The Florida Senate

BILL ANALYSIS AND FISCAL IMPACT STATEMENT

(This document is based on the provisions contained in the legislation as of the latest date listed below.)

Prepared By: The Professional Staff of the Commerce Committee

BILL: SB 2270

INTRODUCER: Senator Gelber

SUBJECT: Water's Edge Taxation

DATE: April 1, 2009 REVISED:

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	Clark-Joseph/Pugh	Cooper	CM	**Favorable**
2.			FT	
3.			GA	
4.			WPSC	
5.				
6.				

I. Summary:

Section 220.11, F.S., taxes at a rate of 5.5 percent the taxable income of certain corporations doing business in Florida. Currently, corporations may opt to file either separate tax returns for each legal entity doing business in Florida, or consolidated returns that include all the members of the affiliated group of corporations used in filing federal corporate income taxes. Both provisions are based primarily on Internal Revenue Code definitions, and allow for otherwise taxable Florida income to be attributed to non-Florida sources.

SB 2270 would mandate combined reporting, which would require all corporations that are members of a newly defined affiliated group (water's edge group) to file a tax return combining income from those entities, apportioning the combined income to Florida based upon a statutory formula. Combined reporting would replace consolidated reporting.

The new combined reporting includes additional regulatory reporting requirements on all multiple-entity groups, disallows consideration of intergroup transfers that currently reduce Florida tax liability, and expands the reach of the corporate income tax to include more corporations than are currently captured under consolidated reporting.

II. Present Situation:

Florida's Current Corporate Income Tax System

Florida levies a corporate income tax at the rate of 5.5 percent. To calculate the base of this tax, Florida requires corporations[1] to apportion earned income into Florida using a three factor formula. The factors and weights are: sales – 50 percent; payroll – 25 percent; and property – 25

[1] Defined in s. 220.03(1)(e) F.S. (2008).

percent. Thus, corporations operating solely in Florida pay tax on 100 percent of their net income. Corporations or groups of corporations with less than 100 percent of their net income attributable to Florida, pay tax only on Florida-attributable income depending on the portion of their total sales, payroll, and property located in Florida.

Under Federal law, multiple-entity groups that share 80 percent ownership can elect to file a single consolidated federal income tax return for the group. Multiple-entity groups currently *may* file separate corporate tax returns for each corporation doing business in Florida, or may file a consolidated return for all of their group's income. The state currently *may* require a consolidated return if the filing of separate returns for such corporations would improperly reflect the taxable incomes of such groups. Both separate and consolidated returns presently allow certain transfers to pass through entities to reduce Florida income tax liability, provided they are consistent with Internal Revenue Code s. 1502.

Last year, DOR received tax returns from about 235,000 corporations. Of that number, about 3,400 filed consolidated returns.

Florida exempts "foreign source income" from its corporate income tax by subtracting it from the Adjusted Federal Income[2] and Florida exempts non-business income from the Adjusted Federal Income[3].

Florida law provides for the allocation of business and non-business income of a corporation pursuant to ss. 220.15 and 220.16., F.S., regardless of whether the corporation files a consolidated return or separate return.

Business income is apportioned to the state in which it is earned, using statutory apportionment formulas.[4]

Non-business income is allocated between the states pursuant to s. 220.16, F.S. Non-business income includes, but is not limited to, interest, royalties, rents, and dividends from unrelated business activities, any of which can be allocable to Florida. Consequently, a Real Estate Investment Trust, which can qualify under the Internal Revenue Code to pay no taxes through a Dividend Paid Deduction, pays no Florida taxes as its adjustable federal income will be non-existent under s. 220.13(1), F.S. A non-Florida Real Estate Investment Trust, earning rent from property in Florida, can pay dividends to a Florida corporation, and Florida will deem the non-business income as not allocated to the state of Florida. Other income, including royalties, can likewise avoid Florida Corporate Income Tax.

Further, a corporation electing Florida's separate accounting option, is currently able to reduce its Florida apportionable income, and hence its Florida income taxes, by isolating highly profitable parts of its business in a corporation that is not taxable in Florida. (Such as locating a factory in a Nevada corporation). Thus the separate accounting option may fail to account for

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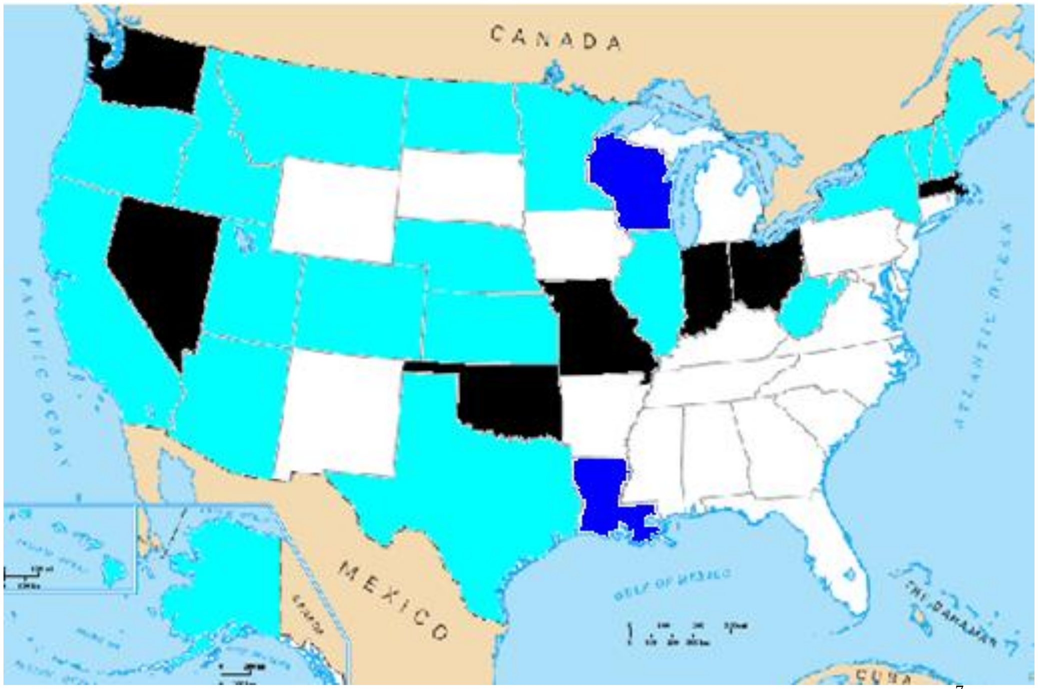
[2] Section 220.13(1)(b)(2)a, F.S., (2008).
[3] Section 220.13(1)(b)(4), F.S., (2008).
[4] Section 220.15, F.S., (2008).

Florida "contributions to income resulting from functional integration, centralization of management, and economies of scale."[5]

Florida is constitutionally permitted to pursue income generated within the state even if it has been transformed into income from another jurisdiction. The U.S. Supreme Court has ruled that it is constitutional for a state to tax dividend income which stemmed from operations within that state, despite the distributing-entity being outside the state.[6]



(Grey: Combined Reporting Mandatory, White: No Combined Reporting, Black: n/a)[7]

Other States Using Combined Reporting:
As of April 2007, 20 states have adopted an approach that mandates a combined filing for corporate income tax purposes. These combined filing approaches include either all groups and foreign entities, or all groups that conduct more than 20 percent of their business in the United States. The latter approach to exclude 80/20 companies is commonly referred to as a "water's edge combination."

Tax Foundation's *State Business Tax Climate Index* ranks states according to the favorability of their corporate taxes.[8] They presently rank Florida 13th nationally for favorable corporate taxes.

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[5] Exxon Corp. v. Department of Revenue, 447 U.S. 207 (1980).
[6] International Harvester Co. v. Wisconsin Dept. Of Taxation, et al., 322 U.S. 435, (1944) , at 445.
[7] Though lacking a specific combined reporting statute, several states including Wisconsin and Louisiana have case law that permits the states to tax dividends received from foreign territories to the extent that those dividends stemmed from in-state transactions. *See* International Harvester Co. v. Wisconsin Dept. Of Taxation, et al., 322 U.S. 435, 64 S. Ct. 1060, 88 L.Ed. 1373 (1944) and *Bridges v. Autozone Properties, Inc.*, 900 So.2d 784 (LA Sup. Ct. 2005), asserting that dividends paid from out-of-state corporations can be taxed to the degree that those dividends stem from in-state activities.
[8] Tax Foundation's *State Business Tax Climate Index*, by foundation economist Curtis S. Dubay and Scott A. Hodge, President of the Tax Foundation.

- Of the top 10 states with the most favorable business climate, two (Utah and Colorado) had combined reporting.
- Of the top 15 states with the most favorable business climate, three (UT, CO, and IL) had combined reporting.
- Of the top 25 states with the most favorable business climate, seven (UT, CO, IL, MT, TX, ID, OR) had combined reporting.
- Of the bottom 25 states, the states with the least favorable business climate, 13 had combined reporting.

In the southeast United States, no states have combined reporting (Florida, Alabama, Mississippi, Louisiana, Georgia, South Carolina, Virginia, Tennessee, and North Carolina).

III. Effect of Proposed Changes:

SB 2270 would mandate "combined" reporting for the state's corporate income tax. Corporations that are members of a newly defined "water's edge group" would be required to file a tax return combining income from those entities, apportioning the combined income to Florida based upon a statutory formula. The current statutory provisions allowing consolidated returns would be replaced with provisions defining and mandating water's edge group reporting.

Section 1 creates an undesignated section of Florida Law to provide legislative findings and intent.

Section 2 amends s. 220.03, F.S., to change or include the following definitions:

- "Taxpayer" is redefined to replace a reference to consolidated returns with members of a water's edge group, consistent with the changes in section 4 of the bill.

- "Tax haven" is defined as a jurisdiction which has been identified as a tax haven or as having a harmful preferential tax regime by the Organization for Economic Cooperation and Development,[9] or meets specified criteria.

- "Water's edge group" is defined to mean a group of corporations related through common ownership whose business activities are integrated with, dependent upon, or contribute to a flow of value among the members. (Membership requirements are specified in section 4 of the bill.)

Section 3 amends s. 220.13, F.S., to restrict deductions used to calculate adjusted federal income and to include the taxable income of one or more taxpayers which constitute water's edge

[9] The Organization for Economic Cooperation and Development is an international organization of 30 countries that accept the principles of representative democracy and free-market economy. Most OECD members are high-income economies with a high HDI and are regarded as developed countries. As stated in its 2008 Annual Report, the organization produces reports and compiles comparable statistical, economic and social data on issues such as trade, employment, migration, education, energy and health. The OECD also produces internationally agreed instruments, decisions and recommendations to promote rules of the game in many areas such as combating bribery in international business transactions, information and communications policy, taxation and the environment. http://www.oecd.org/dataoecd/39/19/40556222.pdf.

groups. A deduction is not allowed to water's edge groups for net operating losses, capital losses, or excess contribution deductions under the federal tax code for a member of a water's edge group that is not a United States member. In addition, carryovers of net operating losses, net capital losses, or excess contributions may be subtracted only by the member of the water's edge group that generates a carryover. Dividends received by a member of a water's edge group (for dividends paid by another member of the water's edge group) are subtracted from taxable income to the extent they had been included in taxable income.

Thus, inter-corporate transactions between the affiliated entities would be eliminated and the income reported of the subsidiary would be added to the income reported by the parent and modified pursuant to state law.

<u>Section 4</u> creates s. 220.136, F.S., to define membership in a water's edge group.

A corporation with 50 percent or more of its outstanding voting stock directly or indirectly owned or controlled by a water's edge group is presumed to be a member of the group.[10] A corporation having less than 50 percent of its outstanding voting stock directly or indirectly controlled by a water's edge group is a member of the group if the businesses activities of the corporation show that the corporation is a member of the group. Ownership and control of voting stock is determined under federal law. All income of members of a water's edge group is presumed unitary.

Excluded from water's edge groups are corporations that conduct business outside the United States and have 80 percent or more of their property and payroll assignable to locations outside the United States. Those corporations do not use combined water's edge reporting, and instead will file separate Florida income tax returns, and avoid all provisions of water's edge reporting. This exclusion does not apply to foreign corporations incorporated in a "tax haven," as defined in the bill.

All income of a water's edge group is presumed to be apportionable business income, and the burden is on the taxpayer to show otherwise.

<u>Section 5</u> creates s. 220.1363, F.S., describing special reporting requirements of water's edge groups to determine the amount of group income apportionable to Florida. Under the water's edge reporting method:

- The adjusted federal income for purposes of s. 220.12, F.S. (net income defined), means the sum of adjusted federal income for all members of the group determined for a concurrent taxable year;
- Income of the members is apportioned to Florida as a single tax payer based on three-factor apportionment of property, payroll and sales;
- Special industry members that are part of a water's edge group that qualify for a special method of apportionment will have to use the same three-factor apportionment;
- The numerators and denominators of the apportionment factors are calculated for all members of the water's edge group combined;

[10] Compare to the 80 percent common ownership necessary to file a consolidated return.

- Intercompany sales transactions are not included in the sales factor;[11]
- The net proceeds for sales of intangibles made to entities outside the group are included in the sales factor;
- Sales that are not allocated or apportioned to any taxing jurisdiction (“nowhere sales”) are not included in the sales factor; and
- The income attributable to the Florida activities of a corporation exempt from taxation under federal law is excluded, even if another member of the water’s edge group has nexus with Florida and is subject to tax.

If members of a water’s edge group have different taxable years, they must all use the single designated “filing member’s” taxable year.

The group is required to file a domestic disclosure spreadsheet, which discloses the income reported to each state, the state tax liability, the method used to apportion or allocate income to each state; and other information provided for by rule as may be necessary to determine the proper amount of tax due to each state and to identify the water’s edge group.

A water’s edge group must file a computation schedule that:

- Combines the federal income of all members of the water’s edge group;.
- Shows all intercompany eliminations;
- Shows Florida additions and subtractions under s. 220.13, F.S.; and
- Shows the calculation of the combined apportionment factors.

<u>Section 6</u> amends s. 220.14, F.S., to replace a reference to consolidated returns with members of a water’s edge group, consistent with the changes in section 4 of the bill.

<u>Section 7</u> repeals parts of s. 220.15, F.S., to remove the ability of a member of an affiliated group to have amounts from another member of the group be included in gross income only to the extent that the amount exceeds directly related expenses of the recipient.

<u>Sections 8-14</u> amend ss. 220.183, 220.1845, 220.187, 220.191, 220.192, 220.193, and 220.51, F.S., to remove references to consolidated returns, which are repealed in section 18 of the bill. Specifically:

- Section 220.183, F.S., is amended to remove the authorization for taxpayers who file a Florida consolidated return as a member of an affiliated group to be allowed the community contribution tax credit on a consolidated return basis;
- Section 220.1845, F.S., is amended to delete the authorization for taxpayers who file a consolidated return as a member of an affiliated group to receive the contaminated site rehabilitation tax credit up to the amount of tax imposed on the consolidated group;
- Section 220.187, F.S., is amended to deny credits for contributions to non-profit scholarship-funding organizations for Florida consolidated returns as affiliated groups;
- Section 220.191, F.S., is amended to remove the capital investment tax credit, for consolidated groups;

[11] The treatment of these intercompany transfers is another principal difference between tax treatment under water’s edge combined reporting and the current consolidated reporting.

- Sections 220.192 and 220.193, F.S., is amended to delete the renewable energy technologies investment tax credit and the renewable energy production credit on consolidated returns; and
- Section 220.51, F.S., is amended to delete rule-making authority relating to consolidated reporting for affiliated groups.

Section 15 amends s. 220.64, F.S., which pertains to special rules relating to taxation of banks and savings association, to replace references to consolidated returns with water's edge provisions.

Section 16 creates transitional rules. For the first taxable year beginning on or after January 1, 2010, a taxpayer that previously filed a Florida return and is part of a water's edge group must compute its income together with all members of the water's edge group and file a separate corporate tax return or may combine its tax return with all members of the affiliated group.

Corporations that previously filed Florida consolidated returns are prohibited from filing consolidated returns for taxable years beginning after January 1, 2010.

Section 17 appropriates from The General Revenue Fund recaptured pursuant to this act $50 million to the State University System for workforce education, and $50 million to community colleges for workforce education, and directs that the remainder of the funds shall be appropriated from The General Revenue Fund to the various school districts to reduce the required local effort.

Section 18 repeals s. 220.131, F.S., which defined adjusted federal income for affiliated groups, which constitutes a consolidated return. This type of return is replaced by filings for water's edge groups.

Section 19 directs that the bill take effect July 1, 2009.

Other Potential Implications:

Because 30 of the 50 states do not have combined reporting, and combined reporting increases corporate tax burdens, adoption of combined reporting as required by this bill may make Florida a less favorable business climate.

However, the overall tax consequences of the combined reporting required by this bill are difficult to determine. A report issued by Earnst and Young concludes that combined reporting can result in either more or less income attributed to Florida. Essentially, combined reporting can shift income apportionment to Florida or away from Florida depending on the nature of the corporation. This would have the effect of distributing income across states unrelated to real economics. Thus while combined reporting may reduce distortions related to tax planning, it will create new distortions in how corporate tax burdens are allocated.[12]

[12] Understanding the Revenue and Competitive Effects of Combined Reporting. Robert Cline. Earnst and Young LLP. (May 2008).

Consequently, Florida may have a less competitive corporate tax regime for some industries and corporate structures compared to other southeastern states such as Alabama and Georgia. This will have an indeterminate effect on investment, as factors such as labor, energy and transportation costs may be more significant.

IV. Constitutional Issues:

A. Municipality/County Mandates Restrictions:

None.

B. Public Records/Open Meetings Issues:

None.

C. Trust Funds Restrictions:

None.

V. Fiscal Impact Statement:

A. Tax/Fee Issues:

The Revenue Impact Conference has not yet produced an estimate of the impact of this bill. However, it is anticipated that corporate tax revenue would likely increase.

The 2007 Florida Tax Handbook listed a positive revenue impact of $364.5 million to the state if this proposal had been in effect in FY 2007-08.

In 2003, the Multistate Tax Commission estimated that Florida could have received $170 million to $365 million in FY 2000-01 from requiring combined reporting.

B. Private Sector Impact:

The bill would increase tax burdens on corporate groups to the extent that they would have to report income that is currently an untaxed under current Florida law.

C. Government Sector Impact:

The Department of Revenue estimates that implementation would require a non-recurring expenditure of $192,362.

VI. Technical Deficiencies:

None.

VII. Additional Information:

A. Committee Substitute – Statement of Substantial Changes:
(Summarizing differences between the Committee Substitute and the prior version of the bill.)

None.

B. Amendments:

None.