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: CS/SB 2546

INTRODUCER: Finance and Tax Committee and Senator Altman

SUBJECT: Corporate Income Tax

DATE: April 1, 2009

REVISED:

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	ODonnell	McKee	FT	**Fav/CS**
2.			CM	
3.			GA	
4.			WPSC	
5.			RC	
6.				

I. Summary:

This bill makes several substantive changes to Chapter 220, F.S., Florida's Corporate Income Tax Code. The enactment of so called "add-back" provisions limits a multi-state corporation's ability to lower its effective tax rate in Florida by preventing otherwise taxable income from being shifted outside the state. The ability to take a position on a federal return regarding the tax treatment of a subsidiary entity that differs from that taken on a Florida return regarding the treatment of a subsidiary is also limited. The sales factor for the sale of services is updated so that income generated from these sales is sourced to this state. Royalties from intangible assets will also be included in the calculation of the sales factor used to apportion income to Florida. Intercompany transactions are eliminated for separate filers unless the transfer does not distort Florida income.

The subtraction for the eligible net income of an international banking facility is repealed. The apportionment factors used by a financial organizations are also changed to reflect the model treatment provided by the Multistate Tax Commission. Legislative clarification is provided that entities that elect to be treated as corporations for federal income tax purposes are treated as corporations for Florida corporate income tax purposes. Taxpayers that elect to file consolidated returns in Florida will continue filing on that basis until they are deconsolidated for federal income tax purposes. Florida will follow the constitutional definition of nonbusiness income announced by the U.S. Supreme Court. The apportionment factor for transportation by air is changed from revenue miles to landings. The "throwout" rule is adopted so that sales that are not allocable to another state are eliminated from the denominator of the sales factor. The net operating loss deduction is limited to the income generated by the corporation that generated the loss unless all members of the affiliated group filed Florida corporate income tax returns. All tax

deficiencies resulting from changes to the underlying federal return will have interest imposed on them for the period beginning on the due date of the original return and ending on the date paid. The Revenue Estimating Conference has not met to review the provisions of the bill.

This bill substantially amends, creates, or repeals the following sections of the Florida Statutes: 213.54

II. Present Situation:

Florida levies a tax on all corporations, organizations, associations and other artificial entities that derive from this state, or any other, attributes not inherent to natural persons, such as perpetual life. The tax is levied on the privilege tax measured by net income at the rate of 5.5 percent on 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 groups have the choice of filing as a separate entity or as a consolidated group. 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 flows primarily from the negative implications of the clause – because the federal government may regulate, the states may not. The second clause prohibits states from reaching beyond their borders to impose tax. Congress, through Public Law 86-272, has prevented states from imposing tax liability for activities considered nominal, such as mere solicitation.

Taxation in Florida begins with the allocation of income. 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 the entity was not integrated, but merely an investment. Florida statutes provide enough ambiguity to raise concern about the validity of such claims, even when the taxpayer has previously claimed ordinary business deductions against income generated by such "investments." These claims 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 formula can be depicted as follows:

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

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 also 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.

The Department of Revenue, through its Executive Director, is statutorily authorized to take certain actions to ensure that taxpayers reasonable account for their taxable income. Significantly, the director of the department is granted authority to adjust any item of income, deduction or exclusion, or any factor taken into account in apportioning income, to the extent necessary to reflect clearly the net income of the taxpayer. Section 220.44, F.S. Consistent with this authority, the director may also require a consolidated return for those members of an affiliated group of corporations that are subject to tax and would be eligible to elect to file on a consolidated basis if the filing of separate returns for these corporations would improperly reflect their taxable incomes. Section 220.131, F.S.

Add-back

The term "sales" is defined as all gross receipts of the taxpayer except interest, dividends, rents, royalties, and gross receipts from the sale, exchange, maturity, redemption, or other disposition of securities. Royalty income is included in the term if a significant portion of the taxpayer's business consists of dealing in or with the production, exploration, or development of minerals.

Section 220.03(1)(r), F.S., provides a definition of "nonbusiness income". The term nonbusiness income does not include income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations, or any amounts which could be included in apportionable income without violating the due process clause of the United States Constitution. Taxpayers are not required to add back expenses related to an item of nonbusiness income that were deducted in prior tax years when the nonbusiness asset was treated as a business asset.

Companies have reduced Florida income by engaging in intercompany transactions. When taxpayers file on a consolidated basis for both federal and Florida purposes, intercompany transactions are eliminated. However, when an affiliated group of corporations file corporate income tax returns on a separate basis in Florida, intercompany transaction are included in the determination of the Florida income for each of the affiliates.

Some multistate firms shift income from Florida and elsewhere into states that do not tax intangible profits, such as trademarks and patents. During the 1990s, companies such as Aaron Rents and Toys ‘‘R’’ Us began to isolate intangible assets in holding companies. These holding companies were nominally located in states that did not tax income, or offered other planning advantages. Once isolated, operating entities in states that impose tax pay the holding company for the use of the intangible asset, increasing their operating cost and reducing the income subject to tax. Although the motivations for these actions are purported to be for business reasons, companies generally reduce income tax liabilities in states that do not require combined reporting because the intangible holding company structure and similar mechanisms take advantage of separate reporting.

In order to minimize tax planning, 18 states have enacted add-back rules since 2000 to curb perceived taxpayer abuses based on deductions for interest and intangible-related expenses between related parties. Generally, the statutes require the payer of related-party interest, royalties, license fees, and similar charges to add back those expenses.

A related member is generally defined as a related entity, i.e., a component member. The add-back rules seem to have the following in common:

- most require the operating company to add-back intercompany interest and expenses regarding intangibles paid to a related party;
- most states define a related party by reference to the Internal Revenue Code ;
- all states have exceptions to the add-back rule and in most cases the exceptions exist to minimize the likelihood of multiple taxation;
- most states provide an exception to add-back based on the recipient’s tax position (so called “subject-to’’ exceptions);
- most states have a conduit exception for interest or royalty expenses ultimately paid to a third party; and
- most states tax both direct and indirect interest and intangible items among related parties.

Financial Organization Apportionment

Special rules apply to the taxation of banks, brokerages and similar businesses. The apportionment factors in Chapter 220, F.S. reflect the regulatory environment prevalent in the industry at the time they were adopted. At that time, interstate banking was not widespread. The property factor for financial institutions is heavily weighted in various forms of intangible personal property. Currently, intangibles “shall be in this state” if:

- it consists of assets in the nature of loans, including balances due from depository institutions, repurchase agreements, federal funds sold, and bankers acceptances, that are located in this state;
- credit card receivables from customers who reside or who are commercially domiciled in this state;
- investments in securities that generate business income if the taxpayer's commercial domicile is in the state, unless such securities have acquired a discrete business situs elsewhere;

- securities used to maintain reserves against deposits to meet federal or state deposit requirements, based on the ratio that total deposits in this state bear to total deposits everywhere;

Financial institutions can now choose among states in which to locate their intangible assets. This provides for tax planning opportunities.

Partnership Elections
Section 220.02(1), F.S., provides that the Code is not intended to tax, and shall not be construed so as to tax, any natural person who engages in a trade, business, or profession in this state under his or her own, or any fictitious name, whether individually as a proprietorship, or in partnership with others, or as a member or a manager of a limited liability company classified as a partnership for federal income tax purposes.

Except for certain entities that must be treated as corporations, all new entities can elect their federal income tax status. Entities with two or more members may select either corporate or partnership status. The tax treatment can be chosen simply by filing an election with the Internal Revenue Service. If no affirmative election is made, the federal tax classification of a new entity will be made under prescribed "default" rules.

Partnerships may be owned or controlled by corporations. "Corporation" includes all general partnerships, limited partnerships, unincorporated businesses, and all other business entities which are owned or controlled by the parent corporation. “Taxpayer" includes a general partnership, limited partnership, limited liability company, trust, or other artificial entity in which a corporation, as defined in s. 220.03(1)(e), owns an interest and is taxed as a partnership or is disregarded as a separate entity from the corporation under this chapter.

International Banking Facilities
A distinction is made in the Code for the "international banking facility" which is a set of asset and liability accounts segregated on the books of a banking organization that includes only international banking facility deposits, borrowings, and extensions of credit. Various items of eligible net income may be deducted from adjusted federal income via the international banking facility classification. The deduction reduces the income subject to Florida tax. The distinction was originally designed to make Florida banks attractive for international transactions. Interstate banking has limited the intended benefit behind the deduction

Florida Nexus (Affiliated) Filing Group
Section 220.131, F.S., allows any corporation subject to tax that is the parent of an affiliated group to consolidate its taxable income with all other members of the group subject to tax. In 1984, a “temporary” measure was put in place to make it possible for a group to file a Florida consolidated return that included less than all the members of the federal affiliated group. Only taxpayers who made the election at that time are able to file in this manner.

Deconsolidation
Section 220.131(3), F.S., allows a taxpayer to voluntarily elect to file a consolidated Florida corporate income tax return with all members of its affiliated group if that taxpayer’s affiliated group has elected to file a federal consolidated return. Once the voluntary consolidated return

election has been made, a taxpayer is required to continue filing consolidated Florida returns as long as its affiliated group continues to file federal consolidated corporate income tax returns, unless the Executive Director consents to the filing of separate returns. The grounds for denying such a request are not clearly specified by statute.

Airline Apportionment

Apportionment represents an approximation using factors to determine how income is distributed. As a constitutional matter, states are given broad discretion in constructing these factors. Section 220.151(2), F.S., provides the apportionment factor for transportation companies: revenue miles in Florida over revenue miles everywhere. For purposes of computing revenue miles in Florida, all miles within a “box” drawn over a map of Florida are included. The box extends beyond the territorial limits of the state and, based on a claim of overreaching, is presently the subject of litigation.

Separate Return Filing Limitation

When taxpayers within an affiliated group (some with net operating losses generated when they filed separately) elect to file a consolidated corporate income tax return, the net operating losses carried forward from the separate filing years may be used to the extent of the affiliated group’s consolidated income. Use of net operating loss carryovers generated prior to combination has the effect of precluding Florida from taxing the income produced in years prior to consolidated while being required to suffer the losses following the consolidation.

Interest on Revenue Agent Report (RAR)

Section 220.23, F.S., requires taxpayers to pay interest on Florida tax deficiencies resulting from changes to the underlying federal return (increased federal taxable income) from the due date of the original return until the tax is paid to Florida. In 1999, the First District ruled in Barnett Bank vs. Department of Revenue, 738 So.2d 502 (Fla. 1st DCA 1999), that the intent of the Florida Legislature to impose interest on tax deficiencies discovered during federal audits was not clearly expressed in Chapter 220. In 2002, the Florida Legislature amended section 220.23, F.S., to overturn Barnett Bank. However, questions remain concerning whether the 2002 changes to section 220.23, F.S., may be applied to Florida deficiencies that arise after 2002, but that concern tax years prior to 2002, i.e. a federal audit completed after 2002, that increases the amount of tax due on a 1995 return, creating a deficiency for Florida.

III. Effect of Proposed Changes:

Section 220.15(5)(d), F.S., is created to eliminate sales from the denominator of the sales factor any sales that are not allocable or apportionable to any taxing jurisdiction -nowhere sales, including sales assignable to jurisdictions where the taxpayer is not subject to an income tax, or where the jurisdiction does not impose an income tax. This treatment is referred to as the “throw-out” rule.

Section 220.15(5)(c), F.S., is created to address the sourcing of sales of services for the sales factor. Sales of services are sourced to Florida if the buyers receive the benefit of the services in Florida. A buyer receives the benefit of services in Florida if any one of the following applies:

- the service relates to real property located in this state;

- the service relates to tangible personal property located in this state at the time the service is received;
- the service relates to tangible personal property delivered directly or indirectly to customers in this state;
- the service is provided to an individual physically present in this state at the time the service is received; or
- the services is provided to a buyer engaged in a trade or business in this state and relates to that trade or business.

If the purchaser of a service receives the benefit of a service in more than one state, the gross receipts from the performance of the service are included in the numerator of the sales factor according to the portion of the service received in Florida.

If the taxpayer is not subject to income tax in the state in which the benefit of the service is received, the benefit of the service is received in Florida to the extent that the taxpayer's employees or representatives performed services from a location in Florida. Fifty percent of the taxpayer's receipts that are considered received in Florida under this paragraph are included in the numerator of the sales factor.

Royalty Apportionment
Section 220.15(5), F.S., is amended to include income from the sale, assignment or licensing of intangible property as a sale if the income from the property is reasonably attributable to a particular income producing activity.

Add-back
Add-backs are adjustments that result in an increase in the tax base. Functionally, these changes could be implemented by way of a subtraction – as in a reduction in the amount of a deduction.

Section 220.03(1)(r), F.S., is amended to redefine nonbusiness income as any amount that cannot be included in apportionable business income without violating the due process clause of the United States Constitution. Section 220.13(1)(a)16., F.S., is created to recapture expenses in the year a business asset is determined to be nonbusiness that had been deducted by a taxpayer in the current year and in the prior two years. Taxpayers are required to add back expenses deducted in the computation of Florida taxable income when they are subsequently determined to be related to a nonbusiness asset allocated to another state.

The bill generally requires that intercompany transactions paid to an affiliated entity and reported on a separate return basis be added back to Florida apportioned income. Section 220.13(3), F.S., is created to eliminate the distortive effect that intercompany transactions and management fees can have on the computation of an individual company's Florida income. Exceptions to requiring an add-back are provided if the entity receiving the expenses also files a Florida return, or the taxpayer establishes the expense does not distort their reported income.

The bill clarifies the definition of non-business income by eliminating the "transactional" test and the "functional" test.

Financial Organization Apportionment

The apportionment factors used by a financial organizations are changed to reflect the model treatment provided by the Multistate Tax Commission. "Financial organization" is redefined in a manner consistent with current industry practices. Presumptions are established for situsing the location of intangible property. A loan is considered to be located within this state if it is properly assigned to a regular place of business of the taxpayer within this state. A loan is properly assigned to the regular place of business with which it has a preponderance of substantive contacts. A loan assigned by the taxpayer to a regular place of business outside the state is presumed to have been properly assigned if the taxpayer has assigned, in the regular course of its business, the loan consistent with Federal or state regulatory requirements; the assignment is based upon substantive contacts of the loan to that regular place of business; and the taxpayer uses the records reflecting assignment of loans for the filing of all state and local tax returns for which an assignment of loans to a regular place of business is required.

International Banking Facilities

The special rules that apply to the taxation of international banking facilities by section 220.62(3), F.S., and items of eligible net income that may be deducted from adjusted federal income via the international banking facility classification, are repealed.

Florida Nexus Group Election

The “temporary” measure put in place in 1984 to make it possible for a group to file a Florida consolidated return is eliminated.

Partnership Elections

Section 220.02(1), F.S., is amended to follow the classification of organizations under the Internal Revenue Code to the greatest extent possible. Section 220.03(1)(e), F.S., is amended to clarify that partnerships and other entities that are taxable as corporations for federal corporate income tax purposes are corporations for Florida corporate income tax purposes. Section 220.03(6), F.S., is created to clarify that a corporation, that is a partner in a partnership that conducts business in Florida, is subject to the Florida corporate income tax. A limited liability company taxed as a partnership for federal income tax purposes is treated as a partnership for Florida corporate income tax purposes. Section 220.13(2)(k), F.S., is created to clarify that taxable income in the case of any partnership, organization, association, legal entity, or artificial person taxable as a corporation for federal income tax purposes is taxable income of such partnership, organization, association, legal entity, or artificial person as if it was required to file, or had filed, a federal corporate income tax return under the Internal Revenue Code.

These changes are determined to be remedial and to apply to tax years beginning on or after December 31, 2000.

Deconsolidation

Section 220.131(3), F.S., is amended to require taxpayer’s that elect to file consolidated returns in Florida to continue filing on a consolidated basis as long as that taxpayer’s affiliated group continues to file consolidated returns for federal income tax purposes. The Executive Director’s authority to allow a taxpayer to deconsolidate without a corresponding federal change in the federal consolidated return, is deleted.

Airline Apportionment
Section 220.151(2), F.S., is amended. Taxpayers furnishing transportation by air must apportion their income to Florida based on landings in Florida over landings everywhere. Taxpayers furnishing transportation services by sea will continue to apportion their income to Florida based on revenue miles in Florida over revenue miles everywhere. However, only miles traveled within the constitutional boundaries of Florida will be included as Florida revenue miles. Revenue miles not allocable or apportionable to any taxing jurisdiction (nowhere miles) are eliminated from both the numerator and denominator of the transportation apportionment factor.

Separate Return Filing Limitation
Net operating losses incurred by a member of an affiliated group of corporations when the members of the affiliated group of corporations were not filing on a consolidated basis in Florida, are limited to the income generated by that member once part of the consolidated group. However, if all members of the affiliated group filed Florida corporate income tax returns in the year the net operating loss was generated, this limitation does not apply.

Interest on Revenue Agent Report (RAR)
Chapter Law is provided to clarify the Legislative intent that all deficiencies arising after the effective date of the 2002 change to section 220.23, F.S., are subject to interest back to the original due date of the return for that tax year.

Other Potential Implications:

IV. Constitutional Issues:

A. Municipality/County Mandates Restrictions:

None.

B. Public Records/Open Meetings Issues:

None.

C. Trust Funds Restrictions:

None.

D. Other Constitutional Issues:

V. Fiscal Impact Statement:

A. Tax/Fee Issues:

The Revenue Estimating Conference has not met to review the provisions of the bill.

B. Private Sector Impact:

This bill:
- provides a comprehensive revision of the Florida Income Tax Code that requires financial institutions and other businesses to make financial reporting adjustments to account for these changes.
- adopts uniform definitions that permit businesses to operate in a competitively neutral fashion.
- requires consistent reporting on a state and federal level
- updates Code provisions to conform with present business practices
- causes businesses to reflect income generated in Florida on their returns

C. Government Sector Impact:

The Department of Revenue will be required to provide notice to corporations doing business in the state and revise forms and rules used by corporations to report income tax.

VI. Technical Deficiencies:

None.

VII. Related Issues:

None.

VIII. Additional Information:

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

CS by Finance and Tax Committee on April 1, 2009:
The CS replaced a shell bill.

B. Amendments:

None.