Corporate Income Taxation Overview

When a corporation operates or owns subsidiaries across more than one state, state governments must figure out how much of the corporation's income is subject to taxes in their state. This process breaks down into two steps: determining if a corporation and its subsidiaries must file a combined report, and then figuring out what portion of the combined reported profits are subject to taxation in a state. In Colorado our tax code uses a Unitary Business Principle as the basis of taxation, which treats corporations as the sum of all of their parts, not as separate entities.

Combined Reporting

Most modern, multistate corporations are composed of a parent corporation and several subsidiaries that are owned by the parent. Combined reporting treats parent and subsidiary corporations as one corporation for tax purposes. Combined reporting has risen in popularity after several decades of declining corporate state tax revenue due to aggressive profit shifting and tax avoidance by large multistate corporations from parent corporations through their subsidiaries. By requiring parent and subsidiary corporations to add their profits together, combined reporting vastly cuts down on this kind of tax avoidance behavior.

Colorado's current standard for determining whether a corporation and its subsidiaries must file a combined report is called the three of six test. If a corporation A possesses three of six unity test factors with corporation B, then it must file a combined return with corporation B. The six unity test factors are the following:

1. If 50% or more of gross operating receipts of an affiliate is from sales or leases to another affiliate, or 50% or more of the cost of goods sold is paid to another affiliate.
2. If 50% or more of the value of five or more services was provided to one corporation by another.
3. If 20% or more of a corporation's long-term debt is owed or guaranteed by an affiliate.
4. If one corporation substantially uses the patents, trademarks, service marks, logo-types, trade secrets, copyrights, or other proprietary materials owned by the other.
5. If 50% or more of the board of directors of one affiliate are members of the board of directors or are corporate officers for another affiliate.
6. If 25% or more of the 20 highest ranking officers or one corporation are members of the board of directors or are corporate officers for an affiliate.

Colorado is the only state that uses the three of six of test for determining whether a corporation and its subsidiaries must file a combined report. Most states follow the guidance of the Multistate Tax Commission (MTC) recommendations when determining their combined reporting approach.

Apportionment

Once the total amount of income of a multistate corporation is established, that income must be allocated to various states where the corporation has some presence. The rules to determine how much of the income in taxed in what state are called “apportionment” rules.

There are three factors generally used by states to determine apportionment of income for state income tax purposes-- the share of property, payroll, and/or sales in a state. Twelve states equally weight property, payroll, and sales in a three-factor formula of determining tax liability, 22 states give extra weight to the sales factor, and 18 states only use sales to determine tax burdens. Most taxpayers in Colorado use a Single Sales Factor method for allocation of income.

When companies own subsidiaries that operate across multiple states, calculating income subject to a state’s income tax becomes even more complicated. There are two basic approaches states used to govern what activities of a complex corporation are included when allocating corporate income to a state. The Joyce Rule, currently used in Colorado, limits the corporate income subject to Colorado taxation to income for entities that have nexus in the state. The Finnigan rule says that income is potentially subject to taxation in a state if any member of its combined reporting group has nexus in that state.

Colorado’s unitary business principle recognizes economic reality over legal form. If a unitary enterprise is engaged in business in the state, that entire enterprise is benefiting from doing business in the state so all its profits should be subject to Colorado apportionment rules.

It is more consistent to tax the enterprise as a whole, and not to carve out parts of the enterprise just because they happen to be legally separate entities.

For example, imagine three corporations that are all members of the same conglomerate and each have $1 million in sales in a given state. The state only has nexus over Corp A, but Corps B and C sell into the state, too. Under Finnigan, all $3 million of the conglomerate’s sales are taxable in the state, whereas under Joyce rules, only $1 million from Company A is taxable. Under the Joyce rule, the other $2 million of sales may not be taxed in any state in some cases.

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