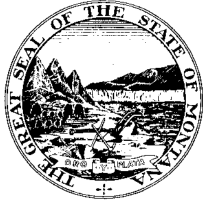

Revenue and Transportation Interim Committee

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58th Montana Legislature

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September 9, 2004

TO: Revenue and Transportation Committee

FROM: Jeff Martin, Legislative Research Analyst

SUBJECT: State-by-State Corporation Income Tax Comparisons

At the July meeting of the Revenue and Transportation Committee, Brian Staley from the Department of Revenue presented an overview of Montana's corporation license tax structure as an introduction to Lee Heiman's analysis of the confidentiality of corporation tax returns. During the discussion, committee members raised questions about other states' carryback and carryforward of net operating loss provisions, combined unitary reporting requirements, and apportionment factors for allocating income to the state. The purpose of this memo is to present state-by-state comparisons of corporation income tax bases and rates, minimum corporation taxes, combined unitary reporting requirements, and apportionment factors (Table 1, attached), and state-by-state comparisons of net operating loss carryback and carryforward periods (Table 2, attached).

Tax Base and Rates

Most states that impose a corporation income tax use federal taxable income as the starting point for computing state taxable income. States that are not tied directly to the federal tax base usually incorporate federal income and deduction provisions (e.g., Minnesota). Arkansas defines income and allowable deductions in state law. Michigan taxes businesses on the basis of value-added (the tax is being phased-out), while Texas taxes on the basis of earned surplus (retained earnings) or net worth. Nevada, South Dakota, Washington, and Wyoming do not impose corporation income taxes. Twenty-eight states and the District of Columbia impose a flat rate on net income and the remainder impose graduated rates. Some states impose separate tax rates on financial institutions and other types of businesses. Pennsylvania also imposes a capital stock tax, a foreign franchise tax, and a corporate loans tax.

Minimum Tax and Alternative Minimum Tax

California, Connecticut, District of Columbia, Idaho, Massachusetts, Montana, New Jersey, Ohio, Oregon, Rhode Island, Utah, and Vermont require a minimum tax payment. The minimum tax (or fee) for these states ranges from $10 in Oregon to $800 in California; Montana's minimum tax is $50.

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Under federal law (Tax Reform Act of 1986), certain corporations are required to recompute taxable income based on a variety of adjustments and tax preferences to determine alternative minimum taxable income. Alternative minimum taxable income that exceeds an exemption amount ($40,000) is subject to an alternative minimum tax and must be paid in addition to the corporation's regular federal tax liability.[1] The purpose of the alternative minimum tax is to collect taxes from corporations that have been able to reduce tax liability with "preferential" tax deductions (e.g., accelerated depreciation).

Several states (Alaska, California, Florida, Iowa, Maine, Minnesota, and New York) impose an alternative minimum tax that is tied in some way to the federal alternative minimum tax or is determined on some basis of minimum taxable income. In addition to the flat tax rate on net income, New York provides for the computation of tax liability of 1.78 mills per dollar of capital, a 2.5% alternative minimum tax, or a minimum of tax of $100 to $1,500 depending on payroll size. Any one of these taxes may be imposed if the tax liability is higher than the amount due from the net income tax. In Virginia, telecommunication companies pay the greater of the corporate income tax or a minimum tax based on gross receipts.

Separate v. Combined Unitary Reporting

States that calculate the taxable income and apportionment percentages of a parent corporation without regard to subsidiaries are known as separate entity states. States that take into account the income and apportionment of parent companies and subsidiaries are known as combined unitary reporting states. Most states do not allow or do not require combined reporting. In separate entity states, tax revenue may be affected by corporate restructuring, transfer pricing, and the creation of holding companies. These tax strategies may result in shifting income or profits to low tax states. Under certain conditions, some states may require combined reporting or grant permission to the taxpayer to file combined reporting. Montana is one of 13 states that require combined unitary reporting. Apparently Oregon no longer requires combined unitary reporting.

Apportionment of Income

The income of a corporation that operates in more than one state is apportioned for tax purposes to each state in which the corporation operates. The apportionment of income formula is the ratio of the corporation's business activity in the state to the corporation's total business activity. The formula used to calculate the ratio typically includes three factors: payroll, property, and sales.

Many states give greater weight to the sales factor in apportioning income. Double-weighting sales increases the tax on some corporations, decreases it on others, and has no effect on others. Giving greater weight to the sales factor may bring a larger share of a foreign corporation's income into the taxing state. On the other hand, giving greater weight to sales usually results in lower taxes for corporations domiciled in-state because these corporations typically have more

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[1] The Taxpayer Relief Act of 1997 repealed the AMT for certain small business provided the 3-year average of gross receipts does not exceed $7.5 million.

property and larger payrolls in the state than do foreign corporations. The weighting of apportionment factors does not affect taxes paid by businesses that operate entirely within the state. Oregon has recently adopted single-sales factor for apportionment. The sales factor, currently at 80%, will be phased-in to 100% by 2008. Some states (e.g., Connecticut, Massachusetts, Missouri, and Rhode Island) allow taxpayers in certain industries to apportion income using a single-sales factor formula. Single-sales apportionment is promoted for economic development because it is designed to attract more investment to the state, either by expansion of existing businesses or the location of new businesses in the state.

Net Operating Loss Carryback and Carryforward

A net operating loss occurs when a business's deductions exceed its operating income for the tax year. The rationale for allowing net operating losses is to tax businesses on the basis of the business cycle rather than individual tax years; the taxpayer is allowed to offset its bad years against its good years with net operating losses. A carryback of a net operating loss generally results in a tax refund in the carryback year, while a carryforward generally reduces tax liability in the carryforward year. For federal income tax purposes, a taxpayer is allowed to carry back losses 2 years and carry forward 20 (previously 3 years back and 15 years forward--some states have retained these periods, see Table 2). The Job Creation and Worker Assistance Act of 2002 temporarily extended the 2 year carryback to 5 years for net operating losses incurred in 2001 and 2002. Several states conform to the federal provisions (including the 5-year extension), but most states have adopted their own provisions by eliminating carrybacks, permitting shorter periods, or limiting the dollar amount allowed in a given year (not shown in the table). Twenty-four states do not allow net operating loss carrybacks. Illinois and Nebraska previously conformed with federal rules. Indiana now allows a 12-year carryforward period and Nebraska allows a 5-year carryforward. Nineteen states (including Montana) and the District of Columbia allow carrybacks (2-5 years) and carryforwards (5-20 years). Vermont follows federal provisions for net operating losses but does not allow a refund for a net operating loss carryback; the effect is to reduce the amount of the net operating loss that may be carryforward.

Table 1 and Table 2 attached

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