KILPATRICK TOWNSEND

5 KEY TAKEAWAYS

State Corporate Income Apportionment: Key Fundamentals & Legislative Trends

Jeffrey S. Reed, Chair of Kilpatrick Townsend's State and Local Tax Group, spoke as part of a Strafford webinar panel on August 9th, on the topic "State Corporate Income Apportionment: Key Fundamentals and Legislative Trends."

Key takeaways from the presentation include:

1

Nationwide State Corporate Income Tax Reform Continues Apace

It seems that every year at least one additional state adopts market-based sourcing. New Jersey is the latest state to follow this trend, effective in 2019. There are several factors driving the trend. Perhaps most significantly, market based sourcing benefits in-state companies, making it politically palatable. There is also a "bandwagon effect" happening, with states piling on and wanting to follow what the other states are doing. Third, market based sourcing is typically presented as "modernization" of the state corporate tax system, necessary to keep the state competitive, which can be hard to politically oppose.

2

Alternative Apportionment (However Framed) Continues to be a Hot Audit Issue

With more states adopting market-based sourcing for services the alternative apportionment audit fights have been decreasing compared to 5-10 years ago. But auditors are not shy about imposing alternative apportionment even for more recent tax periods any time they see an entity with substantial income and 0% in-state apportionment. However, rather than couch a proposed adjustment as alternative apportionment auditors now seem more inclined to frame such adjustments as a proper application of the statutory rules, rather than as a deviation from the standard approach.

3

Keep an Eye Out for Industry-Specific Apportionment Formulas

Industry-specific apportionment formulas can dramatically lower an entity's in-state apportionment percentage. So it is worthwhile to think about whether certain entities meet the requirements to benefit from industry specific apportionment formulas or, if not, if a reorganization could be performed so that the requirements will be met. Notably, some state tax revenue departments seek to INCREASE a company's apportionment percentage by arguing that it is subject to an industry-specific apportionment formula.

4

Determining Where the Benefit Is Received Is Not Always Easy

In many fact patterns it is easy to apply market-based sourcing rules. But where there is a single line item on an invoice for a service that is at least arguably received in several states the rules can be difficult to apply. Generally, most states require that some type of reasonable method be used to allocate the receipt in such cases, but there may be several reasonable alternatives. Where there are a large number of receipts like this, billing address is the most easily administrable method.

5

SPEs Present Special Difficulties

Apportionment rules were designed with operating entities in mind, and can be challenging to apply to holding companies, factoring companies, and other special purpose entities (SPEs) that may have no employees or tangible property. The Multistate Tax Commission has recently adopted model regulations (Reg. IV.18.(c).) that apply in situations where a company has zero (or virtually zero) receipts under the state's general apportionment statutes. As a best practice, companies should think about how state tax apportionment rules will apply to SPEs when creating them, particularly if it is anticipated that the SPEs will have considerable income.

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