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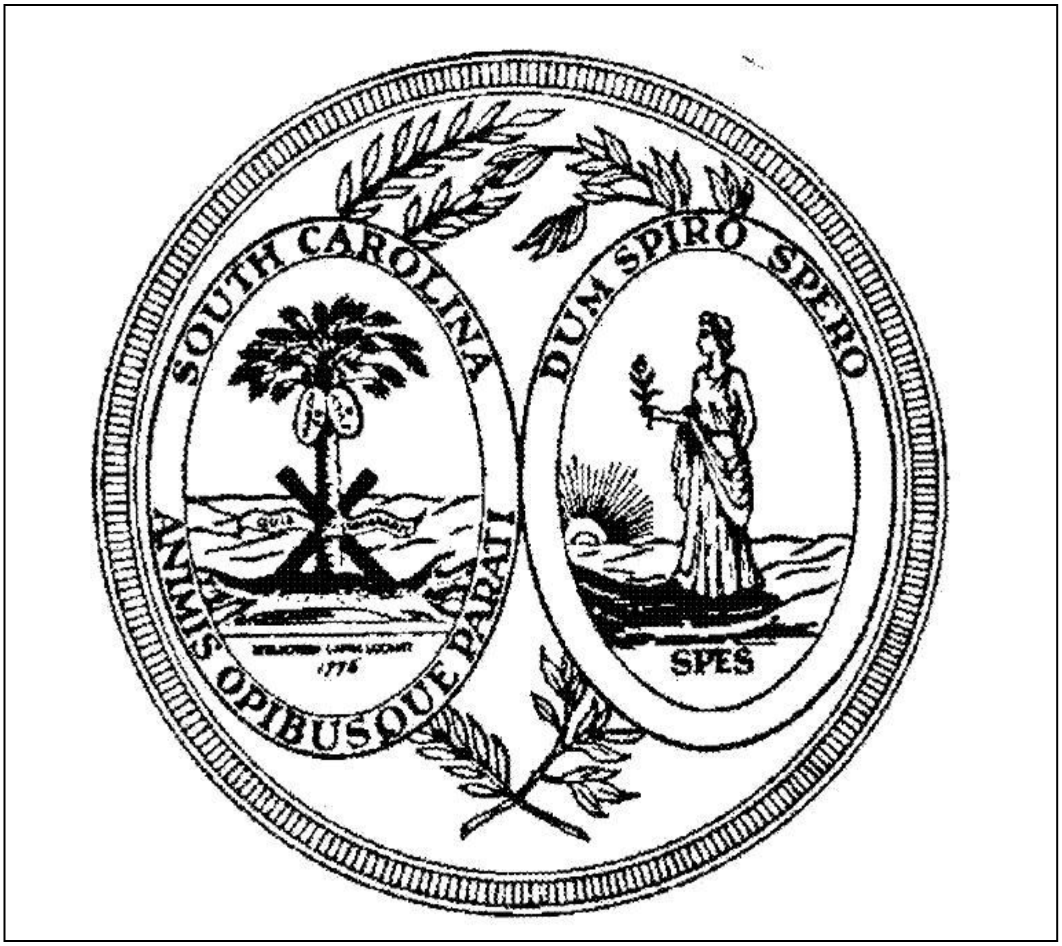
South Carolina's Tax Realignment Commission



State Corporate Income Tax

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I. EXECUTIVE SUMMARY

A. Banks and Other Financial Institutions

Banks and savings and loans pay bank income tax in lieu of many other taxes including sales, personal property, and local business license taxes. Banks nevertheless have a lower income tax rate than other entities. As such, they have significantly lower state and local tax burden then virtually every other business. Federally chartered credit unions pay no income taxes. The General Assembly should consider (1) increasing the income tax rates on banks and savings and loans commiserate with their other tax savings; and (2) conforming or equalizing the tax treatment of credit unions with other financial institutions.

B. Combined Returns

If the General Assembly chooses to retain the current system of separate reporting it should adopt a combined tax return approach to corporate income taxation in South Carolina.

C. Separate Reporting

If the General Assembly chooses to retain the current system of separate reporting it should adopt (1) the state law counterpart to Internal Revenue Code §482 and the economic substance doctrine as well as disallow deductions to related party REITs. It should also adopt IRS Circular 230 in its entirety as well as consider applying Circular 230 to amended returns.

D. Tax Credits

Regarding tax credits, the General Assembly should (1) lower the maximum job tax credit from $8,000 per job to $6,000; (2) reduce the carryforward on a prospective basis from 15 years to 5 or 3 years; and consider (3) eliminating most retail and service jobs from the credit once the economy improves.

II. STATISTICS

Range of State Corporate Income Tax Rates[1]
(For tax year 2008 – beginning January 1, 2008)

State	Tax Rates	Tax Brackets	No. of Brackets	Bank Tax Rates
Alabama	6.5%	Flat rate	1	6.5%
Alaska	1.0 – 9.4%	10,000 – 90,000	10	1.0 – 9.4%
Arizona[2]	6.968%	Flat Rate	1	6.968%

[1] Information taken from the South Carolina Department of Revenue's 2008 annual report.

Arkansas	1.0 – 6.5%	3,000 – 100,000	6	1.0 – 6.5%
California[3]	8.84%	Flat rate	1	10.84%
Colorado	4.63%	Flat rate	1	4.63%
Connecticut[4]	7.5%	Flat rate	1	7.5%
Delaware	8.7%	Flat rate	1	8.7 – 1.7%[5]
Florida[6]	5.5%	Flat rate	1	5.5%
Georgia	6.0%	Flat rate	1	6.0%
Hawaii[7]	4.4 – 6.4%	25,000 – 100,000	3	7.92%
Idaho[8]	7.6%	Flat rate	1	7.6%
Illinois[9]	7.3%	Flat rate	1	7.3%
Indiana	8.5%	Flat rate	1	8.5%
Iowa	6.0 – 12.0%	25,000 – 250,000	4	5.0%
Kansas[10]	4.0%	Flat rate	1	2.25%
Kentucky	4.0 – 6.0%[11]	50,000 – 100,000	3	N/A
Louisiana	4.0 – 8.0%	25,000 – 200,000	5	N/A
Maine	3.5 – 8.93%[12]	25,000 – 250,000	4	1.0%
Maryland	8.3%	Flat rate	1	8.3%
Massachusetts[13]	9.5%	Flat rate	1	10.5%
State	**Tax Rates**	**Tax Brackets**	**No. of Brackets**	**Bank Tax Rates**
Michigan	4.95%[14]	Flat rate	1	N/A
Minnesota[15]	9.8%	Flat rate	1	9.8%
Mississippi	3.0 – 50%	5,000 – 10,000	3	3.0 – 5.0%
Missouri	6.25%	Flat rate	1	7.0%
Montana[16]	6.75%	Flat rate	1	6.75%

2 Minimum tax is $50 in Arizona, $50 in North Dakota (banks), $10 in Oregon, $500 in Rhode Island, $500 per location in South Dakota (banks), $100 in Utah, $250 in Vermont.

3 Minimum tax is $800. The tax rate on S-Corporations is 1.5% (3.5% for banks).

4 Or 3.1 mills per dollar of capital stock and surplus (maximum tax $1 million) or $250.

5 The marginal rate decreases over 4 brackets ranging from $20 to $650 million in taxable income. Building and loan associations are taxed at a flat 8.7%.

6 Or 3.3% Alternative Minimum Tax. An exemption of $5,000 is allowed.

7 Capital gains are taxed at 4%. There is also an alternative tax of 0.5% of gross annual sales.

8 Minimum tax is $20. An additional tax of $10 is imposed on each return.

9 Rates include a 2.5% personal property replacement tax.

10 Rates also contain a surtax of 3.35% (2.125% for banks) on taxable income in excess of $50,000 ($25,000).

11 Minimum tax of $175. Or, an annual Limited Liability Tax for all corporations with over $3 million in gross receipts.

12 Or the Maine Alternative Minimum Tax.

13 Rate includes a 14% surtax, as does the following: an additional tax of $2.60 per $1,000 on taxable tangible property (or net worth allocable to state, for intangible property corporations); minimum tax of $456.

14 The New Michigan Business Tax. First $45,000 of tax base exempt. Plus, 0.8% of modified gross receipts
(receipts less purchases from other firms) on receipts of $350,000 or more. A surcharge of 21.99% applies.

15 Plus a 5.8% tax on any Alternative Minimum Taxable Income over the base tax.

16 A 7% tax on taxpayers using water's edge combination. Minimum tax is $50.

Nebraska	5.58 – 7.81%	50,000	2	N/A
New Hampshire[17]	8.5%	Flat rate	1	8.5%
New Jersey[18]	9.0%	Flat rate	1	9.0%
New Mexico	4.8 – 7.6%	500,000 – 1,000,000	3	4.8 – 7.6%
New York[19]	7.5%	Flat rate	1	7.5%
North Carolina	6.9%	Flat rate	1	6.9%[20]
North Dakota	2.6 – 6.5%	3,000 – 30,000	5	7.0%
Ohio[21]	5.1 – 8.5%	50,000	2	N/A
Oklahoma	6.0%	Flat rate	1	6.0%
Oregon	6.6%	Flat rate	1	6.6%
State	**Tax Rates**	**Tax Brackets**	**No. of Brackets**	**Bank Tax Rates**
Pennsylvania	9.99%	Flat rate	1	N/A
Rhode Island	9.0%	Flat rate	1	9.0%[22]
South Carolina	5.0%	Flat rate	1	4.5%[23]
South Dakota	N/A	N/A	N/A	6.0-0.25%
Tennessee	6.5%	Flat rate	1	6.5%
Texas[24]	N/A	N/A	N/A	N/A
Utah	5.0%	Flat rate	1	5.0%
Vermont	6.0 – 8.5%	10,000 – 250,000	3	N/A
Virginia	6.0%	Flat rate	1	6.0%[25]

[17] Plus a 0.75 percent tax on the enterprise base (total compensation, interest and dividends paid) for businesses with gross income over $150,000 or base over $75,000. Business profits tax is imposed on both corporations and unincorporated associations with gross income over $50,000.

[18] The rate reported in the table is the corporation business franchise tax rate. Corporations with net income under $100,000 are taxed at 7.5%. Corporations with net income under $50,000 are taxed at 6.5%. A 4% surtax applies through July 1, 2009. The minimum tax is $500. An Alternative Minimum Assessment based on Gross Receipts applies if greater than corporate franchise tax. Banking and financial corporations are subject to the franchise tax.

[19] Rates can also be calculated at a rate of 1.78 mills per dollar of capital (up to $350,000); or a 1.5% alternative minimum tax; or a minimum tax of $1,500 to $100 depending on payroll size; if any of these is greater than the tax computed on net income. Small corporations with income under $290,000 are subject to lower rates of tax on net income. An additional tax of 0.9 mills per dollar of subsidiary capital is imposed on corporations. For banks, the alternative bases of tax are 3% of alternative net income; or up to 1/50th mill of taxable assets; or a minimum tax of $250.

[20] Financial institutions are also subject to a tax equal to $30 per one million in assets.

[21] Rates shown are for the Franchise tax, which is being phased out through 2010. Current rates apply to 40% of the liability, or 40% of 4 mills time the value of the taxpayer's issued and outstanding share of stock with a maximum payment of $150,000; or $50 to $1,000 minimum tax, depending on worldwide gross receipts. The Commercial Activity Tax (CAT) equals $150 for gross receipts between $150,000 and $1 million, plus 0.26% of gross receipts over $1 million. The CAT applies to 60% of receipts through March 31, and 80% for the remainder of the year. Banks will pay the Franchise tax. An additional litter tax is imposed equal to 0.11% on the first $50,000 of taxable income, 0.22% on income over $50,000; or 0.14 mills on net worth.

[22] For banks, the alternative tax is $2.50 per $10,000 of capital stock ($100 minimum).

[23] Savings and loans are taxed at a 6.0% rate.

[24] Texas imposes a franchise tax, not a corporate income tax.

West Virginia	8.5%	Flat rate	1	8.5%
Wisconsin	7.9%	Flat rate	1	7.9%
D.C.[26]	9.975%	Flat rate	1	9.975%

South Carolina Department of Revenue
Corporate Income Tax Revenue and Refunds

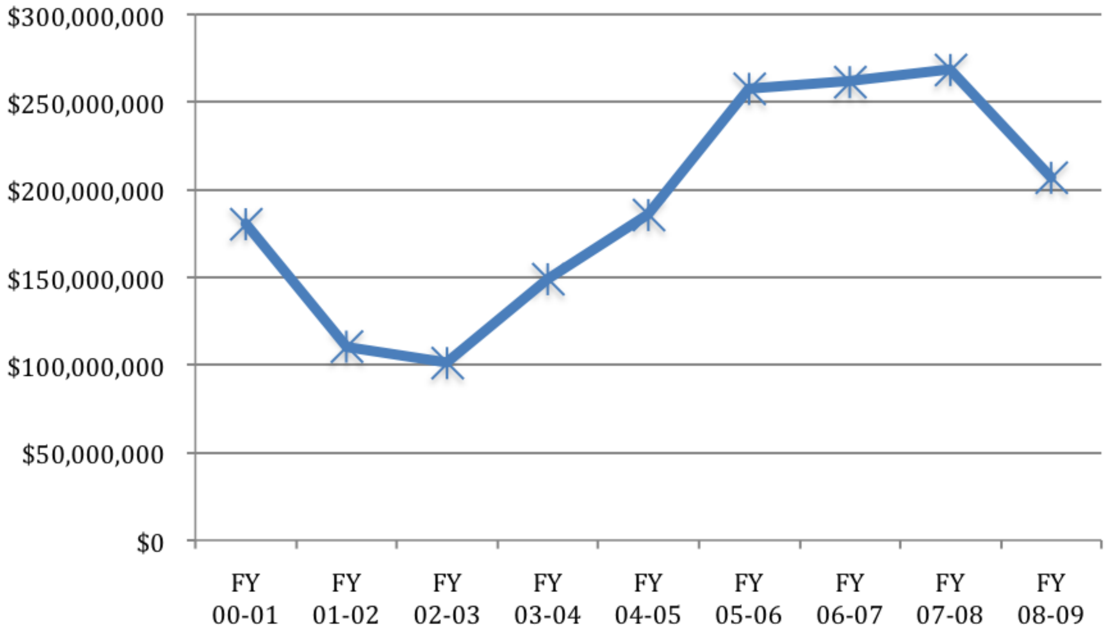
	FY 2007-08	FY 2008-09	Financial Difference	Percentage Change
Corporate Income Tax Revenue	$268,643,839	$207,178,852	($61,464,987)	-22.88%
Corporate Income Tax Refunds	$37,238,977	$59,164,230	$21,925,253	58.88%

Corporate Income Tax Revenue

*Info. From SC Dept. of Rev.	Amount Collected	Change From Previous Year	% Change From Previous Year
Fiscal Year			
08-09	$207,178,852	($61,464,987)	-22.88%
07-08	$268,643,839	$6,929,960	+2.65
06-07	$261,713,879	$3,837,403	+1.11
05-06	$257,876,476	$71,965,474.27	+38.71
04-05	$185,893,059	$36,601,550	+24.52
03-04	$149,291,510	$47,848,559	+47.17
02-03	$101,442,550	($9,392,970)	-8.47
01-02	$110,835,520	($69,817,656)	-38.65
00-01	$180,653,216	$6,787,380	+3.90
99-00	$173,865,836	($41,399,527)	-19.23
98-99	$215,265,364	$22,763,303	+11.83
97-98	$192,502,061	($27,813,720)	-12.6
96-97	$220,316,671	($8,505,243)	-3.7
95-96	$228,821,913	($964,467)	-.42
94-95	$229,786,380	$33,865,427	17.29
93-94	$195,920,952	$195,920,952	24.76

[25] State and national banks subject to the state's franchise tax on net capital is exempt from the income tax.
[26] Minimum tax is $100, which includes the surtax.

Corporate Income Tax Collections Between FY 2000-01 and 2008-09



III. GENERAL TAX PROVISIONS

A. Federal Tax Conformity

South Carolina income tax laws conform substantially to the federal income tax laws. Each year, South Carolina's income tax laws have been amended to conform to the Internal Revenue Code of 1986 as amended through the immediately preceding December 31st, with the exception of Internal Revenue Code Section provisions listed in South Carolina Code §12-6-50 that are specifically not adopted by South Carolina.

This conformity simplifies the filing of returns by adopting federal taxable income as a starting point for South Carolina income tax purposes. With some exceptions, South Carolina income tax liability is determined in accordance with the same set of statutes and rules used in determining federal income tax liability. Subject to certain modifications, the South Carolina gross income and taxable income of a business is the business's gross income and taxable income as determined under the Internal Revenue Code.

B. Corporate Income Tax Rates

South Carolina corporate income tax is imposed upon the South Carolina taxable income of domestic and foreign corporations. Once a business has determined its South Carolina taxable income, it must apply the South Carolina corporate income tax rate to determine the amount of South Carolina corporate income tax due. South Carolina has a 5% corporate income tax rate – one of the lowest in the nation. In addition, multi-state manufacturers now pay taxes on only their South Carolina Sales.

C. Taxation of Other Entities

South Carolina Code §12-6-550 exempts a number of corporations from South Carolina income tax. Exempt corporations include insurance companies, certain nonprofit corporations organized for the purpose of providing water supply and/or sewer disposal, banks, building and loan associations, and certain electric cooperatives. Some of these entities may be subject to other types of South Carolina tax. Also, South Carolina does not generally tax the income of a tax-exempt organization qualifying under Internal Revenue Code §§501 through 528, although the unrelated business income of such an entity is taxed. The taxation of pass through entities and limited liability companies generally conforms to the federal income tax laws. The South Carolina taxation of pass-through entities and withholding requirements are discussed below.

1. S Corporations

South Carolina recognizes a valid federal Subchapter S election. South Carolina Code §12-6-590 provides that a corporation having a valid election under Subchapter S of the Internal Revenue Code is not subject to South Carolina income tax to the extent it is exempt from federal corporate income tax. Further, a termination or revocation of an "S" election for federal purposes automatically terminates or revokes the election for South Carolina income tax purposes.

2. Partnerships

Partnerships are not subject to South Carolina income tax under South Carolina Code §12-6-600. The gross income, adjusted gross income, and taxable income of a partnership and its partners are determined in accordance with applicable provisions of the Internal Revenue Code. Partners include in their South Carolina taxable incomes their proportionate share of the partnership's South Carolina taxable income. See South Carolina Revenue Ruling #97-7 for information on a resident partner reporting personal service income received from South Carolina and one or more states.

3. Limited Liability Companies

South Carolina follows the federal tax treatment of limited liability companies. If a limited liability company is treated as a corporation for federal income tax purposes it is treated as a corporation for South Carolina income tax purposes and is subject to a corporate license fee. South Carolina Code §12-2-25 provides that a partnership includes a limited liability company taxed for all South Carolina income tax purposes as a partnership. Accordingly, a limited liability company that is treated as a partnership for federal income tax purposes is not subject to South Carolina income tax or the corporate license fee.

D. Nexus and Public Law 86-272

Nexus is a sufficient connection between a person and a state, and a sufficient connection between an activity, property, or transaction and a state, that allows the state to subject the person, and the activity, property, or transaction to its taxing jurisdiction. The Due Process and Commerce Clauses of the United States Constitution, 15 U.S.C. §381 (Public Law 86-272), and other federal statutes provide limitations on states' powers to tax out-of-state corporations.

Public Law 86-272 prohibits a state from taxing the income of a taxpayer if the taxpayer's only business activities within the state consist of the solicitation of orders for sales of tangible personal property that are sent outside the state for approval and are filled and shipped from outside the state.

E. Allocation and Apportionment of Income

1. General Provisions

South Carolina Code §12-6-2210 provides for the determination of taxable income of a business. A taxpayer whose entire business is transacted or conducted in South Carolina is subject to income tax based on the entire taxable income of the business for the taxable year. A taxpayer that transacts or conducts its business partly within and partly outside of South Carolina is subject to income tax based on the portion of its business carried on in South Carolina. This portion is determined through allocation and apportionment of income. The sum of these amounts is South Carolina taxable income.

South Carolina Code §§12-6-2220 and 12-6-2230 provide that certain classes of income, less related expenses, are allocated. Items directly allocated include nonbusiness interest, nonbusiness dividends, nonbusiness rents and royalties from the lease or rental of real estate or tangible personal property, gains and losses from the sale of real property, and nonbusiness gains and losses from sales of intangible property.

The income remaining after allocation is apportioned in accordance with South Carolina Code §12-6-2240. South Carolina generally requires the use of one of the following apportionment methods:

a. A "four factor" apportionment method (based on property, payroll, and double-weighted sales) or a "phased in" single factor apportionment method (based on sales) for taxpayers whose principal business in South Carolina is dealing in tangible personal property. This method is typically used by businesses that manufacture, sell, or rent tangible personal property.

NOTE: The "single sales factor" apportionment method is being phased in for tax years beginning in 2007 – 2010. The "single sales factor" apportionment method will replace the "four factor" apportionment method for tax years beginning in 2011 for businesses dealing in tangible personal property. See South Carolina Code §§12-6-2250, 12-6-2252, and 12-6-2295.

b. A "gross receipts" apportionment method for taxpayers not dealing in tangible personal property. This method is typically used by financial businesses and service businesses, including businesses that install or repair tangible personal property, and contractors. See South Carolina Code §§12-6-2290 and 12-6-2295.

c. A "special" apportionment method provided in South Carolina Code §12-6-2310 for certain companies, such as railroad companies, telephone companies, pipeline companies, airline companies, and shipping lines.

d. An individualized apportionment method tailored to a particular taxpayer (a) because the standard method for that taxpayer does not fairly represent the extent of the taxpayer's business in South Carolina, or (b) as an economic incentive allowed the taxpayer. See subsections (b) and (c) below for more information on alternative apportionment provisions.

2. Four Factor Apportionment Method/ New Single Sales Factor Apportionment Method Phase-In Rules for Tax Year Beginning 2007-2010

a. **Original Four Factor Apportionment Method.** South Carolina Code §12-6- 2250 contains the "four factor" formula and provides:

> A taxpayer whose principal business in this State is (a) manufacturing or any form of collecting, buying, assembling, or processing goods and materials within this State, or (b) selling, distributing, or dealing in tangible personal property within this State, shall make returns and pay annually an income tax which includes its income apportioned

to this State. Its income apportioned to this State is determined by multiplying the net income remaining after allocation under South Carolina Code §§12-6- 2220 and 12-6-2230 by a fraction, the numerator of which is the property ratio, plus the payroll ratio, plus twice the sales ratio, and the denominator of which is four. However, where the sales ratio does not exist [*i.e.*, there is zero sales everywhere], the denominator of the fraction is the number of existing ratios, and where the sales ratio exists but the payroll ratio or the property ratio does not exist, the denominator of the fraction is the number of existing ratios plus one. The property, payroll, and sales ratios must be determined in accordance with South Carolina Code §§12-6-2260, 12-6- 2270, and 12-6-2280, respectively.

b. **New Single Sales Factor Apportionment Method.** For tax years beginning after 2010, South Carolina Code §12-6-2252 (*i.e.*, the new single sales factor apportionment method) provides that the above taxpayer's income is apportioned to South Carolina by multiplying the net income remaining after allocation under South Carolina Code §§12-6-2220 and 12-6-2230 by the sales factor defined in South Carolina Code §12-6-2280. However, if a sales factor does not exist, the remaining net income is apportioned to the business's principal place of business.

c. **Phase In of Single Sales Factor Apportionment Method, As Applicable, for Tax Years Beginning 2007 - 2010.**

For taxable years beginning in 2007 through 2010 only, South Carolina Code §12-6-2250(B) provides that a taxpayer apportioning income pursuant to South Carolina Code §12-6-2250(A) (*e.g.*, one whose principal business in South Carolina is dealing in tangible personal property) shall apportion income by using the method provided in South Carolina Code §12-6-2250 (*i.e.*, original four factor apportionment method) and, if applicable, the method provided in South Carolina Code §12-6-2252 (*i.e.*, new single sales factor apportionment method). If the calculation under South Carolina Code §12-6-2252 (single sales factor apportionment method) results in a reduction in income apportioned to South Carolina, the reduction is allowed as follows:

Taxable Year Beginning in	Percentage of Reduction
2007	20%
2008	40%
2009	60%
2010	80%

3. Gross Receipts Apportionment Method

South Carolina Code §12-6-2290 provides for the "gross receipts" formula and states:

> If the principal profits or income of a taxpayer are derived from sources other than those described in South Carolina Code §12-6-2250 or §12-6-2310, the taxpayer shall apportion its remaining net income using a fraction in which the numerator is gross receipts from within this State during the taxable year and the denominator is total gross receipts from everywhere during the taxable year. For purposes of this section, items included in gross receipts are as provided in South Carolina Code §12-6-2295.

The "gross receipts" ratio is most commonly used by service businesses. The proper sourcing of gross receipts was reviewed in *Lockwood Greene Engineers v. South Carolina Tax Commission*, 361 S.E.2d 346 (1987). The court held that in sourcing income of a multistate engineering firm, "gross receipts from within this State" were to be determined according to where the services were performed rather than according to where the customers were located.

4. Fairness Based Alternative Apportionment Provisions

South Carolina Code §12-6-2320 provides for alternative methods to fairly apportion income for companies who do business in more than one state. Any taxpayer who believes that the statutory apportionment formula does not represent the extent of the taxpayer's business within this State may apply to the Department for approval of an alternative method.

Under South Carolina Code §12-6-2320(A), a taxpayer may petition for, or the Department may require, with respect to all or any part of the taxpayer's business activity, one of the following alternatives for reporting:

a. Separate Accounting;

b. The exclusion of one or more factors;

c. The inclusion of one or more factors; or

d. The use of another allocation and apportionment method.

5. Corporate License Fees

South Carolina Code §12-20-50 imposes an annual license fee on the capital and paid-in surplus of a corporation. The license fee is $15 plus $1 for each $1,000, or fraction, of capital stock and paid-in or capital surplus shown on the corporate records on the first day of the tax year. The minimum license fee is $25. The license fee is computed in advance of the taxpayer's income tax year.

If a "consolidated" return is filed, then the license fee is measured by the capital stock and paid-in or capital surplus of each corporation considered separately without offset for investment of one corporation in the capital or surplus of another corporation in the consolidated group. The minimum license fee applies to each corporation in the consolidated group.

South Carolina Code §12-20-60 provides that the license fee imposed by South Carolina Code §12-20-50 must be apportioned in accordance with the ratio prescribed for income tax purposes. However, a taxpayer using the reduction percentage allowed during the phase in of the single sales factor apportionment method in Code §12-6-2250(B) for income tax purposes, may use either the "phased in" factor for license fee purposes or the original four factor apportionment factor, whichever results in the lower license fee (see example in Section 5a above.) The $25 minimum license fee, however, may not be apportioned. A business using an alternative method to apportion income (see above discussion) must also use that alternative method to compute the South Carolina corporate license fee.

IV. CORPORATE INCOME TAXATION OF FINANCIAL INSTITUTIONS

A. Banks

Banks are defined as any person "engaged in a banking business, whether incorporated under the laws of this State, any other state or the United States or whether unincorporated, except cash depositories."[27]

Comment: This definition is generally viewed as being limited to persons who are regulated by federal or state banking regulators.

Banks are exempt from South Carolina income taxes,[28] however, SC Code Title 12, Chapter 11, imposes a franchise tax based upon the "entire net income" of banks. The tax rate is 4.5% of the "entire net income" of the bank doing business in South Carolina or from the sales or rentals of property within South Carolina.[29] Although the chapter is entitled "Income Tax on Banks" and several of its sections refer to it as an income tax,[30] this tax has always been considered a franchise tax based upon net book income.[31] Banks are not subject to any taxes in South Carolina except this tax, use taxes, deed recording fees, and property taxes on real property.[32]

For purposes of administration, allocation and apportionment, enforcement, collection, liens, penalties, and other similar provisions, all of the provisions of the South Carolina's income tax[33] that may be appropriate or applicable are adopted and made a part of the bank franchise tax for the purposes of enforcement and administration, including the requirement to make declarations of estimated tax and make estimated tax payments.[34]

B. Savings and Loan Associations

A savings and loan association (association) includes any mutual or stock-chartered corporation insured by the Federal Savings and Loan Insurance Corporation or any corporation subject to regulatory supervision by the Federal Home Loan Bank, or the Savings and Loan Division of the South Carolina Board of Financial Institutions, other than banks taxed under Chapter 11 of Title 12 of the SC Code, or employees' credit unions.[35]

Associations are exempt from South Carolina's corporate income tax,[36] however, SC Code Chapter 13 of Title 12 imposes an income tax (not a franchise tax) on associations. The tax rate is 6% of the net income from all sources, except for income

[27] SC Code §12-11-10.
[28] SC Code §12-6-550(1).
[29] SC Code §12-11-20.
[30] SC Code §§12-11-30, 12-11-50, and 12-11-60.
[31] See South Carolina Attorney General's Opinion dated March 12, 1948, Commission Decision I-D-189 (1975), and SC Form 1101B and instructions.
[32] SC Code §12-11-30.
[33] Chapter 6 of Title 12 of the SC Code.
[34] SC Code §12-11-40 and Commission Decision I-D-189 (1975).
[35] SC Code §§12-13-10 and 12-13-40.
[36] SC Code §12-6-550(2).

from municipal, state, or federal bonds or securities exempted by law from the tax, including interest earned on deposits at the Federal Home Loan Bank of Atlanta, or its successors, for those savings and loan associations which meet the qualified thrift lender test set forth in the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (Public Law 101-73), as amended.[37]

Associations are exempt from this tax for the first three years of their operation.[38] This savings and loan income tax is imposed in lieu of all other taxes on associations, except use taxes, deed recording fees, and property taxes on real property.

C. Other Financial Institutions

Other financially related corporations like finance companies, credit card companies, securities brokers and dealers, are taxed under the corporate income tax provisions in SC Code Chapter 6 of Title 12.

D. Recommendations Regarding Financial Institutions

1. Conform the Bank Corporate Income Tax Rate to Those Paid by Other Businesses

As a result of legislation passed in the 1940s banks, savings and loans and credit unions to a level commiserate with their other tax savings. and many other financial institutions (savings and loans and credit unions) pay an income tax in lieu of all other taxes except deed recording fees, real property and use taxes. As such, these institutions pay no sales taxes, personal property taxes or local business license taxes. One would think that such financial institutions would accordingly pay an income tax at a higher rate than other businesses. In fact, the converse is true - - the income tax rate for banks is lower than virtually every other business enterprise (4.5% versus 5% for C Corporations and 7 or 5% for individuals, LLCs, S Corporations and the like.) In addition, Federally chartered credit unions pay no income taxes.

The General Assembly should consider raising the income tax rates on banks, savings and loans and credit unions to a level commiserate with their other tax savings.

2. Conform the Tax Treatment of Credit Unions and Savings and Loans to Banks

There is little economic difference today between a credit union, savings & loan and a bank, and yet federally chartered credit unions pay no income taxes. The General Assembly should conform the tax treatment of credit unions and savings and loans to other financial institutions.

3. Allocation and Apportionment of Income of Multi-State Banks

There is little guidance for the allocation and apportionment of income for multi-state banks. The General Assembly should enact legislation to provide clarity in this area.

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[37] SC Code §12-13-30.

[38] SC Code §12-13-40.

V. UNITARY BUSINESS DOCTRINE

A. General Overview

Apportionment is tied to the unitary business concept. Before an apportionment formula can be applied by a state to ascertain the taxable income of a multistate corporation, or an affiliated group of corporations, a determination must be made that the divisions of the corporation, or the members of the controlled corporate group, constitute one unitary business. "The linchpin of apportionability in the field of state income taxation is the unitary business principle."[39]

A state cannot tax value earned outside of the state,[40] but a state may look beyond its borders to get the true value of taxed property or privileges within its borders, when in-state activities are an integral part of an organic interstate system that gives an enhanced value to the property or privileges which are taxed.

"In a unitary enterprise, property outside the state, when correlated in use with property within the state, necessarily affects the worth of the privilege within the state."[41] Thus, the privilege of doing business within a state may be made more valuable owing to its being an integral part of a multistate operation.

Therefore, to determine the amount a state can tax, first the unitary business is determined. A corporation can have income which is not connected with a trade or business, and a corporation can conduct more than one unitary business. The income and apportionment must be computed separately for each unitary business. On the other hand, one unitary business can encompass a group of related corporations[42] and the income from the unitary business, which is not otherwise allocated, is apportioned between the taxing state and everywhere else.

There is no objective and easy definition of unitary business. Rick Pomp and Oliver Oldman explain:[43]

> The unitary business concept is not, so to speak, unitary: there are variations on the theme, and any number of them are logically consistent with the underlying principles motivating the approach.[44] Instead it [US Supreme Court] has identified some of the indicia of a unitary business: unity of use and management;[45] a concrete relationship between the out-of-state and the in-state activities;[46] functional integration, centralization of management, economies of scale;[47] substantial mutual

[39] Exxon Corp v. Dept of Revenue, 447 U.S. 207, 223 (1980).
[40] Conn. General Life Ins. Co. v. Johnson, 303 U.S. 77 (1938).
[41] Ford Motor Co. v. Beauchamp, 308 U.S. 331 at 336 (1939) (franchise tax case).
[42] See Mobil Oil v. Vermont, 445 U.S. 425 (1980).
[43] State & Local Taxation, Richard D. Pomp and Oliver Oldman (3d ed. 2000) at 10-20 to 10-21. See also the draft of the Public Participation Working Group - Uniformity Committee Liaison Group on Definitions of Unitary Businesses on the Multistate Tax Commission website; www.mtc.gov.
[44] Container Corp. v. Franchise Tax Bd., 463 U.S. 159 (1983).
[45] Butler Bros. v. McColgan, 315 U.S. 501 (1942).
[46] Container Corp. v. Franchise Tax Bd., 463 U.S. 159 (1983).
[47] Mobil Oil Corp. v. Vermont, 445 U.S. 425 (1980).

> interdependence;[48] and some sharing or exchange of value not capable of precise identification of measurement — beyond the mere flow of funds arising out of a passive investment or a distinct business operation.[49] The Court has recognized that in a unitary business, it is exceedingly difficult to determine the profits earned by the processes conducted within a state's borders.[50]

In a unitary multistate business, no method of assigning net income can precisely determine the exact amount of income attributable to any geographic area or to any given part of a series of multistate business operations. States have devised statutory apportionment formulas for multistate income designed to arrive at a portion of income reasonably attributable to the state. The formula method provides a rough approximation of a company's income that is reasonably related to the activities conducted within the taxing state; it does not identify the precise geographical source of a company's income.

B. South Carolina Overview

South Carolina is a separate entity state, and generally treats related corporations as if they were unrelated. South Carolina does not normally apportion the income of related corporations together, even when they are part of one unitary business.[51] Single member limited liability companies and QSubs that are disregarded for all South Carolina tax purposes are exceptions to this rule. Another possible exception is provided by SC Code §12-6-2320(A) which provides that if South Carolina's statutory allocation and apportionment provisions do not fairly represent the extent of the taxpayer's business activity in South Carolina, the taxpayer may petition for, or the Department may require, in respect to all or any part of the taxpayer's business activity a different method. It is possible that in certain circumstances the taxpayer may request, or the Department may require, combined reporting; *i.e.,* the apportionment of multiple related corporations together. Although this type of alternative combined apportionment has been discussed, the Department has, to date, never attempted to impose it over a taxpayer's objection.

South Carolina does allow what it refers to as consolidated returns.[52] They are nothing like what federal tax practitioners consider consolidated returns.

South Carolina recognizes that it is possible that one corporation can carry on two or more separate unitary businesses. When that is the case, each unitary business is apportioned separately.[53]

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[48] F.W. Woolworth Co. v. New Mexico, 458 U.S. 354 (1982).

[49] Container Corp. v. Franchise Tax Bd., 463 U.S. 159 (1983).

[50] Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920).

[51] The South Carolina Supreme Court held in Emerson Elec. Co. v. Wasson, 287 S.C. 394, 339 S.E.2d 118 (1986), that parent and subsidiary corporations are not to be considered a single entity for apportionment purposes.

[52] SC Code §12-6-5020 and Emerson Elec. Co. v. Wasson, 287 S.C. 394, 339 S.E.2d 118 (1986).

[53] Exxon Corporation v. South Carolina Tax Commission, 273 S.C. 594, 258 S.E.2d 93 (1979). See also SC Reg. §117-710.1 Proper Allocation and Apportionment of Income:

> The phrase "transacting or conducting his business partly within and partly without this State" … is applicable to a single business operation, which is unitary or homogenous and is carried on both within and without the State. A taxpayer operating two or more unrelated businesses, each of which

C. Unitary Business Issues

There are really two separate unitary business issues.

1. Are two (or more) entities or segments unitary so that their apportionment factors and incomes should be combined and used in determining income subject to income tax in a state? A segment for this purpose is a subdivision of an entity consisting of any grouping of business activities, functions, or transactions.

2. If the answer to the first issue is no, then is the income in question part of apportionable income? A yes answer to the second issue means that the income is apportionable, but that the apportionment factors of the payer are not included in the apportionment formula.

The first issue is the traditional unitary business issue for corporate income tax. Are the entities or segments not separate businesses, but an integral part of a multi-state unitary operation, such that the income from the operations within each state cannot accurately be attributed to a given state by the separate accounting method?[54] The underlying rationale is that there is but one business and the apportionment factors and income are really the apportionment factors and income of one business which should be allocated and apportioned together.[55]

The second issue is a determination of whether income is apportionable. In South Carolina that is the same as determining whether it is business income or non-business income,[56] and in some cases where a corporation is carrying on more than one unitary business, determining to which unitary business the income relates.[57]

> is entirely within and without the State, is not subject to the provisions of this section, but each business determines its South Carolina net income separately. A taxpayer operating a unitary or homogenous business within and without the State and an unrelated business either entirely within or without is subject to the [apportionment] formulas with respect to the unitary or homogenous business but not with respect to the unrelated business. The income from the unrelated business is allocated and apportioned separately as appropriate to the State where such business is conducted.

A review of South Carolina cases below will attest, this possibility is not a common occurrence in South Carolina.

[54] The Supreme Court has declared the "principal virtue of the unitary business principle of taxation is that it does a better job of accounting for 'the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise' than, for example, geographical or transactional accounting." Allied Signal, Inc. v. New Jersey, 504 U.S. 768, 783 (1992) quoting from Container Corp. v. Franchise Tax Bd., 463 U.S. 159, 164-165 (1983).

[55] See e.g., Exxon Corp. v. Wisconsin, 447 U.S. 207 (1980); Mobil Oil Corp. v. Vermont, 445 U.S. 425 (1980); F.W. Woolworth, Co. v. New Mexico, 458 U.S. 354 (1962); ASSARCO, Inc. v. Idaho Sate Tax Comm., 458 U.S. 307 (1982); Container Corp. v. Franchise Tax Bd., 463 U.S. 159 (1983); and see BNA Multistate Tax Portfolio #1110, Income Taxes: Definition of a Unitary Business.

[56] In South Carolina, all apportionable income is business income.

[57] The payee and the payor need not be engaged in the same unitary business as a prerequisite to apportionment. What is required instead is that the transaction serve an operational rather than an

D. Separate Reporting System for Corporate Income Tax

1. Overview of the Separate Reporting System

South Carolina currently operates under a separate reporting system for corporate income tax. This means that the state generally "treats related corporations as if they were unrelated."~~[58]~~ The following example offers some insight for how the separate entity reporting works on an individual basis.

Corporation A operates within South Carolina, and because of these in-state activities, A has nexus with the state. A is therefore liable to pay corporate income tax. Corporation B is a trademark holding firm in another state, and a subsidiary of A. B owns and holds A's trademark, and, as part of A's business within South Carolina, licenses the use of this trademark to A in exchange for a royalty fee.[59] Corporation B has no officers within South Carolina, nor does it do any business within the state beyond this licensing agreement with Corporation A.[60]

Under the separate entity system, Corporation B is an unrelated operation to Corporation A in South Carolina. A and B are separate companies entirely for the purpose of assessing tax liability. Even if the state were to utilize the unitary business principle and define A's operation so broadly as to include its transactions with B, and even though B is a subsidiary A, a corporation liable to pay corporate income tax, the state would still not be able to reach B and its activities with A to tax the income it receives from A's operations in South Carolina. With separate entity reporting, the two companies would be distant from each other, and since B has no nexus with the state, it would avoid liability.

Similarly, since the state treats A and B as strangers, A's operations would have no impact in B's tax liability, since there would be no liability to begin with. More striking however, B's income from it's operations with A would not be held against A when apportioning A's income for tax liability.[61] The money Corporation A pays to its subsidiary, Corporation B, would only serve to negate A's liability since it would only be calculated as an expense against A's income for its in-state activities.[62]

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investment function. For example, interest earned on short-term deposits in a bank located in another state where that income forms part of the working capital of the corporation's unitary business, is part of that corporation's apportionable income, notwithstanding the absence of a unitary relationship (issue 1) between the corporation and the bank.

In order to exclude certain income from the apportionment formula, the company must prove that the income was earned in the course of activities unrelated to those carried out in the taxing state. See Allied Signal, Inc. v. New Jersey, 504 U.S. 768 (1992); and Eastman Kodak Company v. SC Tax Comm., 418 S.E.2d 542 (SC 1992); and see BNA Multistate Tax Portfolio #1110, Income Taxes: Definition of a Unitary Business.

~~[58] *See supra* pp. 23.~~

[59] Under this hypothetical, Corporation B could be referred to as a "Passive Investment Company" or "Delaware holding companies." *See* Sheldon H. Laskin, *Only a Name? Trademark Royalties, Nexus, and Taxing That Which Enriches*, 22 AKRON TAX J. 1, 4 (2007).

[60] *See, e.g.*, Geoffrey, Inc. v. South Carolina Tax Com'n, 437 S.E.2d 13 (S.C. 1993).

[61] *See* RICHARD POMP, STATE & LOCAL TAXATION 10-30 (4th ed. 2001); *see also* HELLERSTEIN & HELLERSTEIN, STATE TAXATION §9.15 (3rd ed. 2010).

[62] *See* PENNSYLVANIA BUDGET AND POLICY CENTER, ENSURING ALL CORPORATIONS PAY THEIR FARE SHARE (2010).

Separate entity reporting creates a potentially massive tax loophole for corporations capable of taking advantage. While the system is very attractive to those companies, it creates a number of problems for the state, as well as for those corporations incapable of seizing its benefits.

2. Problems with Separate Reporting

There are numerous potential issues associated with separate reporting for both the state and the private sector. What follows is a point-by-point breakdown of these problems.

(i) Separate Entity Reporting Creates a Tax Loophole for Corporations to Avoid Tax Liability.

The most obvious concern with separate entity reporting is the massive tax loophole the system leaves open for certain businesses to utilize. Using the example from above, consider a scenario in which Corporation A creates Corporation B as its subsidiary, and that Corporation B files its articles of incorporation in a state that has no corporate income tax.[63] Corporation B would then have no tax liability in South Carolina or in the state in which it is incorporated. A can then pay B extremely high rates and fees for the use of its trademark, thereby reducing its taxable income to a point where its liability within South Carolina would be either minimal or none at all.[64] Tax expert Richard Pomp refers to this form of income maneuvering as the "Delaware loophole" given the high number of corporations who establish subsidiaries in the tax-free state of Delaware and thereby avoid tax liability in separate entity states where they have sufficient nexus.[65]

The implications for South Carolina include significant losses in tax revenue. Pomp recently estimated that Pennsylvania's separate entity system has so far cost that state $615 million.[66]

(ii) Separate Entity Reporting is Discriminatory Against Smaller Businesses.

A second issue with separate entity reporting is that the system provides an unfair competitive advantage for multi-state corporations. The holding company tax loophole, as exemplified in the A and B example, offers a potentially beneficial option for certain businesses capable of setting up subsidiaries in tax-free states. This benefit, however, is felt by only certain corporations, while many others, including small businesses, are left out.

Multi-state corporations operating within South Carolina benefit from state and locally-funded public services. They benefit, like all businesses, from doing business within the state. The difference, however, for these multi-state corporations is that while

[63] See Delaware or Wyoming as examples.
[64] PENNSYLVANIA BUDGET AND POLICY CENTER, ENSURING ALL CORPORATIONS PAY THEIR FARE SHARE (2010).
[65] *Id.*
[66] *Id.*

they accept and use these benefits, they are able to avoid paying their fair share of taxes, which are then used to fund these services. The income they collect can be sent, under the current law, to their holding subsidiary in Delaware.

Other, usually smaller, businesses aren't so fortunate. Corporations that do all of their business within South Carolina, for example, are liable to pay their 5% income tax.[67] Since they aren't capable or sophisticated enough to establish holding companies as tax haven subsidiaries, they operate within their own state at a competitive disadvantage with these multi-state corporations.[68]

(iii) Separate Entity Reporting Leads to Year-by-Year Inconsistencies in State Tax Revenue.

The tax loopholes created by South Carolina's separate reporting structure also lead to inconsistencies with the state's tax revenues. Looking at South Carolina's year-by-year tax revenues from fiscal year 2000-01 to the present shows that over the past nine years, ending in fiscal year 2008-09, revenues have jumped as high as 47% in fiscal year 2003-04, but have likewise dropped in 2001-02 at -38% and -23% in 2008-09.[69]

There are numerous explanations for these inconsistencies, including changes in the economic climate and other areas of legislation, but the ability of corporations to manipulate their multi-state tax liabilities through holding company loopholes only exacerbates the state's problem in enforcing a consistent, dependable tax structure.[70]

3. *Geoffrey* -- Overcoming Separate Reporting

(i) The Case

Geoffrey, Inc. v. South Carolina Tax Commission[71] involved a corporate structure identical to the A and B hypothetical discussed above. Geoffrey, Inc. was a subsidiary of Toys R Us, incorporated in Delaware, and held various Toys R Us trademarks. Geoffrey then issued licensing agreements with Toys R Us so that Toys R Us could then use these marks in various states across the United States, including South Carolina, where they sold their products. Toys R Us used the licensed marks on their buildings and on the tags of their products within South Carolina. Much like Corporation B in the hypothetical, Geoffrey had no officers within South Carolina, nor anything else, such as tangible property, that would have created a sufficient nexus with the state to generate tax liability.[72]

As expected, Toys R Us used the expense associated with its licensing agreements with Geoffrey to limit their in-state tax liability by taking a deduction on their income. Under South Carolina's separate entity structure, the income derived from Toys R Us's

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[67] S.C. CODE ANN. § 12-6-530 (2010).
[68] *See* Andrew Haile, *A Time For Action: Reforming the North Carolina Tax Code*, 2010 N.C. L. REV. ADDENDUM 1 (2010).
[69] *See supra* chart on pp. 4.
[70] *See* Andrew Haile, *A Time For Action: Reforming the North Carolina Tax Code*, 2010 N.C. L. REV. ADDENDUM 1 (2010).
[71] Geoffrey, Inc. v. South Carolina Tax Com'n, 437 S.E.2d 13 (S.C. 1993).
[72] *Id*.

activities within the state, as well as Geoffrey's income from its licensing agreements arising from Toys R Us's activities within the state, could not be reached by the South Carolina Department of Revenue. Toys R Us's income had been diminished by their deductions paid to Geoffrey, and Geoffrey's income suffered no liability since the subsidiary had no nexus with the state.

Despite these facts, the Department of Revenue still forced Geoffrey to pay income tax under the concept that it was doing business in South Carolina through its licensing agreements, which was sufficient activity to trigger nexus with the state.

(ii) Supreme Court's Ruling

Geoffrey challenged the tax on Due Process and Commerce Clause grounds, but to no avail. The South Carolina Supreme Court upheld the tax and held that Geoffrey had nexus with the state for two reasons.[73] First, Geoffrey had intangible property in the state through an account receivable set up by Toys R Us through which Toys R Us paid Geoffrey for the use of the trademarks.[74] The Court ignored a long-held assumption that physical, tangible, presence within the state was necessary for nexus.[75]

Second, the Court held that Geoffrey willingly sought to do business within South Carolina through its agreements with Toys R Us.[76] These agreements read that the trademarks were licensed for Toys R Us's use in all states *except for Massachusetts, Pennsylvania, New Jersey, Texas, and New York*.[77] The Court reasoned that Geoffrey set up the agreements with sufficient specificity such that Geoffrey was on notice of the use of the marks in South Carolina, one of the states unlisted in the exception, and could have prevented Toys R Us from doing so.[78]

Once the Court determined that Geoffrey had nexus with South Carolina, the tax survived both the Due Process and Commerce Clause challenges.[79]

(iii) Problems with *Geoffrey*

Despite the Court's success in overcoming the parent-subsidiary structure[80] for taxing within a separate entity jurisdiction, relying on the *Geoffrey* ruling to deal with the numerous problems posed by separate reporting only leads to more issues for the state.

Listed are a few of the difficulties in using *Geoffrey* as the de facto law for overriding multi-state tax structures taking advantage of separate entity loopholes.

[73] *Id*.
[74] *Id.*.
[75] *See* Quill Corp. v. North Dakota, 112 S.Ct. 1904 (1992).
[76] Geoffrey, 437 S.E.2d 13 (S.C. 1993).
[77] Emphasis added.
[78] Geoffrey, 437 S.E.2d 13 (S.C. 1993). The Court further held that the tax imposed was rationally related to the benefits Geoffrey received from the state for Due Process purposes. The benefit received were Toys R Us's customers, through whom Geoffrey received its income. Geoffrey also received protection, benefits, and opportunities in accordance with doing business in the state, from which it also derived its income.
[79] For further discussion of the Due Process and Commerce Clause holdings by the Court, *see supra* pp. 16-18.
[80] Also referred to as piercing the corporate veil.

(iv) Litigation is Not the Best Answer

From a practical perspective, using *Geoffrey* as the method of overcoming loophole structures means that the only way for the state to gain access to some of the lost revenue is through more litigation. This is an expensive way of dealing with the separate entity problem. Other states, including North Carolina, have already recognized that the use of litigation in dealing with the shortcomings and inefficiencies of separate reporting is not the ideal answer.[81]

(v) *Geoffrey* is Not Entirely Definitive for All Holding Company Loophole Structures

The *Geoffrey* ruling offers a mechanism for dealing with loophole structures that is very fact specific. In a separate entity jurisdiction, a multi-state corporation could still conceivably take advantage of the loophole without facing a successful *Geoffrey* challenge.

For example, a parent and subsidiary could execute less specific licensing agreements than those between Geoffrey and Toys R Us. Those agreements listed specific states as being exempted locations for the use of the trademarks, and this degree of specificity was a crucial factor in the Court's determination that Geoffrey willfully did business within South Carolina. All a post-Geoffrey multi-state corporation has to do is be less specific with their agreements.

A second crucial factor in *Geoffrey* for finding nexus within the state was the presence of an account receivable within South Carolina that Toys R Us used to pay Geoffrey. A post-Geoffrey corporation could simply avoid this type of intangible presence within the state and the parent could simply pay the subsidiary directly to its Delaware (or out of state) address.

The case is helpful, then, in only specific circumstances that are easily overcome. Relying on the courts to use the ruling as a way to overcome every loophole structure is a gamble that need not be taken.

(vi) Legislation is the Better Way

The most definitive way for dealing with separate entity reporting is through new legislation that will change South Carolina's tax structure to a combined reporting system. Legislation would be definitive and not subject to corporations altering their corporate structure to constantly fit within the shifting or narrowing allowable loophole as determined by cases like *Geoffrey*. Other states have also recognized the need to enact legislation to move from a separate entity system to combined reporting when the alternative would be relying strictly on case law.[82]

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[81] *See* Andrew Haile, *A Time For Action: Reforming the North Carolina Tax Code*, 2010 N.C. L. REV. ADDENDUM 1 (2010)..

[82] *See* Andrew Haile, *A Time For Action: Reforming the North Carolina Tax Code*, 2010 N.C. L. REV. ADDENDUM 1 (2010).

4. Combined Reporting for Corporate Income Tax

(i) Overview of the Combined Reporting System

Combined reporting represents another, and more preferred, mechanism for taxing corporate income in South Carolina. Under a combined reporting system, a parent company and all of its subsidiaries file as a single unified or *combined* company, eliminating shifting mechanisms where profits and costs can be funneled disproportionately based on where each was incurred.

In a separate entity reporting structure, the relationship between a parent and subsidiary is ignored, even when both operate within the same unitary business. In a combined reporting structure, on the other hand, the state treats a subsidiary as if it is a division of the parent corporation, operating within the same unitary business. The income of the subsidiary and the parent would be calculated together, with all allocable income removed, and the remaining, taxable income would be determined by the state's apportionment formula from this overall number. Returning to the Corporation A/ Corporation B scenario offers some insight into how combined reporting works.

Corporation A sells its products in South Carolina, where it has nexus with the state. Corporation B, a subsidiary of A, is incorporated in Delaware, where it leases the use of A's trademark to A in South Carolina. Normally, as established above, B would not have nexus with South Carolina, and thus could not be taxed in a separate entity structure. In combined reporting, however, A and B would both be taxed as one entity. Since A has nexus with South Carolina, and part of A's business in the state included the use of the trademarks it leased from B, both would be included in the same unitary business. For tax purposes, both A and B's income would be combined, and then the state would determine the taxable portion of that income to them by their apportionment formula.[83]

Combined reporting states impose numerous conditions on when multi-state corporations qualify for combined reporting. First, the parent and subsidiaries must be part of the same unitary business.[84] Second, states normally require that a common corporation own the subsidiaries and parent, measured by a minimum ownership of stock.[85] This minimum ownership requirement usually entails that one corporation own more than 50% of common stock[86] in the parent and subsidiaries involved in the unitary business.[87]

(ii) Forms of Combined Reporting

Combined reporting serves numerous purposes for the state, and most important of which, it prevents the use of holding companies and subsidiaries in tax-free states that can be used as tax havens. Despite the general usefulness of combined reporting in bolstering the state's corporate income tax revenue, there are various forms of combined reporting that need to be explored.

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[83] For a discussion of South Carolina's apportionment formula, *see supra* pp. 7-15.
[84] *See supra* pp. 22-25.
[85] *See* RICHARD POMP, STATE & LOCAL TAXATION 10-31 (4th ed. 2001).
[86] Some states require 80% share of common stock over the corporations. *See* HELLERSTEIN & HELLERSTEIN, STATE TAXATION §8.11 (3rd ed. 2010).
[87] *See* RICHARD POMP, STATE & LOCAL TAXATION 10-31 (4th ed. 2001).

1. "Pure" Combined Reporting[88]

The most basic method used by combined reporting states entails requiring all corporations to file combined returns. This "pure" combined reporting involves, first, that a subsidiary or parent company have nexus with the state. Second, the state must determine the unitary business of the corporation. Then, this unitary business must satisfy the more than 50% common ownership requirement. Once all of this satisfied, then the parent and subsidiaries file a combined report that includes all of their income, whether some of these subsidiaries have nexus with the state or not. The state then uses its apportionment formula to calculate the tax liability of this unitary business operation.

2. Forced Combined Reporting

A second method in which a state enforces combined reporting is by authorizing the Department of Revenue to compel a corporation to file a combined return. This would entail the South Carolina DOR determining that a unitary business includes subsidiaries that do not have nexus with the state, and then forcing the corporate entity that does have nexus with the state to file a report that includes the income of its parent and subsidiaries, whether they have nexus with the state or not, so long as they are considered part of the unitary business. A very recent South Carolina Supreme Court decision, *Media General v. SCDOR,* arguably authorizes forced combined returns.

Kansas, North Carolina, and Tennessee utilize a forced combined reporting mechanism. In Kansas, Kan. Stat. Ann. § 79-32.141 empowers the department of revenue director to require a unitary business to file a combined report even though corporations are not otherwise required to do so under state law.[89] Once the director decides that a corporation must file a combined report in a given year, that business must continue to do so for as long as combined reporting is allowed in the state.[90]

In North Carolina, the tax administrator may require a unitary business to file a combined return if a separate entity report does not effectively determine the taxable income for the state.[91] Similarly, in Tennessee, the state tax commissioner can compel "two or more entities owned or controlled" by the same person or corporation to file a combined report when filing separate reports would fail to properly reflect taxable income.[92]

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[88] *See* RICHARD POMP, STATE & LOCAL TAXATION 10-31 (4th ed. 2001).
[89] *See State by State Analysis of Income Taxes: Consolidated Returns and Combined Reporting*, BNA Tax Management Portfolios (2010).
[90] *See State by State Analysis of Income Taxes: Consolidated Returns and Combined Reporting*, BNA Tax Management Portfolios (2010).
[91] *See State by State Analysis of Income Taxes: Consolidated Returns and Combined Reporting*, BNA Tax Management Portfolios (2010).
[92] *See State by State Analysis of Income Taxes: Consolidated Returns and Combined Reporting*, BNA Tax Management Portfolios (2010).

3. “Water’s Edge” Combined Reporting

One of the most controversial issues affecting combined schemes is what states should do with unitary business operations that include foreign corporations or subsidiaries. While some states, most notably California, initially included these foreign entities in a combined report, concerns over foreign affairs eventually led most states with worldwide reporting to adopt “water’s edge” combined reporting. Water’s edge reporting adheres to the policy that combined reporting should only concern United corporations or corporate entities within the United States.

(iii) Benefits of Combined Reporting

1. Combined reporting prevents the use of tax loopholes linked to corporate structure.

In a separate entity tax system, multi-state corporations are able to control their tax liability through their own structures. Using out of state subsidiaries, for example, provides a tax haven from which the state cannot reach because the subsidiary does not have nexus. Under a pure combined reporting scheme, corporations within a unitary business are required to file a combined report, thus eliminating the usefulness of holding companies and other subsidiaries. In a forced combined reporting scheme, corporations are similarly forced to file as a unitary business when the department of revenue determines doing so better reflects their taxable corporate income.

2. Combined reporting discourages corporations from creating out of state subsidiaries.

In combined reporting, corporations are no longer incentivized to establish out of state subsidiaries. If these subsidiaries, typically holding companies, are deemed to be part of the same unitary business as the parent company, which has nexus with the state, then any income that is shifted to them will be taxed. Subsidiaries whose sole purpose is to take advantage of the loopholes created by separate entity reporting will cease to serve that purpose, and corporations will no longer feel the need to shift income out of the state.

3. Combined reporting leads to increased tax revenue for South Carolina.

Since companies can no longer shield themselves from liability through the restructuring loopholes created by separate entity reporting, the state will be much more successful at capturing taxable income in a combined system.

4. Combined reporting is a more equitable tax system for all taxpaying businesses.

In a separate entity system, intrastate companies are at a disadvantage since they cannot take advantage of holding company loopholes like multi-state corporations.

Combined reporting prevents those loopholes, meaning that all taxpaying companies within South Carolina are on equal footing.

5. Combined reporting better reflects the economic realities of present day corporations.

Companies operating in multiple states are often part of a group of companies controlled by a parent. Merging these related companies for tax purposes better represents their true economic activity as decisions are made by the parent company.

More specifically, combined reporting better captures the true income of a multi-state corporation. In a separate entity system, the state is limited in determining and taxing corporate income for business activities that take place within its jurisdiction. The only corporate entities with tax liability in a separate system are those with nexus within the state. This eliminates transfers of income, "flows of value," "sharing of knowledge," and experience that contribute to the earnings and income of multi-state corporations. In a separate system, these and other intangible elements of a business operation are eliminated from consideration and all that remains to be allocated and apportioned is the sales income of the one or two corporate entities within the state. The reality, however, is that what a corporation earns from its activities in South Carolina reach beyond just what can be seen or experienced within the state's borders. Combined reporting states recognize the complexity of the current corporate culture, and in certain cases, even in South Carolina, corporations themselves have recognized the need for combined reporting as a way to properly determine tax liability.

6. Case Note – *Media General Communications v. South Carolina Department of Revenue*

In *Media General Communications v. South Carolina Department of Revenue*, the taxpaying corporation challenged the Department of Revenue's use of the separate entity accounting procedures authorized by the state on the grounds that it did not correctly reflect the unitary business's corporate income.[93] The parent corporation, Media General, Inc., was domiciled in Virginia and owned Media General Communications, incorporated in Delaware. Media General Communications in turn owned Media General Options, who then owned a subsidiary named Media General Broadcasting of South Carolina Holdings, Inc. This corporate structure, indicative of the complexities of the current corporate climate, comprised a unitary business of shared ownership and management.

The Department of Revenue performed an audit of Media General, Media General Communication, and Media General Broadcasting and issued tax assessments on each of them individually for income earned through licensing intangible assets within South Carolina. Media General challenged these individual assessments performed under the separate entity accounting formula on the grounds that they resulted in a distortion of the income and business activities of the unitary business within the state. Media General instead argued that a combined accounting better represented their taxable income.

[93] Media General Communications, Inc. v. South Carolina Department of Revenue, 2010 WL 2347037 (S.C. June 14, 2010).

The administrative court sided with Media General, holding that S.C.C. § 12-6-2320 (A)(4) allows for combined reporting. That specific code section reads

> If the allocation and apportionment provisions of this chapter do not fairly represent the extent of the taxpayer's business activity in this State, the taxpayer may petition for, or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> > (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.[94]

The South Carolina Supreme Court upheld the administrative court's ruling. The Court held that the code section authorizing the use of "any other method to effectuate an equitable allocation and apportionment of the taxpayer's income" included the use of combined reporting as a possible mechanism in South Carolina.

The Court's ruling in *Media General* recognized that combined reporting is preferential to separate entity reporting in certain circumstances. What is also of note is the fact that while separate entity reporting has been the common method in South Carolina, there is case law recognition within the state that combined reporting is better equipped to handle the complexities of multi-state corporate structures, particularly when such structures impact the ability of the state to properly tax corporate income.

7. Combined reporting does not necessarily mean increased tax liability for corporations.

Tax expert Richard Pomp argues that while some businesses may fear that combined reporting increases the tax liability for multi-state corporations, this is not always or necessarily the case.[95] *Media General* offers a clear example of when multiple parts of a unitary business have nexus with the state, and each are taxed separately, shifting to a combined reporting system may actually lessen the tax liability while also giving corporations a much easier and cost-effective way of filing income tax.

8. Combined reporting does not inhibit economic growth.

Economist Robert Lynch found that combined reporting has not interfered with the economic progress of states that employ it.[96]

9. Combined reporting is now the corporate income tax system followed by 23 of 45 states.

One of the most pressing concerns for shifting from a separate entity reporting structure to a combined system is that it would encourage multi-state corporations to leave South Carolina for more tax-friendly states. The reality, however, is that 23 of the

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[94] S.C. CODE ANN. § 12-6-2320 (A)(4) (2010).
[95] *See* RICHARD POMP, STATE & LOCAL TAXATION 10-31 (4th ed. 2001).
[96] PENNSYLVANIA BUDGET AND POLICY CENTER, ENSURING ALL CORPORATIONS PAY THEIR FARE SHARE (2010).

45 states that impose corporate income tax now use combined reporting as their tax structure. In many of the 22 states without pure or forced combined reporting, legislation allows for the elective use of combined reporting by either administrative agencies or taxpayers. Keeping with the current separate entity reporting system places South Carolina at a disadvantage with these other states and prevents the state from joining a movement by most jurisdictions to utilizing combined reporting, particularly when complex corporate structures require the use of a more comprehensive tax system to better reflect income tax liability.

10. Final Recommendation

For the reasons articulated above, the final recommendation is for the General Assembly to consider legislation requiring the use of combined reporting for corporate income tax. Ideally, such legislation would recognize the benefits of the combined system over the current separate entity reporting structure. Combined reporting is a way to avoid discrimination against certain businesses, to tax income that would otherwise be shifted out of state, and to deal with the growing complexities of the current corporate climate.

The two best methods for enforcing combined reporting include pure combined reporting, which means an across the board requirement that all corporations and unitary businesses with nexus with the state file a combined report, and forced combined reporting, which authorizes the Department of Revenue to compel corporations to file combined reports should it be determined that doing so better reflects the income of a corporation.

VI. RECOMMENDATIONS RELATING TO SEPARATE REPORTING

In the event the General Assembly retains South Carolina as a separate reporting state (see prior discussion) the General Assembly should consider adopting the following reforms.

A. Adopt State Law Counterpart to IRC §482

Regardless of whether their statutes or case law authorize combined reporting for affiliated corporate entities, many states have adopted provisions identical or analogous to Section 481 of the Internal Revenue Code, which authorizes the Secretary of the Treasury to "distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among" commonly controlled entities "in order to prevent evasion of taxes or clearly to reflect income." For example Alaska, California, and Hawaii have expressly incorporated Section 482 into their own tax codes. Other state legislatures have adopted their own statutes based on Section 482, and still other states provide their respective taxing authorities with broad power to prevent distortions of net income and evasion of taxes.

B. Economic Substance Doctrine

The General Assembly should consider adopting the federal income tax requirement for economic substance. This would allow the SCDOR to better challenge unlawful tax shelters.

C. Disallow Deduction for Related Party REITs

REITs are a creature of federal tax law. Deductions for payments to related party REITs should be disallowed.

D. Forced Combinations

The DOR has the authority to require forced combinations under the recent *Media General* ruling. The DOR should issue regulations or Policy Documents regarding the ground rules for forced combinations.

E. Ethical Issues

Most illegal tax shelters historically have resulted from contingency fee tax planning wherein the tax professional charges for a portion of the tax savings. (Such changes are sometimes contingency fees and other times are large flat fees with no relationship to the amount of professional time spent on the matter.) Contingency fees are barred by IRS Circular 230, which only applies to original filed returns. Circular 230 does not apply to amended returns. The General Assembly should consider the following reforms:

1. Adopt all of Circular 230

South Carolina has adopted most, but not all of IRS Circular 230. The General Assembly should consider adopting Circular 230 in its entirety.

2. Amended Returns

As stated above, Circular 230 does not prohibit contingency fees on amended returns. South Carolina should consider: (1) going beyond Circular 230 and barring contingency fees on amended returns; or (2) requiring a statement on any return prepared on the basis of contingency fees.

VII. CORPORATE INCOME TAX CREDITS

A. Year-by-Year Comparison of Corporate Income Tax Credits

Credit Claimed	FY 06-07 No. of Returns	FY 06-07 Amount	FY 07-08 No. of Returns	FY 07-08 Amount	FY 08-09 No. of Returns[97]	FY 08-09 Amount[98]

[97] These numbers are preliminary and not yet finalized.
[98] These numbers are preliminary and not yet finalized.

TC Column A Carry Over from Previous Year	161	$574,948,328	175	$631,714,509	248	$664,735,750
TC 1 Drip/ Trickle Irrigation Systems	-	-	3	$1,295,285	1	$97,500
TC 2 Socio/ Econ Disadvantage Small Business	5	$100,068	3	$56,742	-	-
TC 3 Water Resources	1	$2,500	1	$82,500	3	$1,042,344
TC 4 New Jobs Credit	93	$72,059,902	102	$36,581,029	124	$41,479,523
TC 5 Scenic River	-	-	-	-	-	-
TC 6 Infrastructure	5	$673,570	8	$1,519,781	9	$3,043,408
TC 7 Palmetto Seed Capital	-	-	-	-	-	-
TC 8 Corporate Headquarters	2	$434,737	1	$434,736	5	$9,287,269
TC 9 Employer Child Care	-	-	-	-	-	-
TC 10 Base Closure	1	$4,186	1	$482	-	-
TC 11 Economic Impact Zone	62	$9,070,623	84	$20,772,039	69	$23,190,705
TC 12 Family Independence Payments	16	$381,202	12	$71,739	17	$136,697
TC 12A Add. AFDC	6	$35,987	6	$17,262	6	$25,561
TC 17 Recycling Property Tax	1	$12,187,836	1	$7,026,056	3	$7,877,996
TC 18 Research Expenses	33	$4,142,805	47	$7,425,132	88	$15,753,004
TC 19 Qualified Conservation Contribution	1	$2,557	1	$469	2	$24,499
TC 21 Certified Historic Structure	2	$242,876	1	$77,477	1	$235,155
TC 28 SC Quality Forum	-	-	3	$1,158,981	-	-
TC 30 Increased Port Cargo	-	-	2	$53,144	6	$1,702,268
TC 34 Corporate Tax Moratorium	2	$922,428	-	-	-	-
TC 36 Industry Partnership Fund	1	$5,300	1	$500,000	-	-
TC 37 Toxicity Testing Credit	-	-	2	$142,200	-	-
Health Insurance Pool Credit[99]	-	-	**-**	**-**	1	$795,484
Unidentified Taken[100]	1	$2,500	**-**	**-**	14	$926,833
Total	**393**	**$675,217,405**	**454**	**$708,929,563**	**597**	**$770,353,996**
Expired Credits	4	$742,572	5	$589,273	5	$2,740,273

[99] There is no form for this credit.
[100] Previously these were not broken out.

Total Carryforwards	154	$626,509,297	279	$645,733,375	253	$708,376,217

B. Summary of Income Tax Credits

DRIP/TRICKLE IRRIGATION SYSTEMS CREDIT: For purchasing and installing conservation tillage equipment, drip/trickle irrigation system or dual purpose combination truck and crane equipment. (TC-1)

CREDIT FOR STATE CONTRACTORS SUBCONTRACTING WITH SOCIALLY AND ECONOMICALLY DISADVANTAGED SMALL BUSINESSES: For state contractors that subcontract with socially and economically disadvantaged small businesses. (TC-2)

WATER RESOURCES CREDIT: For investing in the construction of water storage and control structures for soil and water conservation, wildlife management, agriculture and aquaculture purpose.

NEW JOBS CREDIT: For qualifying employers that create ten or more jobs. (TC-4)

SMALL BUSINESS ALTERNATIVE JOB CREDIT: For qualifying small businesses that create 2 or more full-time jobs. (TC-4SA)

SMALL BUSINESS JOB CREDIT: For qualifying small businesses that create and maintain 2 or more full-time jobs. (TC-4SB)

SCENIC RIVER CREDIT: For donating certain lands adjacent to designated rivers or sections of a river. (TC-5)

INFRASTRUCTURE CREDIT: For construction or improvements of water lines, sewer lines and road projects eventually dedicated to public use or qualifying private entity. (TC-6)

CORPORATE HEADQUARTERS CREDIT: For qualifying costs related to establishing a corporate headquarters in South Carolina or expanding or adding to an existing headquarters. (TC-8)

EMPLOYER CHILD CARE CREDIT: For employers that establish child care programs to benefit employees or donate to a non-profit corporation providing child care. (TC-9)

BASE CLOSURE CREDIT: For hiring employees who lost their jobs because of federal military installation closure or realignment. (TC-10)

ECONOMIC IMPACT ZONE CREDIT: For placing qualifying property in service in an economic impact zone. (TC-11)

FAMILY INDEPENDENCE PAYMENTS CREDIT: For employers hiring qualifying recipients of Family Independence Payments. (TC-12)

ADDITIONAL FAMILY INDEPENDENCE PAYMENTS CREDIT: For employers hiringqualified Family Independence Payment recipients in a least developed county. (TC-12A)

COMMUNITY DEVELOPMENT CREDIT: For investing amounts not claimed as charitable deductions in qualifying development corporations or financial institutions. (TC-14)

RECYCLING PROPERTY CREDIT: For taxpayers constructing or operating a qualified recycling facility when investing in recycling property. (TC-17)

RESEARCH EXPENSES CREDIT: For taxpayers claiming a federal research expenses credit. (TC-18)

QUALIFIED CONSERVATION CONTRIBUTION CREDIT: For donating a qualifying gift of land for conservation or a qualified conservation contribution of a real property interest. (TC-19)

BROWNFIELD VOLUNTARY CLEANUP PROGRAM CREDIT: For costs of voluntary cleanup activity by a non-responsible party. (TC-20)

CERTIFIED HISTORIC STRUCTURE CREDIT: For rehabilitation projects that qualify for the federal credit. (TC-21)

TEXTILES REHABILITATION CREDIT: For rehabilitating an abandoned textile manufacturing facility. (TC-23)

COMMERCIALS CREDIT: For production companies producing commercials in South Carolina. (TC-24)

MOTION PICTURES CREDITS: For investing in motion picture projects or motion picture production or post-production facilities in South Carolina after June 30, 2004. (TC-25)

VENTURE CAPITAL INVESTMENT CREDIT: For lending money to the SC Venture Capital Authority (TC-26)

SC QUALITY FORUM CREDIT: For participating in quality programs of the SC Quality Forum. (TC-28)

PORT CARGO CREDIT: For increasing usage by volume at state ports. (TC-30)

RETAIL FACILITIES REHABILITATION CREDIT: For revitalizing abandoned retail facilities. (TC-31)

MERCURY SWITCH DISPOSAL CREDIT: For vehicle recycler or scrap recycling facility participating in End-of-Life Vehicle Solution (ELVS) Program for each mercury switch collected and admitted for disposal. (TC-33)

CORPORATE TAX MORATORIUM: For qualifying taxpayers that make a substantial investment and creates at least 100 new, full-time jobs, a 10 year, or in some cases, a 15 year moratorium on corporate income taxes. (TC-34)

ALTERNATIVE MOTOR VEHICLE CREDIT: Taxpayers with federal credit allowed under Internal Revenue Code 30B, will receive SC Credit. (TC-35)

INDUSTRY PARTNERSHIP FUND CREDIT: For contributing to the SC Research Authority's Industry Partnership Fund. (TC-36)

WHOLE EFFLUENT TOXICITY TESTING CREDIT: For a manufacturing facility incurring costs in complying with whole effluent toxicity testing. (TC-37)

SOLAR ENERGY OR SMALL HYDROPOWER SYSTEM CREDIT: For installing a solar energy system or small hydropower system in a South Carolina facility. (TC-38)

ETHANOL OR BIODIESEL PRODUCTION CREDIT: For producers of corn-based or non-corn-based ethanol or soy-based or non-soy-based biodiesel. (TC-40)

RENEWABLE FUEL FACILITY CREDIT: For constructing a renewable fuel production or distribution facility in South Carolina. (TC-41)

APPRENTICESHIP CREDIT: For employing an apprentice. (TC-45)

HYDROGEN INFRASTRUCTURE DEVELOPMENT FUND CREDIT: For contributions to the South Carolina Hydrogen Infrastructure Development Fund. (TC-47)

PLUG-IN HYBRID VEHICLE CREDIT: For in-State purchase or lease of a plug-in hybrid vehicle. (TC-48)

CELLULOSIC ETHANOL OR ALGAE-DERIVED BIODIESEL RESEARCH AND DEVELPMENT CREDIT: For qualified expenditures for research into and development of feedstocks and processes for cellulosic ethanol and for algae-derived biodiesel. (TC-49)

BIOMASS RESOURCE CREDIT: For costs incurred by corporation for purchases and installation of equipment used to create power, etc. for commercial use. (TC-50)

VENISON FOR CHARITY CREDIT: For processing deer meat for charity. (TC-51)

SPRINKLER SYSTEM CREDIT: For installing a fire sprinkler system. (TC-52)

ENERGY EFFICIENT MANUFACTURED HOME CREDIT: $750 credit for new purchase of an Energy Star manufactured home. (TC-53)

C. Issues Relating to the Jobs Tax Credit

South Carolina has a host of tax credits. Most have relatively little revenue impact. The one tax credit with a major revenue impact is the Job Tax Credit. This revenue impact is a function of several reasons. First, the credit is relatively rich, ranging from $1,500 to $8,000 per job depending upon the wage scale and the county in which the job is located. Second, the carryforward for the credit is 15 years. Third, new jobs – even retail and service – in many poorer counties now qualify for the credit. Lastly, the General Assembly has steadily increased the types of jobs which qualify even in richer counties. When originally enacted, the minimum number of jobs which had to be created was ten, and only manufacturers, warehouse and distribution qualified. Currently, only 2 new jobs need to be created as such entities as banks and general contractors qualify.

1. Credit Amounts Should be Reduced

The General Assembly should consider reducing the maximum credit amount from $8,000 to $6,000.

2. The Carryfoward Should be Reduced

South Carolina has a staggering $650 million plus in tax credit carryforwards, many of which relate to the Job Tax Credit. The carryforward on new hires should be reduced from 15 to 5 or 3 years. Three years is the typical carryforward period for most state and federal tax credits. South Carolina's fifteen year carryforward is likely the longest in the country. The General Assembly should, however, reduce the carryforward prospectively (i.e. only on jobs created after the effective date of the Act.)

3. Retail and Service Jobs Should be Eliminated

When the economy improves, the General Assembly should consider eliminating the creation of retail and service jobs from the Job Tax Credit.

D. R&D Credit

The federal R&D credit is extraordinarily broad and has the potential of great revenue impact. The General Assembly should limit use of the credit to e.g., manufacturers and high tech industries.