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APPORTIONMENT OF THE CORPORATE MULTISTATE TAX BASE

A Background Paper Prepared For

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APPORTIONMENT OF THE CORPORATE MULTISTATE TAX BASE

Once the basic form (e.g., net income or profits) and accounting method (e.e., unitary approach) of a general business tax has been agreed upon, the most critical issue facing a jurisdiction is the methods its employs to tax multistate business activity. Since subnational governments operate in open economies, a mechanism must be established to determine both the extent of a local firm's total tax base and the fraction of that tax base which is attributable to a particular jurisdiction. Which mechanism is chosen is important both to the business being taxed and to the taxing jurisdiction. For governments the formula has both legal and revenue implications. This is true because the courts have recognized that no state may levy general business taxes on an unapportioned base.

The apportionment method that a state adopts will determine the size of its tax base, and therefore, of its total revenues. And, of course, business firms will not only have different tax costs under alternative approaches, but also may find that they are subject to multiple taxation of their income if they are operating in jurisdictions which do not use the same apportionment methods. Despite these concerns there is no general agreement as to the "correct" formula to employ in the various taxing jurisdictions in which it operates.

There are three fundamentally differrent approaches to the apportionment of multistate business receipts: separate accounting, specific allocation, and formula apportionment.

Separate accounting or "separate entity" permits a business firm to treat its operations in different states as if they were separate and distinct value creating activities. If a business adopts this approach it must organize its book-keeping as if each of its multistate operations were a separate business with its own receipts, balance sheets, and income statement (including all items which appear in these accounts).

Specific allocation requires a business to divide its tax base among states by directly allocating certain kinds of income wholly to one tax jurisdiction or another. For example, income from personal services (e.g., consulting fees) is attributed to the state where the service is performed, interest is usually allocated to the state of the lender, and royalties from patents and copyrights are allocated to the domicile of the patent or copyright holder.

As discussed at greater length in the paper on the corporation net income tax (Tab B), both of these methods have conceptual and practical difficulties which limit their usefulness. For example, it is often the case that several operating establishments of a given business firm are mutually dependent upon one another for their success. To the extent that this is so, neither approach reflects a location's contribution to total (multistate) receipts.

Due to the difficulties inherent in separate or specific accounting techniques, all income tax states rely on some type of formula apportionment (although separate accounting is permitted in cases where the taxpayer can demonstrate its suitability). With this approach a business computes a ratio that measures the fraction of total business activity applicable to a particular state. The numerator of the ratio measures the amount of business activity created within the taxing jurisdiction (Minnesota) and the denominator measures the firm's total activity (e.g., net income, value added) everywhere.

The general form of formula apportionment is:

Tax Base x Apportionment Ratio x Tax Rate = Tax

If the tax base is net income, the formula operates as follows:

(1) Total Net Income x Apportionment ratio = Apportioned Net Income

(2) Apportioned Net Income x Tax Rate = Tax

Note that the correct formula apportionment is distinct from that of "unitary" vs. "non-unitary" apportionment. Specifically, if in the above general form Total Net Income is defined to include net income from a business firm and only its divisions (e.g., Control Data, Bloomington plus the Control Data, Seattle division), the method is non-unitary. Under the "unitary" approach, the Total Tax Base includes in addition to the parent firm the divisions and affiliates that are part of a "unity of operations" (see text discussion). If the firms included as contributing to the Total Tax Base include affiliates throughout the world, there is said to be a worldwide combination. If, however, the "total" operation limited to firms located within the U.S. borders, there is said to be a form of domestic combination.

Equal Weighted, Three Factor Formula

Most states use an equal weighted, three factor formula including property, payroll, and sales (by destination) as its mechanism for determining how much of a multistate business firm's total net income from its operations is attributable to State sources. The use of each factor is justified on the grounds that it provides proxy measures of the extent to which a business employs a tax jurisdiction's economic market. For example, it is argued that the very existence of property and payrolls within the tax jurisdiction indicates the extent to which local resources are being used in the creation of the firm's profits. The sales factor is justified in that it gives recognition to the role a jurisdiction plays in providing the business firm with a marketplace to sell its goods and services.

To illustrate further how a Minnesota firm would apply the equal weighted three factor apportionment formula, consider the following hypothetical example: Assume a firm which operates throughout the U.S. has total net income (profits) of $10,000,000. Looking at just Minnesota operations it has payrolls (salaries, wages and fringe benefits) of $900,000; property holdings (average value of real and tangible personal property owned and rented during the tax period) of $5,000,000, and sales of $30,000,000. Its total U.S. payrolls, properties and sales equal $4,500,000, $50,000,000 and $90,000,000, respectively. Under these circumstances Minnesota apportions 21.0 percent of the firm's total income as taxable for purposes, i.e.,

$$\frac{\dfrac{\text{Minnesota payroll}}{\text{Total payroll}} + \dfrac{\text{Minnesota property}}{\text{Total property}} + \dfrac{\text{Minnesota sales}}{\text{Total sales}}}{3} =$$

$$\frac{\dfrac{1,500,000}{4,500,000} + \dfrac{20,000,000}{50,000,000} + \dfrac{9,000,000}{90,000,000}}{} =$$

$$\frac{33 + 40 + 10}{3} = 27.7\%$$

Thus, at a 12.0 percent nominal (statutory) corporate tax rate, the firm's Minnesota tax liability is:

$$\$332,400 = (\$10,000,000 \times .277 \times .12)$$

Alternative Formulas

The choice of the apportionment formula is not restricted to the equally weighted three factor method despite the efforts of certain state organizations (e.g., the Multistate Tax Commission) to lobby for its uniform adoption. Alternative formulations include one (sales only) or two (payroll and profits) factor approaches or a scheme of weighting one of the three factors more heavily than the others.

The consuming states have been the most recent activists in considering the abandonment of the conventional equally weighted three factor approach. For example, the State of Iowa, with the active support of its Iowa Manufacturers Association, has adopted a sales-only formula. Alone among the states in using their approach, in 1976 and 1977 Iowa had its formula challenged by an Illinois firm on the grounds it resulted in multiple taxation and inhibited the free flow of interstate commerce. The U.S. Supreme Court, dividing 6 to 3, upheld the Iowa formula declaring that not only is the existence of duplicative taxation "speculative" but that even assuming some overlap it cannot be Constitutionally argued that Iowa rather than Illinois is at fault.

Three states - Florida, New York and Massachusetts - have taken a more subtle approach in emphasizing the role of their marketplace in interstate commerce by requiring a double weighting of the sales component in the three-factor formula. This double weighting of sales has also been given serious consideration in New Jersey ("exports are treated favorably relative to imports") and the District of Columbia ("to provide incentives for investment...").

Minnesota and Wisconsin place special emphasis on their sales components by offering optional apportionment formulas. Wisconsin business taxpayers have the option of using the double sales weighting described above or using a two-factor approach of 66-2/3 percent to sales and 33-1/3 percent to either payrolls or property.

In **Minnesota** the taxpayer may use the lesser of the equal weight three factor approach or a formula that weighs sales by 70 percent, property by 15 percent, and payroll by 15 percent. This weighted option, which tends to be favorable to firms with large out-of-state sales activities received much praise from the large Minnesota businesses that have operations both within and outside Minnesota.

The reason for this popularity with business is not difficult to understand since it reduces the tax paid to the Minnesota Treasury. Returning to the firm illustrated above, the apportionment works as follows:

$$.15\left(\frac{\text{Minnesota Payroll}}{\text{Total Payroll}}\right) + .15\left(\frac{\text{Minnesota Property}}{\text{Total Property}}\right) + .70\left(\frac{\text{Minnesota Sales}}{\text{Total Sales}}\right) =$$

$$= (.15)(33) + (.15)(40) + (.70)(10) =$$

$$= 5.0 + 6.0 + 7.0 = 18.0\%$$

Thus, at a 12.0 nominal corporate tax rate, the firms Minnesota tax liability is:

$$\$216,000 = (\$10,000,000 \times .18 \times .12)$$

The ability for corporations to choose between the equally weighted (which those firms with large ratios of Minnesota sales to total sales are more likely to adopt) or sales weighted formula largely explains why the effective rates for corporations that are shown in Table 3A of the corporation net income tax are less than .12 (12%).

Use in Minnesota

Of the 8,240 corporations using formula apportionment in Minnesota;

- o 3,393 corporations use the equally weighted arithmetic average and account for 31% of total tax liability of apportioning firms;

- o 4,487 corporations use the 15-15-70 weighted option. These firms account for 69% of total tax liability of apportioning firms.

Another 1,723 multistate corporations file in Minnesota and use either a separate accounting or sales factor only approach (with permission of the Department of Revenue); or they are firms that have little and file on a pro forma basis. (Data supplied by the Minnesota Department of Revenue and Income Tax Bulletin No. 59, 1982).

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Form
M-5 Minnesota Apportionment Information
(Rev. 12/83)

To be attached to the income tax return of every taxpayer whose taxable net income is from a trade or business carried on both in and outside Minnesota.

Name of taxpayer	Minnesota identification number	Tax year ended

Schedule A — Net income apportionable to Minnesota

Complete this schedule if your net income is subject to apportionment or your business consists of the manufacture and sale of personal property both in and outside Minnesota. If you are part of a unitary group filing under the combined income approach, you must complete Schedules M-4C and M-5C instead.

1	Net income (loss) before net operating loss deduction . . . 1	
2	Total non-apportionable net income (income from property not used in your business and income from a farm) (attach itemized list) . . . 2	
3	Apportionable business income (subtract line 2 from line 1) . . . 3	

Business income apportionment formula **Tangible property owned or used** Exclusive of property yielding income reported in lines 2 and 14	A Within Minnesota	B Total	C Ratio of Within Minn. to Total	D Weight Accorded Factors	E Weighted % (multiply col. C by col. D)
4 Average tangible property owned (at original cost) . . . 4					
5 Rents paid (capitalized) Gross rents x 8 . . . 5					
6 Total property owned or used (add lines 4 and 5) . . . 6			%	15%	%
7 **Total payroll,** including compensation of officers . . . 7			%	15%	%
8 **Sales,** gross earnings or receipts (whichever applicable) . 8			%	70%	%
9 Total (add percentages on lines 6, 7 and 8, column C) . . . 9			%		
10 Arithmetic average (divide total on line 9, column C by 3) . . . 10			%		
11 Weighted ratio (add percentages on lines 6, 7 and 8, column E) . . . 11					%

12	**Apportionment percentage** (lesser of column C, line 10 or column E, line 11) . . . 12	%
13	Income apportioned to Minnesota (multiply line 3 by line 12) . . . 13	
14	Minnesota non-apportionable net income (income from property not used in your business and income from a farm in Minnesota) (attach itemized list) . . . 14	
15	Taxable net income before net operating loss deduction (add lines 13 and 14) . . . 15	
16	Net operating loss deduction . . . 16	
17	Net income per Minnesota return (subtract line 16 from line 15) (fill in on appropriate line of income tax return) . . . 17	