



Service-Based Businesses and the Apportionment Rule



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Published on www.lorman.com - December 2017

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The Apportionment Rule continues to be one of the most controversial provisions under the U.S. Tax Code. Many businesses grapple with apportionment rules and struggle in figuring out the states that offer the most competitive tax advantages. Apportionment refers to the taxation of a multistate corporation that is “fairly apportioned” to a state. A state may only tax a corporation on income that it derives through its connection to the state. Even if a business operates in a state for a couple months out of the year, it may still incur tax liability. The tax code prevents states from imposing taxes on corporations for the total income produced if they operate in multiple states throughout the year. If a state were able to tax a business on all of its income, this would be unconstitutional. Businesses would be negatively impacted and would likely choose to function out of a single state. Interstate commerce would likely take a downturn.

Separate Accounting Apportionment

Separate accounting apportionment is a basic calculation method for determining a corporation’s tax liability. This method determines the amount that a company owes based on standard accounting processes.

Formula Apportionment

Formula apportionment compares the in-state sales of a business to its total sales. Formula apportionment utilizes a rough measurement to determine an in-state income of a corporation. The majority of states require that businesses use formula apportionment to determine their tax liability.

State Apportionment Rules

States vary in the manner in which apportionment is calculated. In 2014, Minnesota will only base apportionment on the company's sales for that year. In previous years, Minnesota used a three-factor formula involving the property, payroll and sales of the company. In 2013, sales were weighted at 96 percent. Property and payroll were each weighted at 2 percent. After multiplying each factor, the factor amounts are then added together to determine apportionment. The location in which a sale takes place determines whether it is a Minnesota sale.

In Texas, apportionment is calculated by dividing Texas gross receipts by total gross receipts. Health care providers, security brokers and legal services are subject to different apportionment rules. Like the Minnesota Tax Code, the Texas Tax Code has been revised to provide for a single-factor apportionment formula.

California has implemented legislation that allows taxpayers to choose whether they wish to use the three-factor apportionment formula or the single-sales factor apportionment method. California differs from Texas and Minnesota because taxpayers have the freedom to choose which apportionment method they prefer.

State tax codes clearly show a trend of moving toward the adoption of market-based apportionment rules. In many states, a business must calculate apportionment based on receipts received in the state. This new approach has raised controversy and inconsistencies amongst state and federal tax code provisions. CPAs must be aware of the conflicting tax code provisions and arrive at a calculation that they believe is most accurate.

The Uniform Division of Income for Tax Purposes Act

CPAs must consider Section 17 of the UDITPA as they calculate apportionment for businesses. This Act categorizes gross receipts of a corporation based on the corporation's cost of performance. The UDITPA attributes an income-producing activity that is performed in two or more states based on the cost of performance.

To proceed with this test, a taxpayer must determine which activities produce income for his or her corporation. After defining the income-producing activities, a taxpayer must then determine the cost of performance for each activity. Income-producing activity is defined as any transaction or activity that the taxpayer regularly engaged in throughout the ordinary course of business for the purpose of producing income.

The UDITPA test may produce errors if a seller performs the activities in one state and the recipient is located in a different state. Internet-based businesses may face difficulty in calculating apportionment under UDITPA. Internet-based businesses may distribute products to customers who are located throughout the world and only manufacture their goods in one state.

If a state uses cost of performance sourcing for apportionment, a CPA may want to assist a business in carefully tracking receipts throughout the year. A CPA may also want to advise a business to perform many of its direct-cost activities outside of the state to reduce the tax liability of the business. If a state has a high rate of tax for direct-cost activities, the business may be able to circumvent the payment of taxes in this state. For states that have low tax rates, a CPA may wish to advise the business to perform many of its direct-cost activities in the state.

Tax professionals will also need to be aware of the implication of direct-cost apportionment rules for businesses that engage in activities in more than one state. If a business engages in direct-cost activities in two states, a state may base tax liability upon the state in which a majority of direct-cost activities take place. If a business conducts 80 percent of its activities in a high-tax state and 20 percent of activities in a low-tax state, a CPA may want to advise the business to change its strategy. A business may need to conduct the majority of its activities in the low-cost state to minimize its tax burden.

How Apportionment Rules Impact Service Businesses

All service-based businesses will be impacted by the single-sales factor apportionment method. They will likely benefit from the new apportionment method. The new apportionment method will likely produce the significant tax savings for service-based businesses.

As the apportionment rules continue to become uniform, businesses are becoming solely based in one state. Because states now place great weight on the sales factor, businesses have an incentive to minimize their tax liability by locating property and payroll within one state. By doing this, a business is able to continue to sell products to customers outside of the state and enjoy great tax savings.

Opportunities to Decrease One's Tax Liability

Every year, businesses have the opportunity to change the apportionment formula that they use. Businesses that are not sure of the best formula to use should work exclusively with a CPA. A CPA should have the ability to compare a company's tax liability under all of the apportionment methods available. A CPA may be able to save a business tremendous savings if he or she is familiar with the company's production methods and location of customers. A CPA may want to make recommendations that a company perform direct-cost activities in states that have a low tax rate.

Companies that are consistently generating losses should also consider the apportionment method that they use. A company suffering from losses may want to use the three-factor apportionment formula.

The Importance of Hiring a CPA

A business should consider working with a CPA at its early stages of planning. Ideally, a business will begin working with a CPA in its early stages of formation to determine the best states for the production of goods and direct-cost activities. A tax advisor will be crucial in helping the business understand how to minimize its tax liability.

CPAs should also make an effort to stay updated on tax reforms and changes in state tax codes. As state tax codes change every year, a CPAs recommendations for a business may also change. A business plan may change as a result of dramatic amendments made to a state's tax code. CPAs may be able to help businesses in taking advantage of tremendous tax savings by having a solid understanding of apportionment rules.

CPAs also assist businesses in maintaining documentation that may be required in the event of a federal or state tax audit. CPAs should diligently retain all receipts of a service-based business and request these receipts as necessary. A CPA may need to provide proof to the IRS for the apportionment accounting method that he or she has chosen.

If a business does not work with a CPA or tax professional, it is at risk for exposing itself to an audit. The business may be liable for tax fraud in the event that it does not maintain accurate records of its payroll, inventory, income and expenses.

Service-based businesses should also know that they may be subject to unique apportionment rules based on their industry. In Tennessee, several different apportionment methods are used for common carriers, air carriers and air express carriers. The formulas used to calculate tax liability are very complex and require extensive documentation.

States may also have penalty and late fee charges for businesses that fail to accurately report apportionment liability. In addition, a business may owe interest in the event that it underpays the apportionment tax that it owes. A CPA has a professional responsibility to ensure that a company's taxes are filed on time and are filled out as accurately as possible.

A company may be required to file a tax return even if it is inactive. States like Mississippi require that companies file a tax return even if they have no direct-cost activities. A CPA should be aware of a state's tax code and its filing requirements for inactive corporations.

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