27d

(Gov) Agency: General Fund Taxes -- Combined Reporting

Recommendations:

Paper #112:

Comments: In Wisconsin, each separate corporation -- including a member of a group of affiliated corporations -- reports its own income, its own deductions and its own net tax due

The governor's proposal would adopt combined reporting, under which affiliated corporations under a formula composed of factors applicable to all the related corporations. Illinois, Minnesota, Michigan and Indiana all use combined reporting, as do roughly 2/3rds of all states.

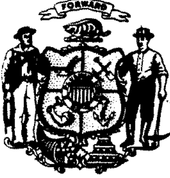
The gov said this would increase state tax collections by $70 million over the biennium. New estimates have added $31 million to the revenue.

Combined reporting is used to protect states from corporations that finesse their liabilities by shifting profits from high tax to lower tax states. Under combined reporting, Wisconsin corporations would have less incentive to establish out-of-state firms to escape taxation.

Big business, especially banks, hate it.

Burke Motion:

Prepared by: Bob



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June 7, 1999 | Joint Committee on Finance | Paper #112

Corporate Income and Franchise Tax -- Combined Reporting (General Fund Taxes -- Individual and Corporate Income Taxes)

[LFB 1999-01 Budget Summary: Page 31, #10]

CURRENT LAW

In general, the Wisconsin corporate income and franchise tax is computed using federal provisions to determine income and deductions and then apportioning the net income of a multistate corporation, applying the tax rate and allowing for any credits. Under current Wisconsin law, each separate corporation, including a member of a group of affiliated corporations, is taxed as a separate entity. Each individual corporation reports its own income, its own deductions and its own net tax due.

GOVERNOR

Require corporations that are subject to the state corporate income and franchise tax and that are members of an affiliated group engaged in a unitary business to compute state corporate income and franchise tax liability using the combined reporting method of determining income. In the bill, the administration estimated that use of combined reporting would increase corporate income and franchise tax revenues by $23,100,000 in 1999-00 and $47,000,000 in 2000-01. The specific provisions related to combined reporting are described in the following sections.

DISCUSSION POINTS

1. In an audit of a multicorporate taxpayer in 1937, the California Franchise Tax Commissioner (predecessor of the Franchise Tax Board) computed the taxable income of a corporate taxpayer by combining the income and expenses of the taxpayer with its related corporations and apportioning a part of the combined net income to California by means of a formula composed of factors applicable to all of the related corporations. In Edison Stores, Inc. v

McColgan, (1947), the California Supreme Court first approved the "combined report method" of determining the taxpayer's California taxable income.

2. Table 1 provides summary information regarding combined reporting for individual states for 1998. Generally, combined reporting is required where two or more entities having more than 50% common ownership are engaged in a unitary business. A majority of states permit combined reporting upon the application of the group while 16 states require combined reporting of all unitary income. There is much variety in the requirements, computations and nomenclature for combined reports. Due to this lack of uniformity, it is necessary to consult the appropriate law of each state to determine the content and form of each required combined report.

TABLE 1

State Provisions for Combined Reporting
1998

State	State Has Combined Reporting?	Always Required of Unitary Business?	Include Foreign Affiliates?
Alabama	No*	No	N/A
Alaska	Yes	Yes	Yes. Including affiliates organized outside U.S. without U.S. operations
Arizona	Yes	Yes	No
Arkansas	No*	No	N.A.
California	Yes	Yes	No. If water's edge election made
Colorado	Yes	Yes	Yes. Except certain affiliates with 80% or more foreign property and payroll
Connecticut	No**	No	N.A.
Delaware	No	No	N.A.
Florida	No*	No	N.A.
Georgia	Yes	No	Yes. If consolidated return filed
Hawaii	Yes	Yes	No
Idaho	Yes	Yes	Yes. If water's edge election is not made or if water's edge election is made and foreign affiliates meet certain conditions
Illinois	Yes	Yes	Yes. Except certain affiliates with 80% or more foreign property and payroll
Indiana	Yes	No	Yes. Except certain affiliates with 80% or more foreign property and payroll
Iowa	No	No	N.A.
Kansas	Yes	Yes	No
Kentucky	Yes	No	No
Louisiana	Yes	No	No
Maine	Yes	Yes	Yes. Except certain affiliates with 80% or more foreign property and payroll
Maryland	No	No	N.A.
Massachusetts	No**	No	N.A.
Michigan	Yes	No#	Permitted of foreign-based affiliates subject to Michigan single business tax
Minnesota	Yes	Yes	No
Mississippi	Yes***	No	N.A.

State	State Has Combined Reporting?	Always Required of Unitary Business?	Include Foreign Affiliates?
Missouri	Yes	No	N.A.
Montana	Yes	Yes	No. If water's edge election made
Nebraska	Yes	Yes	No
New Hampshire	Yes	Yes	No. If water's edge election made
New Jersey	No	No	N.A.
New Mexico	Yes	No	Yes. But only for foreign based affiliates engaged in trade or business in U.S.
New York	Yes	No	No
North Carolina	No	No	N.A.
North Dakota	Yes	Yes	Yes. If water's edge election is not made or if water's edge election is made and foreign affiliates have more than 20% U.S. property and payroll
Ohio	Yes	No	No
Oklahoma	No*	No	N.A.
Oregon	Yes	Yes	Not stated
Pennsylvania	No	No	N.A.
Rhode Island	No**	No	N.A.
South Carolina	No*	No	N.A.
Tennessee	Yes. Unitary financial corps only	No #	No
Utah	Yes	Yes	Yes. If they meet threshold level of U.S. activity or if worldwide election is made
Vermont	No*	No	N.A.
Virginia	Yes	No	Only to extent controlled foreign subsidiary is subject to Virginia income tax
West Virginia	Yes	No	Not stated
Wisconsin	No	No	N.A.

* Affiliated groups may file a state consolidated return if a federal consolidated return is filed.

** Affiliated groups may not file a state consolidated return but may elect to file a state combined return if a federal consolidated return is filed.

*** Affiliated groups are permitted or may elect to file a state consolidated return with various restrictions.

#Combined reporting required for certain members of an affiliated group.

Source: CCH Charts, State Tax Guide, Multistate Corporate Tax Guide and Tax Management Portfolios

3. A state that employs the combined reporting method of attributing income of a group of affiliated corporations for tax purposes looks beyond the legal structure of separate incorporation to determine whether two or more members of an affiliated group of corporations are engaged in a single unitary business. Combined reporting is intended to insure that the income of a multi-corporate business is computed and apportioned in the same manner as in the case of a single corporate business to promote equality and uniformity in the application of the state's tax laws. For this purpose, the unitary concept rather than a corporate entity is used in determining the tax base and the apportionment formula used in attributing income to the taxing state. However, much of the controversy and difficulties associated with combined reporting arise from attempts to determine

whether activities constitute a single unitary business.

4. The U.S. Supreme Court and various state courts have affirmed use of the unitary principle in combination with formula apportionment as an appropriate method for assigning a portion of income and value of a multijurisdictional business to a single jurisdiction when it conducts its operations in a number of states. Certain state and federal court decisions have established tests for determining the existence of a unitary business such as: vertical integration; horizontal integration; unity of ownership, use and operation; contribution or dependency; centralized management; functional integration; economies of scale; and the flow of value. The Multistate Tax Commission has formulated a regulation creating a strong presumption of the existence of a single unitary business when: (a) activities are in the same general line of business; (b) activities are steps in a vertically structured enterprise; or (c) there is strong central management coupled with the existence of centralized departments for such functions as advertising, financing, research or purchasing. A number of states have administratively adopted this approach.

5. However, there is no universally accepted definition of unitary. In most cases, the existence of unity must be determined by specific facts and circumstances. Two recent Illinois court cases provide examples of the difficulties faced by taxpayers and tax administrators in determining whether a multicorporate business is unitary. In A.B. Dick v McGraw, the taxpayer created a wholly owned subsidiary to handle a new product line that was developed with the parent company. There was common ownership, both companies were in the same line of business, shared officers, and shared legal, real estate and insurance departments. Initially the taxpayer filed separate income tax returns but later filed on a combined basis. However, the Illinois Department of Revenue contended that the multicorporate business was not unitary. Conversely, in Borden, Inc. v. The Illinois Department of Revenue the parent company was engaged in the manufacture of food products and the subsidiaries manufactured carbonated beverages and operated as bottlers. There was common ownership, similar lines of business, shared accounting, treasury insurance, and benefits with some overlapping officers. In this case, the group was determined to be unitary.

6. Wisconsin taxes all multijurisdictional corporations based on the unitary principle. Generally, all gross income and all the business expenses of the unitary operation of a single corporation are used in determining that company's apportionable income. The apportionment percentage is based on the ratio of the company's Wisconsin payroll, property and sales to the total payroll, property and sales for the unitary business. However, Wisconsin taxes each corporation separately. Consequently, only the gross income, business expenses and apportionment formula factors which reflect the unitary operations of a single corporation are used to determine net taxable income. The income, business expenses and formula factors of affiliated corporations are not included, even if the business operations of the affiliated corporations would be considered part of a single unitary business. If the state has nexus with affiliated corporations engaged in a unitary business, they are taxed separately. If the state does not have nexus with such corporations, they are not taxed by the state.

7. One means of extending the unitary concept to the taxation of affiliated groups of corporations is using combined reporting to attribute net income to a particular state. Under the combined reporting method, all of the separate units of a unitary business, including divisions,

subsidiaries and affiliates, are treated as a single entity for tax purposes. In general, combined reporting requires that each unitary member's apportionable income be added together, intercompany transactions are eliminated and total apportionable income is allocated based on the ratio of apportionment factors in the taxing state to the total of such factors everywhere. Nonbusiness income is separately allocated to the individual affiliates. Each member of the unitary group may file a separate state tax return with net tax liability based on the firm's share of the unitary group's combined income. However, in other cases, the affiliated group may file a single return with the tax liability for the entire unitary group.

Typically, combined reporting is required for two or more corporations that are part of the same unitary business and that are related through at least 50% joint stock ownership. In most states that use combined reporting, all corporate affiliates that are part of the unitary group are included in the combined report, even if the affiliated corporation does not have nexus with the taxing state. However, affiliated corporations would not file separate returns with states that did not have nexus with the firm. In some states, only corporations with nexus are included in the combined report. Generally, three types of combined reporting are used—worldwide, water's edge and domestic. Under worldwide combined reporting, the income and formula factors of foreign affiliates are included, even when the foreign affiliate operates entirely outside the United States. Water's edge combined reporting is generally applied to U.S. corporations and affiliates having more than 20% of property and payroll assigned to the United States. Domestic combination is limited to affiliated corporations that are incorporated within the U.S.

8. Exhibits 1 through 3 provide a comparison of the calculation of net corporate income and franchise tax liability for an affiliated group of corporations under current law, combined reporting, a consolidated return and two methods of combination using a consolidated return. Exhibit 1 shows the calculation of tax liability using current law provisions. Exhibit 2 illustrates the calculation of net tax liability using combined reporting for determining individual corporate tax liabilities. Exhibit 3 shows a consolidated return for the same combined group. These examples are based on information included in a May, 1992, Department of Revenue report (Combined Reporting by Affiliated Corporations). The exhibits illustrate the calculation of state tax liability for a group of three affiliated corporations that are engaged in a unitary business. The parent corporation is incorporated under Wisconsin law and conducts business in and outside of Wisconsin. One of the subsidiary corporations is also incorporated in Wisconsin and has business activities inside and outside of the state. The second subsidiary is incorporated in Delaware and does not conduct business in the state. The tax amounts shown in the exhibits assume that no credits will be claimed. In the example, the Wisconsin parent corporation makes sales of $100,000 to the Wisconsin subsidiary and sales of $300,000 to the Delaware subsidiary. The Wisconsin subsidiary has $200,000 of sales with the Delaware subsidiary; the Delaware subsidiary has sales of $200,000 with the Wisconsin parent corporation. Intercompany transactions among the related corporations generate $500,000 in net income. Of the total amount, $50,000 is earned by the Wisconsin parent, $50,000 is earned by the Wisconsin subsidiary and $400,000 is earned by the Delaware subsidiary.

9. Exhibit 1 illustrates the calculation of net Wisconsin income and franchise tax

liability for each of the three corporations under current law. Each corporation computes its apportionable income as a separate entity. Generally, this is federal taxable income with specified state adjustments. A portion of this income is attributed to the state using the apportionment percentage that is calculated for the firm through the apportionment formula. The apportionment percentage is based on the ratio of the corporation's formula factors (payroll, property and sales) in Wisconsin to the total of the corporation's formula factors. The income that is attributed to the state is Wisconsin net taxable income and is taxed at the state flat corporate income and franchise tax rate of 7.9%. The example does not include nonapportionable income (certain income from tangible and intangible property) and net operating loss carryforwards. These items are included in Wisconsin taxable income before applying the tax rate. The Delaware subsidiary does not pay tax or file a state tax return because it does not have nexus with the state.

10. Exhibit 2 shows the calculation of net tax liability for each of the related corporations using a combined report. Combined reporting treats a unitary group of corporations as a single business. The apportionable incomes (federal taxable income with state adjustments) or losses of each corporation in the unitary group are added together. Even income earned by members of the unitary group that do not have nexus with the taxing state, such as the Delaware corporation, is included in combined income. Also, if a corporation reports a loss, total combined income would be reduced by this amount. Income or losses from all transactions between the members of the unitary group are eliminated. In the example, the income each firm received from intergroup transactions (totaling $500,000) is subtracted in computing combined net income. Although not shown, nonbusiness income or losses would also be subtracted in arriving at combined net income. Combined net income measures the group's business income or loss that was generated from business transactions with entities that are not part of the unitary business.

The combined net income of the unitary group is allocated to Wisconsin based on the ratio of the aggregate group property, payroll and sales in Wisconsin to the total aggregate property, payroll and sales of the unitary group. The total aggregate apportionment factors for the unitary corporations include the formula factors of corporations which do not have nexus with the taxing state (such as the Delaware subsidiary). Factor amounts which represent transactions between members, such as the $800,000 in total sales between members, are eliminated in computing the combined apportionment ratio for the group. The amount apportioned to the state represents the income that is generated by Wisconsin business activities of the unitary group of corporations.

The combined Wisconsin income of the unitary group is allocated to each corporate member based on the ratio of the member corporation's state apportionment factors to the group's aggregate state apportionment factors. Nonbusiness income or loss would be separately allocated to the individual corporations based on state law provisions. Thus, the combined report is used to determine an individual corporation's share of the total business income of its unitary group. Each corporation in the unitary group files a separate tax return and determines its income or franchise tax liability based on its apportioned share of combined state income plus any nonbusiness income or loss allocated to the firm. However, in some states, such as Illinois, a single return is filed for the entire unitary group.

11. A return for the combined group in Exhibit 2 is shown in Exhibit 3. This return

includes the Delaware subsidiary. Note that the total consolidated tax liability ($70,616) is the same as the aggregate total of individual company liabilities in Exhibit 2. Also, this type of return would be filed for a federal consolidated group under a consolidated/one company method of filing.

EXHIBIT 1

Example Calculation of Separate Entity Net Tax Liability
Wisconsin Parent and Two Subsidiaries

A. NET INCOME

	(1) WI Parent	(2) WI Subsidiary	(3) DE Subsidiary
Taxable Income	$2,000,000	$150,000	$2,000,000

B. APPORTIONMENT PERCENTAGE

		(1) WI Parent	(2) WI Subsidiary	(3) DE Subsidiary
Property:	Wisconsin	$3,000,000	$1,000,000	$0
	÷ Total	4,000,000	2,000,000	6,000,000
	= Percent	75.00%	50.00%	0%
Payroll:	Wisconsin	$800,000	$300,000	$0
	÷ Total	1,000,000	500,000	2,000,000
	= Percent	80.00%	60.00%	0%
Sales:	Wisconsin	$1,950,000	440,000	$0
	÷ Total	6,000,000	1,200,000	8,000,000
	= Percent	32.50%	36.67%	0%
	(x 2) Double-Weighted	65.00%	73.34%	0%
Total Factor Percentages		220.00%	183.34%	0%
(÷ 4) Percent to Wisconsin		55.00%	45.84%	0%

C. WISCONSIN NET INCOME

	(1) WI Parent	(2) WI Subsidiary	(3) DE Subsidiary
Taxable Income	$2,000,000	$150,000	$2,000,000
x Apportionment Percentage	x 55.00%	x 45.84%	x 0%
= WI Net Income	$1,100,000	$68,760	$0

D. TAX LIABILITY

	(1) WI Parent	(2) WI Subsidiary	(3) DE Subsidiary
WI Net Income	$1,100,000	$68,760	$0
x Tax Rate	x 7.90%	x 7.90%	x 7.90%
= Tax	$86,900	$5,432	$0
Total Wisconsin Liability		$92,332	

EXHIBIT 2

Example Calculation of Combined Reporting Net Tax Liability
Wisconsin Parent and Two Subsidiaries

A. NET INCOME

	(1) WI Parent		(2) WI Subsidiary		(3) DE Subsidiary		(4) Combined
Taxable Income	$2,000,000	+	$150,000	+	$2,000,000	=	$4,150,000
- Income from Inter-Company Transactions	-50,000	+	-50,000	+	-400,000	=	-500,000
= Net Income	$1,950,000	+	$100,000	+	$1,600,000	=	$3,650,000

B. APPORTIONMENT PERCENTAGE FOR UNITARY GROUP

		(1) WI Parent		(2) WI Subsidiary		(3) DE Subsidiary		(4) Combined
Property:	Wisconsin	$3,000,000	+	$1,000,000	+	$0	=	$4,000,000
	÷ Total	4,000,000	+	2,000,000	+	6,000,000	=	12,000,000
	= Percent							33.33%
Payroll:	Wisconsin	$800,000	+	$300,000	+	$0	=	$1,100,000
	÷ Total	1,000,000	+	500,000	+	2,000,000	=	3,500,000
	= Percent							31.43%
Sales:	Wisconsin	$1,950,000	+	$440,000	+	$0	=	$2,390,000
	Total	$6,000,000	+	$1,200,000	+	$8,000,000	=	$15,200,000
	- Intercompany Sales	-400,000	+	-200,000	+	-200,000	=	-800,000
	÷ Net Total	$5,600,000	+	$1,000,000	+	$7,800,000	=	$14,400,000
	= Percent							16.60%
	(x 2) Double-Weighted							33.20%
								(33.33+31.43+33.20)
Total Factor Percentages								97.96%
(÷ 4) Percent to Wisconsin								24.49%

C. WISCONSIN NET INCOME OF UNITARY GROUP

	(1) WI Parent		(2) WI Subsidiary		(3) DE Subsidiary		(4) Combined
Taxable Income	$1,950,000	+	$100,000	+	$1,600,000	=	$3,650,000
x Apportionment Percentage						x	24.49%
= WI Net Income							$893,885

D. APPORTIONMENT PERCENTAGE FOR INDIVIDUAL MEMBER

		(1) WI Parent		(2) WI Subsidiary		(3) DE Subsidiary		(4) Combined
Property:	Wisconsin	$3,000,000		$1,000,000		$0		$4,000,000
	÷ Combined Total	12,000,000		12,000,000		12,000,000		12,000,000
	= Percent	25.00%	+	8.33%	+	0%	=	33.33%
Payroll:	Wisconsin	$800,000		$300,000		$0		$1,100,000
	÷ Combined Total	3,500,000		3,500,000		3,500,000		3,500,000
	= Percent	22.86%	+	8.57%	+	0%	=	31.43%

EXHIBIT 2 (continued)

		(1) WI Parent		(2) WI Subsidiary		(3) DE Subsidiary		(4) Combined
Sales:	Wisconsin	$1,950,000		$440,000		$0		$2,390,000
	÷ Combined Total	14,400,000		14,400,000		14,400,000		14,400,000
	= Percent	13.54%	+	3.06%	+	0%	=	16.60%
	(x 2) Double-Weighted	27.08%	+	6.12%	+	0%	=	33.20%
Total Factor Percentages		74.94%	+	23.02%	+	0%	=	97.96%
(÷ 4) Average Factor Percentage		18.74%	+	5.75%	+	0%	=	24.49%
Percent of Combined Percentage		76.52%		23.48%		0%		

E. WISCONSIN NET INCOME OF INDIVIDUAL MEMBER

Combined Group Net Income	$893,885	$893,885	$893,885
x Percent of Combined Apportionment Percentage	x 76.52%	x 23.48%	x 0%
= WI Net Income	$684,000	$209,884	$0

F. TAX LIABILITY

WI Net Income Tax Rate	$684,000	$209,884	$0
x Tax Rate	x 7.90%	x 7.90%	x 7.90%
= Tax	$54,036	$16,580	$0
Total Wisconsin Liability	$70,616		

EXHIBIT 3

Example Calculation of Combined Reporting Net Tax Liability on Group Return
Wisconsin Parent and Two Subsidiaries

A. NET INCOME		(1) WI Parent		(2) WI Subsidiary		(3) DE Subsidiary		(4) Combined
Taxable Income		$2,000,000	+	$150,000	+	$2,000,000	=	$4,150,000
- Income from Inter-Company Transactions		-50,000	+	-50,000	+	-400,000	=	-500,000
= Net Income		$1,950,000	+	$100,000	+	$1,600,000	=	$3,650,000
B. APPORTIONMENT PERCENTAGE FOR UNITARY GROUP								
Property:	Wisconsin	$3,000,000	+	$1,000,000	+	$0	=	$4,000,000
	÷ Total	4,000,000	+	2,000,000	+	6,000,000	=	12,000,000
	= Percent							33.33%
Payroll:	Wisconsin	$800,000	+	$300,000	+	$0	=	$1,100,000
	÷ Total	1,000,000	+	500,000	+	2,000,000	=	3,500,000
	= Percent							31.43%
Sales:	Wisconsin	$1,950,000	+	$440,000	+	$0	=	$2,390,000
	Total	$6,000,000	+	$1,200,000	+	$8,000,000	=	$15,200,000
	- Intercompany Sales	-400,000	+	-200,000	+	-200,000	=	-800,000
	÷ Net Total	$5,600,000	+	$1,000,000	+	$7,800,000	=	$14,400,000
	= Percent							16.60%
	(x 2) Double-Weighted							33.20%
								(33.33+31.43+33.20)
Total Factor Percentages								97.96%
(÷ 4) Percent to Wisconsin								24.49%

C. WISCONSIN NET INCOME OF UNITARY GROUP

Aggregate Taxable Income	$3,650,000
x Apportionment Percentage	x 24.49%
= WI Net Income	$893,885

D. TAX LIABILITY

Combined/Consolidated WI Net Income	$893,885
x Tax Rate	x .079
= Tax	$70,616

12. Combined reporting is used to protect states from many tax planning techniques. In separate entity states, tax revenues are more directly linked to the structure of the corporate group. Under separate entity reporting, a corporation is likely to pay a different amount of tax if it incorporates a branch or division or liquidates a subsidiary. In addition, when separate entity reporting is used, transfer prices must be established for transactions between members of an affiliated group. In a separate entity state, intercorporate transactions can be used to shift profits from high effective tax rate states to low effective tax rate states. For example, consider a parent corporation that manufactures inventory that it sells to its subsidiary. The parent is taxable only in state A, while the subsidiary is taxable only in state B. The income of the parent will be a function of the price at which the inventory is sold to the subsidiary. If state A has a higher effective tax rate than that of State B, the temptation for the corporate group will be to sell the inventory at the lowest defensible price, which would have the effect of shifting profits from the parent to the subsidiary. Although the example involves the sale of tangible personal property, the same shifting of profits can occur using management fees, consulting fees, royalty payments, interest charges or payments for goodwill or know-how. Combined reporting eliminates the need to establish fair transfer prices for transactions between members of a unitary group. Such transactions are not included in determining the combined taxable income of the group. However, transfer prices would still need to be established for all intercorporate transactions that were not part of the unitary business activities of the group.

13. Combined reporting gives states an advantage in addressing the use of out-of-state holding companies and affiliates to shift profits to other states. One common technique is to use an out-of-state holding company or subsidiary to manage intangible assets that generate income, such as capital gains, dividends, interest, and royalties in states that do not tax such income. An illustration would be the strategy of Toys R Us. Toys R Us incorporated a subsidiary in Delaware to which it transferred valuable trademarks and tradenames, including the "Toys R Us" trademark. The subsidiary executed a license agreement allowing its parent to use the Toys R Us trademark, other trademarks and know-how. In return, the parent paid its subsidiary a royalty, which it deducted in calculating the taxable income it apportioned to the states where it had stores. Thus, the business deducted the royalty in calculating apportionable income without paying any state tax on the receipt of the royalty. In one year, the subsidiary received $55 million of income and paid no state taxes. Other similar techniques involve loans to related corporations and transfer of stocks and bonds.

14. One concern expressed about separate entity reporting in Wisconsin is that it allows a corporation to structure itself to reduce its state tax liability through the creation of out-of-state subsidiaries or affiliates. There is particular concern that state firms are establishing out-of-state investment subsidiaries to manage investment income. These out-of-state firms are not subject to the Wisconsin corporate income and franchise tax. Moreover, the state provides a deduction for dividends received from another corporation if the receiving corporation owns 70% of the voting stock of the payer corporation. Thus, the out-of-state subsidiaries can distribute the investment income to the Wisconsin parent corporation in the form of nontaxable dividends and those dividends would not be subject to the state corporate income and franchise tax.

15. Through combined reporting, the income earned by out-of-state holding companies and subsidiaries would be included in combined income for the Wisconsin firm. The apportionment

factors of the out-of-state subsidiary would be included in the denominator of the combined apportionment ratio used to allocate income to Wisconsin. If the amount of investment income was substantial and the values of the formula factors were relatively small, then the amount of combined income allocated to the state would probably be greater under combined reporting than it would under separate entity reporting. Consequently, Wisconsin firms would have less incentive to establish out-of-state firms in order to escape taxation. On the other hand, establishing subsidiary or affiliated corporations is a common and potentially expensive business practice. Firms are organized in a certain structure for many business-related purposes and not solely because of the tax consequences. Also, it can be difficult to determine if a particular investment activity is an integral part of the unitary business operations of an affiliated group of corporations.

16. Combined reporting is viewed as antibusiness by many corporate taxpayers. Taxpayers object to what is believed to be the arbitrary nature of administrative definitions of the unitary business. In addition, the method tends to shift income from the more profitable members to the less profitable members of a commonly owned group of corporations. Corporate officials may conclude that the apportionment of the affiliated group's combined income would assign more income to the in-state affiliate than is actually generated by its activities. Corporations that are members of affiliated groups subject to combined reporting can be placed at a competitive disadvantage when compared to businesses subject to separate entity reporting. As a result, corporations may be reluctant to establish, expand or continue operations in states which use combined reporting. However, since a majority of states currently permit or require combined reporting for corporate income tax purposes, combined reporting may be more readily accepted by corporate officials.

17. Taxpayers must address a number of issues related to filing combined returns. These issues include:

- Determining what parts of a business are unitary. Acquisitions and dispositions can change the make-up of an affiliated group and this can affect determinations of unity.

- Internal compliance costs increase. Unitary groups can differ from state to state which requires multiple determinations of intercompany transactions and business liabilities and increased research.

- Compliance problems arise when members have different tax years.

- Apportionment information for non-filing foreign affiliates is often difficult to obtain.

- Foreign transactions must be translated using U.S. tax accounting principles.

- Auditors must spend additional time reviewing combined returns.

- Unitary returns are generally more time-consuming and complex to prepare.

- Estimated tax liabilities are more difficult to determine for unitary groups.

- The treatment of net operating loss carryforwards is more complicated when filing a combined return.

However, with a majority of states requiring some form of combined reporting, many corporations are already compiling the additional information and conducting activities necessary to file combined returns.

18. The combined reporting provisions would apply to tax years beginning on January 1 of the year in which the bill takes effect, if it takes effect by July 31. If the bill takes effect after July 31, then the provisions would first apply to tax years beginning on January 1 of the following year. Under the bill, use of combined reporting is estimated to increase corporate income and franchise tax revenues by $23.1 million in 1999-00 and $47.0 million in 2000-01. The fiscal estimate assumes that the new provisions would first apply to tax year 2000.

19. Since AB 133 was introduced, the Department of Revenue (DOR) has developed a new estimate of the combined reporting provisions. DOR constructed a model using information from 1994, 1995 and 1996 Wisconsin, Minnesota and federal tax returns. Minnesota data was included because the state requires combined reporting for unitary groups. In addition, information was obtained from the Department of Financial Institutions to estimate the fiscal effect of combined reporting on banks and other financial institutions. Based on these simulations, the Department estimates that implementing combined reporting for state tax purposes would increase state corporate income and franchise tax revenues by $31.5 million in 1999-00 and $70.0 million in 2000-01. These estimates are higher than the figures used in the bill by $8.4 million in the first year and $23.0 million in the second year.

20. These estimates should be viewed as potential revenues for a number of reasons. First, many taxpayers would be uncertain as to whether combined reporting was required. If combined reporting resulted in higher liabilities, some would not file combined returns and wait for a determination on audit. Conversely, taxpayers with reduced liabilities would file returns. Both Minnesota and Illinois experienced significant declines in revenues in the year following adoption of combined reporting. However, in part this reflected the poor national economy at the time (1981).

21. If the Committee wishes to approve combined reporting but there is concern about its effect on small Wisconsin financial institutions, one alternative would be to adopt combination but provide an exclusion for income from U.S. government obligations. Because the corporate tax is a franchise tax, Wisconsin can tax such income. Providing an exclusion for interest on federal obligations would reduce corporate franchise tax revenues by an estimated $15.8 million in 1999-2000 and $35 million in 2000-01. If this exclusion were adopted in conjunction with combined reporting, corporate income and franchise tax revenues would increase by an estimated $15.7 million in 1999-00 and $35 million in 2000-01 compared to current law.

22. If there is concern that some Wisconsin businesses are establishing out-of-state affiliates to manage intangible income and shifting profits to those companies, the Committee may

wish to consider an alternative to the combined reporting proposal. As noted, the state provides a 100% deduction for dividends received from 70% subsidiaries. This deduction can allow out-of-state affiliates to transfer intangible investment income to Wisconsin parent corporations without tax. As an alternative the Committee could reduce the deduction from 100% to 80% beginning with tax year 2000. This would make such practices less attractive and increase state corporate income and franchise tax revenues by an estimated $4.3 million in 1999-00 and $9.5 million in 2000-01.

23. DOR has developed an amendment to the bill which includes modifications and new provisions it believes would be necessary to implement combined reporting. These provisions include: (a) creating a definition of doing business in Wisconsin; (b) treatment of a partner's or member's share of a partnerships or limited liability company's apportionment factors; (c) definitions related to combined reporting, including commonly controlled group and unitary; (d) providing an election to use either water's edge or worldwide combination methods; (e) providing DOR with necessary information; (f) accounting periods; (g) agents; (h) part-year members; amended returns; (i) income computation; (j) intercompany transactions; (k) computation of apportionment factors; (l) treatment of net operating losses; (m) use of separate and group combined returns; (n) estimated tax payments; and (o) entering and leaving a group. The Appendix provides more detailed descriptions of some of these provisions. The Department's revised estimates reflect adoption of this amendment.

ALTERNATIVES

1. Approve the Governor's recommendation to require corporations that are subject to the state corporate income and franchise tax and that are members of an affiliated group engaged in a unitary business to compute state corporate income and franchise tax liability using the combined reporting method of determining income. Reestimate the fiscal effect to be an increase of corporate income and franchise tax revenues of $31.5 million in 1999-00 and $70.0 million in 2000-01.

Alternative 1	GPR
1999-01 REVENUE (Change to Bill)	$31,400,000

2. Approve the Governor's recommendation to adopt combined reporting for the corporate income and franchise tax and provide that income from interest on U.S. obligations be excluded from income. Reestimate corporate income and franchise tax revenues from combined reporting to be $15.7 million in 1999-00 and $35.0 million in 2000-01.

Alternative 2	GPR
1999-01 REVENUE (Change to Bill)	- $19,400,000

3. Delete the Governor's recommendation and, instead, reduce the corporate income and franchise tax deduction for dividends received from 70% subsidiaries from 100% to 80% beginning with tax year 2000.

Alternative 3	GPR
1999-01 REVENUE (Change to Bill)	- $56,300,000

4. Adopt the Department of Revenue's recommended amendment to the combined reporting provisions.

5. Maintain current law.

Alternative 5	GPR
1999-01 REVENUE (Change to Bill)	- $70,100,000

Prepared by: Ron Shanovich

Attachment

APPENDIX

DOR's Proposed Combined Reporting Amendment
Selected Provisions

Definitions

"Doing business in this state" means actively engaging in any transaction for the purpose of financial or pecuniary gain or profit. A corporation that directly or indirectly owns a general or limited partnership interest in a partnership that does business in this state, regardless of the percentage of ownership, or that directly or indirectly owns an interest in a limited liability company that does business in this state, regardless of the percentage of ownership, is doing business in this state in a corporate capacity, subject to constitutional limitations. A corporation that issues credit, debit, travel, entertainment or similar charge cards to customers located in this state is doing business in this state.

"Affiliated corporation" means a corporation that is a member of a commonly controlled group.

"Brother-sister parent corporation" means a parent corporation that is a member of a commonly controlled group, some of whose members are not connected through stock ownership with that parent.

"Combined report" means a form prescribed by the Department that is required to be attached to the tax return of a taxpayer member of the combined reporting group and that shows each taxpayer member's income from sources within this state under the combined reporting method.

"Combined reporting group" means those corporations that are required to be included in a combined report, depending on whether the commonly controlled group elects to use the water's edge or the worldwide combined reporting method.

"Combined reporting method" means the method under which the total apportionable income or loss of all members of the combined reporting group engaged in a unitary business is apportioned to this state, to determine each taxpayer member's income from sources within this state.

"Community controlled group" includes any of the following:

a. A parent corporation and any corporation or chain of corporations that are connected to the parent corporation by direct or indirect ownership by the parent corporation if the parent corporation owns stock representing more than 50% of the voting power of at least

one of the connected corporations or if the parent corporation or any of the connected corporations owns stock that cumulatively represents more than 50% of the voting power of each of the connected corporations.

b. Any two or more corporations if a common corporate or noncorporate owner owns directly or indirectly stock representing more than 50% of the voting power of the corporations or connected corporations.

c. A partnership or limited liability company if a parent corporation or any corporation connected to the parent corporation by common ownership directly or indirectly holds more than a 50% ownership interest in the partnership or limited liability company.

d. Any two or more corporations if stock representing more than 50% of the voting power in each corporation are interests that cannot be separately transferred.

e. Any two or more corporations if stock representing more than 50% of the voting power is directly owned by or for the benefit of, members of the same family. Members of the same family are limited to an individual, the individual's spouse, parents, brothers or sisters, grandparents, children and grandchildren, and their respective spouses.

f. A corporation, partnership or limited liability company if a parent corporation or any corporation connected to the parent corporation by common ownership does not hold more than a 50% ownership interest in the corporation, partnership or limited liability company but does effectively control the corporation, partnership or limited liability company.

"Group return" means a return filed on behalf of eligible electing taxpayer members of a combined reporting group by the designated agent.

"Intercompany transaction" means a transaction between corporations, partnerships or limited liability companies that are members of the same combined reporting group immediately after the transaction.

"Separate return" means a return filed by one corporation, whether or not it is a member of a combined reporting group.

"Taxpayer member" means a corporation that is a member of a combined reporting group and that is required to file a tax return in this state.

"Top tier corporation" means a member of an commonly controlled group and is either a parent corporation, a brother-sister parent corporation or any other member of the group that is not connected through stock ownership with a parent corporation. A corporation is a top tier corporation whether or not it is doing business in or deriving income from sources within this

state, or whether or not its income and apportionment factors are excluded from a combined report under the water's edge combined reporting method or any other provision of law.

"Unitary business" includes, but is not limited to, business activities or operations that are of mutual benefit, integrated with, dependent upon, or contribute to the activities of one or more other entities, individually or as a group; transactions that serve an operational function; or other activities that justify the apportionment of a multistate entity's income. Unity is established whenever there is unity of ownership, operation, and use, evidenced by centralized management or executive force, centralized purchasing, advertising, accounting, or other controlled interaction, but the absence of these centralized activities or any of these centralized activities will not necessarily evidence a nonunitary business. Other factors that may indicate the existence of a unitary business include, but are not limited to, intercorporate sales or leases, intercorporate services, intercorporate debts, intercorporate use of proprietary materials, interlocking directorates, interlocking corporate officers or any combination of the latter two.

"Water's edge combined reporting method" includes the income apportionment factors and tax credits of any of the following unitary businesses:

a. Any corporation organized or incorporated under the laws of the United States or any state, the District of Columbia, the Commonwealth of Puerto Rico, any possession of the United States, or any political subdivision thereof.

b. Any domestic international sales corporation.

c. Any foreign sales corporation.

d. Any export trade corporation.

e. Any corporation regardless of its place of incorporation if the average of its property and payroll factors, computed on an annual basis, within the United States is 20% or more. If the corporation is a part-year member of the commonly controlled group, the 20% test applies only to that part of the year for which the corporation is a member of the commonly controlled group.

f. Any corporation not otherwise described above to the extent of the corporation's income within the United States and the corporation's apportionment factors assignable to a location within the United States.

"Worldwide combined reporting method" means the income, the apportionment factors and the tax credits of a unitary business regardless of the country where any member of the unitary business is organized or incorporated or conducts business.

Election to Use Water's Edge or Worldwide Combined Reporting

A corporation that is subject to tax and that is a member of a commonly controlled group having business activities, which in whole or in part constitute parts of a unitary business, shall compute the corporation's income and apportionment factors using the combined reporting method. The commonly controlled group shall use the water's edge combined reporting method unless the commonly controlled group elects, to use the worldwide combined reporting method.

a. The election to use the worldwide combined reporting method shall be made by a top tier corporation on behalf of the corporations that are members of the commonly controlled group. If there is more than one top tier corporation in the commonly controlled group, for the election to be effective, all top tier corporations shall elect.

b. The election period begins for all members of the group on the first day of the designated taxable year of a taxpayer member. The designated taxable year is the taxable year of a specific member of the commonly controlled group, which is subject to taxation in this state and is designated by the top tier corporation, or top tier corporations, with the filing of the election. A designated taxable year shall not begin before January 1, 2000. The elections of all top tier corporations shall be filed, in the form and manner prescribed by the Department, at any time prior to the last day of the designated taxable year.

c. If a timely election is not made, the commonly controlled group shall be deemed to have elected to use the water's edge combined reporting method.

d. The worldwide combined reporting election shall remain in effect for an initial term of 60 months. At the expiration of each 60-month period, the election is automatically renewed for an additional 60-month period unless one or more of the top tier corporations files written notice of nonrenewal, in a form and manner prescribed by the Department, on or before the last day of the election period.

e. The Department may grant a request to terminate an election under this paragraph prior to the expiration of the 60-month period for good cause. Good cause shall be determined in a manner similar to the good cause sufficient to discontinue filing a consolidated return pursuant to regulations under the Internal Revenue Code.

f. If an election is terminated, or is not renewed, another election to use the worldwide combined reporting method may not be made for any taxable year beginning 60 months after the last day of the election period that was terminated or not renewed. The Department may waive the application of this subdivision for good cause.

Income Computation

Under the combined reporting method, income attributable to this state shall be determined as follows:

a. Determine the net income of each corporation.

1. A member of the combined reporting group may elect to determine the member's income or loss under a method of accounting or an election authorized under state law, as appropriate, independently of the method of accounting or elections used in determining the net income or loss of the other members of the combined reporting group. Once an accounting method or other election is made for each member, that member's net income or loss must be consistently determined in the combined report of all members of the combined reporting group and in the group return filed by the taxpayer members or in the separate return filed by that taxpayer member.

2. The income of a unitary business with operations in foreign countries shall be computed. (A method is specified in the amendment.)

b. Adjust each corporation's income for certain specific circumstances as provided under current law.

c. From the amount determined, subtract intercompany transactions such that intercompany accounts of assets, liabilities, equities, income, costs, or expenses are eliminated from the determination of income to accurately reflect the income, the apportionment factors and the tax credits in a combined report. Except as otherwise provided, treasury regulation s. 1.1502-13 applies to the extent consistent with combined reporting principles. Exceptions include, but are not limited to, differences between the composition of the federal consolidated group and the combined reporting group, the requirements of the allocation and apportionment provisions, jurisdictional limitations and treatment of members of a combined reporting group as separate entities for certain purposes. In the taxable year that intercompany items are taken into account, their source shall be determined as if the selling member and the buying member are divisions of a single corporation. Therefore, such intercompany items are treated as current apportionable income and apportioned to this state. Intercompany transactions shall be reported in accordance with a matching rule and an acceleration rule. Under the matching rule, intercompany transactions shall be taken into account as if the selling member and the buying member were divisions of a single corporation. Under the acceleration rule, intercompany transactions shall be taken into account when the selling member and the buying member may not be treated as divisions of a single corporation, including when either the selling member or the buying member leaves the combined reporting group or the subject of the intercompany transaction is converted to nonbusiness use. Intercompany transactions do not include transactions which produce nonapportionable income or loss to the selling member or income attributable to a separate business activity of the selling member. When the subject of a transaction is acquired

for the buyer's nonbusiness use or for the use of a separate business activity of the buyer, the transaction is not considered an intercompany transaction. An intercompany transaction includes the following:

1. Income or gain from sales, exchanges, contributions or other transfers of tangible or intangible property from one member of the combined reporting group to another member of the combined reporting group.

2. Annual rent paid by one member of the combined reporting group to another member of the combined reporting group.

3. Annual license fees or royalties paid by one member of the combined reporting group to another member of the combined reporting group.

4. Loans, advances, receivables, and similar items that one member of the combined reporting group owes to another member of the combined reporting group, including interest income and interest expense related to these items.

5. Stock or other equity of one member of the combined reporting group that is owned or controlled by another member of the combined reporting group.

6. Intercompany dividends paid out of earnings and profits by one member of the combined reporting group to another member of the combined reporting group.

7. Management or service fees paid by one member of the affiliated group to another member of the affiliated group.

8. Income or expenses allocated or charged by one member of the combined reporting group to another member of the combined reporting group.

d. From the amount determined above for each corporation, subtract nonapportionable income, net of related expenses, and add nonapportionable losses, net of related expenses, to determine each corporation's apportionable net income or apportionable net loss.

e. Calculate the apportionment factors and multiply each corporation's apportionable net income or apportionable net loss, by the corporation's apportionment fraction.

f. To the amount determined above, add each corporation's nonapportionable income attributable to this state and subtract each corporation's nonapportionable losses attributable to this state.

g. For each corporation, combine the amounts determined above for each trade or business.

h. If the combined reporting group is filing a group return, combine the amounts determined above for the corporations participating in the group return.

i. From the amount determined above under g or h, as appropriate, subtract the Wisconsin net business loss

Apportionment Factor Computation

Under the combined reporting method, this state's apportionment factors are determined as follows:

a. Determine the numerator and the denominator of each corporation's apportionment factors. For purposes of determining the numerator of the sales factor, the term "taxpayer" means the specific member of the combined reporting group that transferred title to tangible personal property to the purchaser. In the case of sales other than sales of tangible personal property, "taxpayer" means the specific member of the combined reporting group that made the sale. If a member of the combined reporting group does not have sufficient nexus with this state as a separate entity to be subject to this state's franchise or income tax, the numerator of that member's sales factor is zero. If a member of the combined reporting group is engaged in business wholly within this state, the numerator of the member's apportionment factors shall equal the denominator of the member's apportionment factors. If a member of the combined reporting group is not within the jurisdiction for income tax purposes as a separate entity of the state to which a sale would be sourced, the sale is thrown back to this state. If a combined reporting group includes an insurance company, financial institution, broker-dealer, air carrier, motor carrier, railroad, sleeping car company, pipeline company or professional sports club, the apportionment factors for the group shall take into account the factors for the specialized companies.

b. Subtract intercompany transactions from both the numerators and the denominators.

c. Add the denominators of the apportionment factors for each corporation, to arrive at the combined denominators.

d. Compute each corporation's apportionment factors by dividing the corporation's numerator by the combined denominator.

Treatment of Net Operating Loss Carryforwards

a. For taxable years beginning on or after January 1, 2000, to the extent that a corporation that is a member of a combined reporting group determines a net business loss that is not offset against the net income of the other members of the combined reporting group in the current taxable year, the unused net business loss may be carried forward. In a subsequent taxable year, the loss carry-forward may be offset against the incurring corporation's net income or the combined reporting group's net income under Treasury regulations except as otherwise provided and to the extent consistent with combined reporting principles.

b. A corporation may not carry forward a business loss from a taxable year beginning before January 1, 2000, if the corporation was not subject to this state's income or franchise tax for the same taxable year beginning before January 1, 2000.

c. A corporation that incurred a Wisconsin net business loss in a taxable year beginning before January 1, 2000 may use its loss carry-forward to the extent of its separate net income. If the corporation incurring a Wisconsin net business loss carry-forward participates in the filing of a group return, to the extent that the loss carry-forward exceeds the corporation's separate Wisconsin net income for its first taxable year beginning on or after January 1, 2000, it may annually offset against the net income of the other members participating in the group return up to 20% of that remaining net business loss carry-forward.

Net Tax Liability

a. Separate Returns. Each corporation's net tax liability shall be determined as follows:

1. Multiply each corporation's net income by the tax rate.

2. From the amount determined above, subtract each corporation's tax credits based on the expenses of that corporation. Tax credits and credit carry-forwards computed by one corporation may not be offset against the tax liability of another member of the combined reporting group.

b. Group Return. The combined reporting group's net tax liability shall be determined as follows:

1. Multiply the combined reporting group's net income by the tax rate.

2. From the amount determined above, subtract the taxpayer members' tax credits.

(Gov) Agency: General Fund Taxes -- Activity Not Creating Nexus

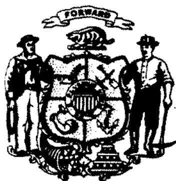
Recommendations:

Paper #113: Alternative 2 (maintain current law)

Comments: Fiscal Bureau makes a pretty good case for how this could help some Wisconsin companies that rely on out-of-state suppliers for just-in-time delivery.

But, ultimately, it's just another corporate tax break, going directly to out-of-state businesses. $5.8 in lost revenue for the state.

Prepared by: Bob



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June 7, 1999 | Joint Committee on Finance | Paper #113

Corporate Income and Franchise Tax -- Activity Not Creating Nexus (General Fund Taxes -- Individual and Corporate Income Taxes)

[LFB 1999-01 Budget Summary: Page 43, #15]

CURRENT LAW

Under current law, essentially two circumstances give Wisconsin taxing jurisdiction over corporations. First, corporations which are created and authorized to act in a corporate capacity (incorporated) under Wisconsin law or foreign corporations which are licensed to transact business in the state are subject to the Wisconsin corporate income and franchise tax. Such firms are subject to the corporate income and franchise tax whether or not they conduct business or own property in the state.

Second, corporations which are organized under the laws of other states or foreign nations are generally subject to the Wisconsin corporate income and franchise tax if they exercise a franchise, conduct business or own property within the state.

GOVERNOR

Provide that an out-of-state corporation is not considered to have nexus with Wisconsin and is not subject to the corporate income and franchise tax if the corporation stores tangible personal property in or on property in the state that is not owned by the corporation and the tangible personal property is transferred to another person in the state for fabricating, processing, manufacturing or printing in the state. The provision would first apply to tax years beginning on January 1 of the year in which the bill takes effect, if the bill takes effect prior to July 31. If the bill takes effect after July 31, the provision would first apply beginning on January 1 of the following year. The bill does not include a fiscal effect for this provision.

DISCUSSION POINTS

1. States have the power to levy taxes in accordance with their own laws, subject to the restrictions imposed principally by the due process clause of the 14th Amendment and the commerce clause of the U.S. Constitution. Under the due process clause, a minimal connection must exist between a corporation's activities and the taxing state and the income attributed to the state for tax purposes must be rationally related to income-generating activities within the taxing state. Under the commerce clause, a state is prohibited from adopting a taxation scheme which discriminates against, or places undue burden on, interstate commerce.

2. In 1959, the U.S. Congress enacted Public Law 86-272, which provides that a state may not impose its income tax upon a corporation which is organized under the laws of other states and which sells tangible personal property if the corporation's only activities in the state are:

a. Solicitation, by employes, of orders for tangible personal property which are sent out-of-state for approval or rejection. (The orders must be filled from a delivery point outside the state.)

b. Solicitation of sales by nonemploye independent contractors conducted through their own offices or businesses located in the state.

Public Law 86-272 does not apply to corporations which are organized (incorporated) under the laws of the taxing state or a foreign nation. The law also does not apply to corporations which sell services, real property or intangible personal property in more than one state.

3. The Department of Revenue has promulgated administrative rules which describe, for non-Wisconsin firms, what type of business activities are needed to make such firms subject to the state's corporate income tax. Under the administrative rules, a non-Wisconsin (foreign) corporation is considered to have "nexus" with Wisconsin and be subject to taxation if it has one or more of the following "activities" in the state:

a. Maintenance of any business location in Wisconsin, including any kind of office.

b. Ownership of real estate in Wisconsin.

c. Ownership of a stock of goods in a public warehouse or on consignment in Wisconsin.

d. Ownership of a stock of goods in the hands of a distributor or other nonemploye representative in Wisconsin, if used to fill orders for the owner's account.

e. Usual or frequent activity in Wisconsin by employes or representatives soliciting orders with authority to accept them.

f. Usual or frequent activity in Wisconsin by employes or representatives engaged in purchasing activity or in the performance of services, including construction, installation, assembly or repair of equipment.

g. Operation of mobile stores in Wisconsin, such as trucks with driver-salespersons, regardless of frequency.

h. Miscellaneous other activities by employes or representatives in Wisconsin such as credit investigations, collection of delinquent accounts, conducting training classes or seminars for customer personnel in the operation, repair and maintenance of the taxpayer's products.

i. Leasing of tangible property and licensing of intangible rights for use in Wisconsin.

j. The sale of other than tangible personal property such as real estate, services and intangibles in Wisconsin.

k. The performance of construction contracts and personal services contracts in Wisconsin.

4. An out-of-state corporation is not considered to have nexus with Wisconsin and is not subject to the corporate income tax if: (a) the corporation stores tangible personal property, such as inventory or a stock of goods, in or on property in the state that is not owned by the corporation and the tangible personal property is delivered to another corporation in the state for manufacturing, fabricating, processing or printing in the state; (b) the corporation stores, in or on property not owned by the corporation, finished goods that have been fabricated, processed, manufactured or printed in the state and the entire amount of such goods is shipped or delivered out-of-state by another corporation in the state; or (c) the corporation is an out-of-state publisher which has finished publications printed and stored in this state in or on property not owned by the publisher whether or not the finished publications are subsequently sold or delivered in this state or shipped outside of it.

5. Generally, states that impose a corporate income tax consider ownership by a corporation of tangible personal property in the state as a condition that is sufficient to establish nexus with a state and to subject the corporation to income taxation. For example, the member states of the Multistate Tax Commission generally follow the provisions of federal public law 86-272 to establish taxing jurisdiction over out-of-state corporations. In these states, for an in-state activity to be protected under PL 86-272, it must be limited solely to solicitation. Owning, leasing or maintaining a stock of goods in-state creates nexus. In analyzing PL 86-272, the House State Taxation of Interstate Commerce subcommittee of the Judiciary Committee enumerated the following activities as rendering a corporation taxable in a given state: ownership of real property in the state; ownership of a stock of goods in a public warehouse; and ownership of a stock of goods in the hands of a distributor or other nonemploye representative, if used to fill orders for the owner's account.

6. The neighboring states of Minnesota, Iowa, Illinois, Indiana and Michigan generally treat ownership of tangible personal property in the state as creating nexus. However, Minnesota provides an exemption for a business that would not be subject to taxation under PL 86-272 except for the fact that the business stored tangible personal property in a state-licensed facility. Illinois has a provision that excludes from taxation persons that would otherwise not be subject to taxation if they own tangible personal property that is located at the premises of printer with which the person has contracted for printing. The person who contracts for printing can have employes or agents located solely at the printer's premises that engage in activities related to quality control, distribution or printing. Finally, under Indiana law, an exclusion from taxation is provided for a corporation that does not operate a fixed place of business in the state and that has contracted with a commercial printer for printing for the following: (a) the ownership or leasing by the corporation of tangible or intangible property located at the Indiana premises of the commercial printer; (b) the sale by the corporation of property of any kind produced at and shipped or distributed from the Indiana premises of the commercial printer; (c) the activities of any kind performed by or on behalf of the corporation at the Indiana premises of the commercial printer; and (d) the activities of any kind performed by the commercial printer in Indiana for or on behalf of the corporation.

7. The current law nexus exclusions require an out-of-state business to retain ownership of the tangible personal property that is moved to Wisconsin for processing, printing, manufacturing or fabrication for the entire time the property is in the state. The nexus exclusion included in the bill is intended to apply to suppliers of Wisconsin firms that ship raw materials (inputs to the production process) into the state, store the materials here and then sell them to Wisconsin businesses. The exclusion would allow in-state manufacturers and other businesses to use just-in-time inventory management practices with out-of-state suppliers. The exclusion would also extend the tax benefit currently provided to out-of-state publishers to other out-of-state corporations, particularly manufacturers. Firms practice just-in-time inventory techniques by purchasing just in time to produce and producing just in time to sell. Businesses adopt these practices because they incur costs in holding inventories instead of holding other income-producing assets. Just-in-time purchasing calls for frequent delivery of material and supplies. Upon delivery, the materials and supplies are moved directly to the assembly line. The nexus exclusion would reduce the costs of out-of-state suppliers of Wisconsin manufacturers. To the extent this cost savings is passed on, Wisconsin manufacturers would benefit in the form of lower production costs and improved competitiveness. In many cases, out-of-state suppliers do not provide inputs for Wisconsin firms because placing inventory in the state creates nexus for corporate franchise tax purposes. Consequently, the nexus exclusion would expand the number of suppliers that could provide manufacturing inputs at competitive prices.

8. The nexus exclusion would provide a tax benefit to an out-of-state supplier while an in-state supplier in the same industry would continue to pay taxes. This would place the in-state firm at a competitive disadvantage. In addition, there would be a state tax incentive that would encourage in-state firms to relocate outside of Wisconsin, while out-of-state firms would face tax increases if they moved to Wisconsin. Businesses which produced inputs would also have some incentive to restructure in order to benefit from the tax exclusion. A firm that is currently taxable could create an out-of-state subsidiary supplier corporation in order to avoid taxation.

9. AB 133 does not include a fiscal effect for the exclusion. At the time the budget was introduced, available information indicated that the number of firms that would be affected would be relatively few. However, since the bill was introduced, additional data has been developed that indicates that the fiscal effect of providing the nexus exclusion would be substantial. Based on the 1993 corporate income and franchise tax sample and data developed by DOR, it is estimated that the provision would reduce corporate income and franchise tax revenues by $1.8 million in 1999-00 and $4.0 million in 2000-01. These estimates assume that the new provision would first apply to tax years beginning on January 1, 2000.

ALTERNATIVES

1. Adopt the Governor's recommendation to provide that an out-of-state corporation is not considered to have nexus with Wisconsin and is not subject to the corporate income and franchise tax if the corporation stores tangible personal property in or on property in the state that is not owned by the corporation and the tangible personal property is transferred to another person in the state for fabricating, processing, manufacturing or printing in the state. Reestimate the fiscal effect to be a decrease in corporate income and franchise tax collections of $1.8 million in 1999-00 and $4.0 million 2000-01.

Alternative 1	GPR
1999-01 REVENUE (Change to Bill)	- $5,800,000

2. Maintain current law.

Prepared by: Ron Shanovich