State and Local Taxes (SALT)

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Multi-State Taxation

Every state, city or other governmental area has a right, subject to that particular states constitutional laws to impose taxes, as defined by that particular state upon its residents, non-residents, and/or business entities having real or economic nexus within a particular state. Each states definition of taxes will be allowed within that state unless there is a clear and distinct violation of one of the following two US constitutional limitations.

a) Due Process Clause, 14 amendment
b) Commerce clause US constitution Article 1, section 8, clause 3

The following are fairly simple examples of how multi-state taxation is applied:

Individuals

a) A MA taxpayer works either full or part time in another state
b) A MA taxpayer delivers goods to another state
c) A MA taxpayer provides services to someone living in another state
d) A MA taxpayer ships goods to another state
e) A MA taxpayer owns rental property in another state
f) Pass through entities and whether a state allows direct allocation or apportionment based on factors

Please note for most Massachusetts partnerships, LLC's, LP's and trusts (flow-through) they follow the Massachusetts laws applicable to individuals. If the entity is owned solely by corporations then the flow through entity follows corporate law.

a) If a corporation only operates within Massachusetts, the there are no issues that need to be addressed
b) If a MA corporation operates, sells to, provides services, ships merchandise to or delivers such via either common carriers or company owned trucks or has economic nexus, then the laws of both the resident state and foreign state must be reviewed to determine how income is allocated, apportioned, or prorate. There is no simple answer due to the fact that each taxing jurisdiction has a right to create their own laws and interpret such, or has economic nexus.
c) Cloud Computing
d) Royalty fees for use of corporate names or symbols.

One of the purposes of this presentation is to make you aware of this multi-state tax issue so that those who are not experienced in this area may bring to the attention of your supervision the question that may be addressed by a knowledgeable KPM professional with the client and a determination may be made as to additional state tax filings and/or appropriate written notification to the client as to the tax issues or issues.

If you ask why is there a multitude of different state laws it is because the United States is a union of fifty different states with each state having a right to govern as such state seems fit within its border as long as no constitutional/violation.

A fairly recent innovation that various states have adopted is the theory of unitary taxation. The following slides which were part of a recent CPE presentation that I attended.

I've also attached at the end of the PDF on AICPA State Tax Nexus Guide, which provides additional reading material. If you really want to obtain in depth information on a state by state basis, please contact me as I have a BNA multistate survey of the 50 State Revenue Department.

Characteristics of a Unitary Business Return

Three factors:

- centralized management
- functional integration
- economies of scale

Flow of value

Investment vs. operational income

Characteristics of a Unitary Business Return

Centralized Management

- Focus on actual common control exercised between business segments. The potential to control is not relevant if the subsidiaries in fact operate as discrete businesses.
- Must exceed the typical oversight functions performed by a parent corporation on behalf of a subsidiary.
- Overlapping directors and officers is not enough to establish centralized management. Common directors and officers must exert, or be able to exert, day to day control grounded in their own operational expertise.

Characteristics of a Unitary Business Return

Functional Integration

- **Shared operational functions** – different business segments share operational business functions such as purchasing , marketing, sales, research and development, distribution or manufacturing.
- **Other shared functions**- shared administrative services may also be considered, such as personnel, legal, and accounting functions.
- **Distinct lines of Business**- functional integration is much less likely to be found where the business segments are in unrelated.

Economies of Scale

The economies of scale test focuses on whether there is any income earned as a result of shared functions, activities or operations. The question asked is whether the business segments are more profitable when operated together than those business segments would be if each business segment were operated independently.

Flow of Value

Container Corp. the Court found the existence of a unitary business based on a flow of value between Container and its subsidiaries. In *Allied Signal,* the United Sates Supreme Court reiterated that "a unitary business may exist without a flow of goods between the parent and subsidiary, if instead there is a flow of value between the entities." However in examining "the flow of capital resources from appellant to its subsidiaries through loans and loan guarantees" the Court noted that there was "no indication that any of these capital transactions were conducted at arm's length, and the resulting flow of value is obvious." By implication Transactions at arm's-length consideration would not result in a flow of value.

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Characteristics of a Unitary Business Return

Investment vs. Operational Income

In Allied Signal, the Supreme Court states, “the payee and the payor [of income] need not be engaged in the same unitary business as a prerequisite to apportionment… [w]hat is required instead is that the capital transaction serve an operational rather than an investment function.” For example, interest earned on deposits in an out-of-state bank is unitary business income if it is part of working capital even though the corporation and the bank are not unitary.

In *MeadWestvaco,* the Court stated the operational function test is not separate test for apportionability and should not be applied where “the asset in question is another business.” However, the Court did not explain what constitutes “another business.”

Statutory and Regulatory Definitions

Illinois Compiled Statutes, 35 ILCS 5/1501 (a)(27):

The term “unitary business group” means a group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other. The group will not include those members whose business activity outside the United States is 80% or more of any such member’s total business activity.

Statutory and Regulatory Definitions

Maine Revised Statutes Annotated, Title 36, Section 5102.10a:

“Unitary business” means a business activity which is characterized by unity of Ownership, functional integration, centralization of management and economies of scale.

Statutory and Regulatory Definitions

Multistate Tax Commission (MTC), Model Regulation IV.1.(b):

A unitary business is a single economic enterprise that is made up of separate parts of a single business entity or of a commonly controlled group of business entities that are sufficiently interdependent, integrated and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts.

Any of the following factors creates a strong presumption that the activities of the taxpayer constitutes a unitary business:

Same type of business;
Steps in a vertical process; and
Strong centralized management

Unitary Business Tax Planning

- Advantages of unitary combined reporting
    - Ability to offset income and losses among affiliated entities
    - Elimination of intercompany income gain
    - Utilization of credits
- Disadvantages of unitary combined reporting
    - Eliminates use of separate entity tax planning
    - Restrictions against electing out of combined reporting
    - Restrictions on credit utilization

Unitary Business Tax Planning

Variables that drive combined unitary return tax planning:

- Relative amount of income/loss or profitability
- Apportionment
- Throwback/throw-out rules
- Special deductions and credits

COMBINED REPORTING DOCUMENT

AICPA STATE TAX NEXUS GUIDE