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 Finance and Tax Committee

BILL: SB 2270

INTRODUCER: Senator Gelber

SUBJECT: Water's Edge Taxation

DATE: April 7, 2009 REVISED:

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

## I. Summary:


Section 220.11, F.S., imposes tax at a rate of 5.5 percent of net income above $5,000 on certain corporations doing business in Florida. Florida uses federal taxable income as the starting point for determining the net income subject to state tax. The net income is the corporation's adjusted federal income, or that share apportioned to Florida, plus any nonbusiness income allocated to the state, less the $5,000 exemption. For a corporation that is a member of an affiliated group filing a consolidated return for federal purposes, taxable income is computed as if the corporation had filed a separate federal return unless a consolidated return is required or elected.

Currently, affiliated corporations subject to income tax in this state may opt to file returns either on a separate company basis - separate tax returns for each legal entity doing business in Florida, or on a consolidated basis - the parent company of an affiliated group subject to Florida tax consolidates its taxable income with each member of the group; the group files a consolidated federal return for the year; the group is composed of the same members as those filing the federal return; and each member apportions its income in the same manner.

SB 2270 mandates combined reporting by requiring all members of a unitary business (water's edge group) to file a combined return and to apportion income to Florida using a single apportionment computation. Their intercompany sales are disregarded. A throw-out rule is adopted for sales and income attributable to Florida by a member whose activities are excluded from apportionment by Public Law No. 86-272. The group is required to file a domestic disclosure spreadsheet disclosing the income reported to each state, the state tax liability and the method used to apportion or allocate income to each state. Transition rules are provided.

The Revenue Impact Conference has not yet produced an estimate regarding the impact of this bill on the General Revenue Fund.

## II. Present Situation:

Florida's Current Corporate Income Tax System

Florida levies a tax on all corporations, organizations, associations and other artificial entities that have attributes not inherent to natural persons, such as perpetual life, and that derive income from the state. The tax is levied on the privilege and measured by net income at the rate of 5.5 percent on net income derived from the state.

Florida does not require commonly controlled corporations engaged in a unitary business to compute their state taxable income on a combined basis. Corporations who are members of an affiliated group have the choice of filing on a separate entity basis or as a consolidated group. To file on a consolidated basis, the parent company of an affiliated group subject to Florida tax must consolidate its taxable income with each member of the group. Each member must consent to consolidation. The group must have filed a consolidated federal return for the year. The group must be composed of the same members as those filing the federal return and each member must apportion its income in the same manner.

Florida adopts (piggy-backs) the federal definition of taxable income. A taxpayer's net income is its adjusted federal income, or the share of its adjusted federal income for the year that is apportioned to Florida, plus non-business income allocated to Florida, less the $5,000 exemption.

State income taxation of a multistate business conducted in corporate form is primarily restricted by the Commerce Clause and the Due Process clause. The first delegates the power to regulate commerce among the states to the federal government. The restraint it provides flows primarily from the negative implications of the clause – because the federal government may regulate, the states may not. Congress, through Public Law 86-272, has exercised its authority in this regard and has prevented states from imposing tax liability for activities considered nominal, such as mere solicitation.

The Due Process clause prohibits states from reaching beyond their borders to impose tax. States are afforded significant latitude in taxing the income of multistate businesses. However, a state may not tax income wholly attributable to another jurisdiction, even on an apportioned basis.[1] Many states, including Florida, recognize this constraint by permitting the allocation of income.

Florida subtracts non-business income from adjusted federal income.[2] Passive income is generally assigned to a particular state. Taxpayers often claim a subtraction for this non-business income in the context of the sale of a division or subsidiary, claiming that the entity was not part of the integrated unitary business, but was merely an investment. Florida statutes provide enough ambiguity to raise concern about the state challenge to the validity of such a position, even when the taxpayer has previously made ordinary business deductions against income generated by such

[1] *Allied Signal, Inc. v. Director,* 504 U.S. 768 (1992).
[2] Section 220.13(1)(b)(4), F.S., (2008).

"investments." These positions are often based on reference to application of the "transactional" test, or the "functional" test referenced in the Code.

After allocation, corporations that conduct business both in Florida and outside the state apportion their business income among those states. Each state provides its own formula to apportion income. The theory is that income from an integrated business results from a complex combination of factors. The generic formula can be depicted as follows:

$$\text{State's Taxable Income} = \frac{\text{State's Share of Apportionable Income}}{\text{Total Apportionable Income}}$$

Florida generally uses a three factor formula apportionment consisting of a sales factor representing 50 percent, payroll at 25 percent and property at 25 percent. There are special formulary apportionment rules for specific industries.

Section 220.15(5), F.S., defines the sales factor. The numerator of the sales factor is the total sales of the taxpayer in Florida during the taxable year and the denominator is the total sales of the taxpayer everywhere during that time. All sales everywhere are included in the denominator of the sales factor. The receipt from a sale of tangible property is sourced to the state where it is delivered. If delivery is to Florida, the receipt is added to the numerator and denominator of the sales factor for apportionment purposes. Section 220.15(5), F.S., does not specifically address the sourcing of the sale of a service. The sale of a service is either apportioned to the state in which the customer is located, or the state to which the majority of the income producing activity - also known as cost of performance - can be attributed. The Department adopted a rule in the 1970's generally sourcing sales of services based on the income producing activity. A cost of performance basis may be used for the sourcing of some services.

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. Last year, the Department received tax returns from about 235,000 corporations. Of that number, about 3,400 filed consolidated returns. Both separate and consolidated returns presently allow certain transfers to pass through entities that may have the effect of reducing Florida net income.

Consistent with and bounded by the Due Process clause, a state may determine that affiliated companies operate as a single business with income subject to a single apportionment factor.[3]This is referred to as the unitary business principle. This principle has been adopted by several states that determined that separate accounting did not accurately measure contributions to income resulting from the group's functional integration, centralization of management, and economies of scale."[4]

<u>Other States With Combined Reporting Requirements</u>

[3] See Mobil Oil Corp. v. Comm'r of Taxes of Vt., 445 U.S. 425(1980).
[4] Exxon Corp. v. Department of Revenue, 447 U.S. 207 (1980).

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 excluding 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.[5] They presently rank Florida 13th nationally for favorable corporate taxes.

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

In the southeast United States (Florida, Alabama, Mississippi, Louisiana, Georgia, South Carolina, Virginia, and North Carolina), no states require combined reporting for all filers. Tennessee requires combined reporting for unitary groups of financial institutions.

## III. Effect of Proposed Changes:

SB 2270 mandates combined reporting for the state’s corporate income tax. Corporations that are members of a “water’s edge group” are required to file a return combining income from those entities, and apportion 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 a reference to 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,[6] or meets specified criteria.

[5] Tax Foundation’s *State Business Tax Climate Index*, by foundation economist Curtis S. Dubay and Scott A. Hodge, President of the Tax Foundation.

[6] 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,

- "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 a water's edge group. A deduction is not allowed to water's edge groups for net operating losses, net 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 the 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.

Inter-company transactions between the affiliated entities are disregarded and the income reported by the subsidiary is added to the income reported by the parent and modified pursuant to state law.

Section 4 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.[7] 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 to be 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, avoiding the water's edge reporting requirements. This exclusion does not apply to foreign corporations incorporated in a "tax haven" as defined by 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.

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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.

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

Section 5 creates s. 220.1363, F.S., describing special reporting requirements for 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;
- Intercompany sales transactions are not included in the sales factor;[8]
- 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.

Section 6 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.

Section 7 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.

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[8] 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 8-14 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 on Florida consolidated returns;
- Section 220.191, F.S., is amended to remove the capital investment tax credit for consolidated groups;
- Sections 220.192 and 220.193, F.S., are 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 associations, 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 separate 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 tax that is "recaptured" pursuant to this act in the amount of $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 recaptured 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 defines adjusted federal income for affiliated groups and authorizes the filing of a consolidated return. This type of return is replaced by the return required for a water's edge group.

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

**Other Potential Implications**:

Combined reporting is portrayed as increasing regulatory burdens. So the adoption of combined reporting may lead to the reaction that Florida now has created a less favorable business climate.

The overall fiscal impact of combined reporting is difficult to determine. Combined reporting will change the Florida apportionment factors, but the effect will be different for each affiliated group. The gains in tax revenue are most pronounced for affiliated groups that use planning techniques that shift income to tax havens. However, while combined reporting may reduce distortions related to tax planning, it will create new distortions in how corporate tax burdens are allocated.[9]

Florida may be perceived by some as having 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 prove 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 regarding the impact of this bill on the General Revenue Fund.

### 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 untaxed under current Florida law.

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

### 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.

This Senate Bill Analysis does not reflect the intent or official position of the bill's introducer or the Florida Senate.