (whether long or short term debt) is any type of approval needed or are the subsidiaries free to incur debt on their own?
  - A. Please describe any restrictions that the parent company has placed on the Subsidiaries.
7. When outside financing is obtained does the parent company or any other member of the group provide loan guarantees?

If the answer is yes, and loan guarantees were in existence during the audit years, please provide the following detail:

- A. The amount of the original loan.
  - B. The date of the original loan.
  - C. The balance of the loan at the end of each year under audit.
  - D. The name of the corporation the loan was made to and the name of the corporation that guaranteed the loan.
  - E. The rate of interest.
8. Does any intercompany financing occur between members of your worldwide consolidated group? If so, please provide the following information for each loan:
  - A. The amount of the original loan.
  - B. The date of the original loan.
  - C. The balance of the loan at the end of each year under audit.
  - D. The lender's name and the borrower's name.
  - E. The term of the loan.
  - F. The interest rate.
9. How is the excess cash of the subsidiaries handled?
  - A. Is there any type of daily or weekly reporting to the parent or is some other method used?
  - B. Are these funds used on a daily, weekly or some other basis by other members of the worldwide consolidated group?
  - C. Does the parent company or some other member of the worldwide consolidated group use these excess funds to make short term investments or other types of investments? Please describe these procedures in detail.
10. When investments are made with excess cash who decides when to invest, how much to invest, where to invest, and how long to hold the investment? Please provide the name and title of the person who makes the investment decisions and the company this person is employed by.
11. Please provide a detailed list of all intercompany transactions. This detail should include the following:
  - A. The name of the seller.
  - B. The name of the purchaser.
  - C. The type of intercompany transaction.

- D. The total of the intercompany transactions for each year under audit.
  - E. An explanation of how the intercompany transaction is valued.
12. During the years under audit was there been any transfer of personnel from one corporation to another? If so, list the following information:
- A. the name and title of the person and the date of the transfer.
  - B. the names of the companies which were involved.
13. Does your company have any type of policy or procedure manuals that it uses or has distributed to any of its subsidiaries? If so, please list the policy manuals or procedural manuals that are in use and which companies are using them.
14. During the years under audit did your company or any of its affiliates conduct any type of training classes or seminars or other activities of this nature for any of its personnel or the personnel from any of its subsidiaries? If so, please indicate the purpose, the location and the names and titles of the personnel in attendance.
15. Does your company have an internal audit department? If so, please list by company the subsidiaries it conducted internal audits on, the type of audit conducted and the year.
16. Have any standards of conduct, performance, ethics been established which apply to more than one company? Please list these and explain fully.
17. Are standards for profitability for one company established by the management of another company? If so, explain.
18. Marketing:
- A. Do any of the companies share central distribution facilities or sales offices? If so provide a list of the location of each shared facility, the type of facility and the names of the companies that share the facility.
  - B. Do any of the companies have common customers? If so, list the companies.
  - C. Do any of the companies have a common sales staff? If so, list the companies.
  - D. Do any of the sales catalogs or literature cover products from more than one company? If so, provide detail.
  - E. Is there a central 800 number for placing orders for parent and subsidiary Products? If so, provide detail.
19. Do any licensing arrangements exist between any members of the worldwide consolidated group? If so provide detail.
20. Does any member of the worldwide consolidated group provide computer services to any other subsidiary? If so, provide detail.

21. Does any member of the worldwide consolidated group provide legal services to any other subsidiary? If so, provide detail.
22. Does any member of the worldwide consolidated group provide insurance or other employee benefits to any other subsidiary? If so, provide detail.
23. Does any member of the worldwide consolidated group provide centralized accounting or purchasing services to any other subsidiary? If so, provide detail.
24. Does any member of the worldwide consolidated group provide a pension plan for any other subsidiary? If so, provide detail.
25. Does any member of the worldwide consolidated group provide administrative services for any other subsidiary? If so, provide detail.



# Exhibit H. Audit Satisfaction Survey



Taxpayer, and Subsidiaries

## AUDIT SATISFACTION SURVEY

**Thank you for taking a few moments to complete this survey to relay your experience of your recent MTC audit. Your feedback is important to us and will help us improve our audit process and procedures and enhance the overall MTC audit experience. Please send your completed survey to Holly Coon, Director of the Joint Audit Program- [hcoon@mtc.gov](mailto:hcoon@mtc.gov).**

For each item identified below, circle the number to the right that best fits your judgment of its quality. Use the following scale to select the quality number

1-far below expectations, 2-below expectations, 3-met expectations, 4-exceeded expectations, 5-far exceeded expectations

| <b>Based upon your recent MTC audit, please rate each of the following, if applicable:</b> |   |   |   |   |   |
|--------------------------------------------------------------------------------------------|---|---|---|---|---|
|                                                                                            | 1 | 2 | 3 | 4 | 5 |
| 1. The auditor's courtesy, professionalism, and knowledge                                  | 1 | 2 | 3 | 4 | 5 |
| 2. The auditor's responsiveness to telephone calls, written requests, and e-mails          | 1 | 2 | 3 | 4 | 5 |
| 3. The auditor's explanation and presentation of the MTC audit procedures and audit manual | 1 | 2 | 3 | 4 | 5 |
| 4. The explanation of the information and records requested to complete the audit          | 1 | 2 | 3 | 4 | 5 |
| 5. Appropriate length of time to conduct the audit                                         | 1 | 2 | 3 | 4 | 5 |
| 6. The auditor's knowledge of tax and audit issues                                         | 1 | 2 | 3 | 4 | 5 |
| 7. The auditor's explanation of the audit findings upon completion of the audit            | 1 | 2 | 3 | 4 | 5 |
| 8. Your overall audit experience                                                           | 1 | 2 | 3 | 4 | 5 |

Do you have any specific comments about your audit experience?

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Do you have any suggestions to improve our audit process?

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May we contact you about your responses? If so, please provide the following information:

Name: \_\_\_\_\_ Telephone Number: \_\_\_\_\_  
 e-mail address: \_\_\_\_\_

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