Privately held business entities were swept up into the complexity of accounting for uncertainty in income taxes in 2009. Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 740, relating to accounting for uncertainty in income taxes, requires evaluation and disclosure of the risk associated with uncertain tax positions taken or expected to be taken in a tax return. The portion of ASC 740 formerly known as FIN 48 was effective for fiscal years beginning after December 15, 2006, for publicly traded companies and was made applicable to all business enterprises including not-for-profit organizations, pass-through entities, real estate investment trusts, and registered investment companies for years beginning after December 15, 2008.

This column examines the unique state tax issues that arise under ASC 740 for privately held business entities that are organized as pass-through entities. For federal purposes, only a small percentage of pass-through entities pay income taxes, with the most notable exception being certain S corporations. If the scope of ASC 740 did not extend beyond federal law, the number of pass-through entities subject to the analysis would be minimal. For state purposes, a significantly larger population of pass-through entities will be subject to this analysis as states move toward assessing various types of gross receipts taxes on pass-through entities. States have adopted gross receipts tax structures in lieu of the more traditional income tax as a means of expanding their tax base under the guise of relative ease of administration and the lack of complexity in their calculation. This column discusses assessments made by various states to determine whether they are income taxes and subject to the ASC 740 analysis.

**Assessment of an Income Tax**

ASC 740 applies only to business entities subject to income taxes. The question of whether a wide variety of state taxes fall under the rubric “income taxes” has raised vexing questions, including whether the assessment is subject to apportionment, state constitutional standards, income tax nexus standards (such as P.L. 86-272), treatment on the state return (i.e., deductible as a fee or creditable as a tax paid to other states), and applicability of ASC 740.

Several states (most notably Texas, Michigan, Ohio, and recently Oklahoma) have enacted tax systems that have characteristics of both sales and income taxes. These states (and others) have issued their own opinions on whether these assessments are income taxes or are more in the nature of fees. These determinations generally deal with whether the levy is a sales and use tax or an income tax and, if an income tax, whether it is deductible on the state return. The results are far from consistent.

ASC 740-10-20 defines “income tax” as domestic and foreign federal (national), state, and local (including franchise) taxes based on income. While ASC 740 does
not include a definition of “income subject to tax,” it does include a definition of certain types of assessments to which ASC 740 does not apply. It does not apply to a franchise tax to the extent it is based on capital and there is no additional tax based on income. If there is an additional tax based on income, that excess is considered an income tax and is subject to ASC 740.2

Example: In August 1991, State A amended its franchise tax statute, effective January 1, 1992, to include a tax on income apportioned to the state based on the federal tax return. The amount of franchise tax on each corporation was set at the greater of 0.25% of the corporation’s net taxable capital or 4.5% of the corporation’s net taxable earned surplus. Net taxable earned surplus was defined in the state statute by reference to the corporation’s federal taxable income.3

ASC 740-10-55-141 concludes that the total computed tax in this case “is an income tax only to the extent that the tax exceeds the capital-based tax in a given year.” Only that portion of the tax is subject to the analysis required under ASC 740.

Under this very broad definition, most state assessments, including some franchise taxes based on earned surplus or income taxes, qualify as income tax payments under the umbrella of ASC 740. Assessing a tax on the earned surplus implies that an income tax is assessed if the base of the tax is reduced by at least some deductions. This is the approach taken by most practitioners with respect to the applicability of ASC 740, although this is not the approach taken by the states when they analyze taxes for purposes of determining deductibility.

An increasing number of state assessments are based on gross receipts or gross income and exhibit characteristics of both fees and income taxes. Various state and local taxes may have income tax-like elements that can potentially belie their nomenclature as something other than an income tax. When compared with net income taxes, the most significant difference is that deductions are not permitted. Several of these taxes are discussed here to the extent that they have spawned controversy.

Texas: The Texas Margin Tax

Effective January 1, 2008, Texas changed its former franchise tax to a margin tax. The margin tax is described as a tax based on gross receipts with certain allowable deductions.4 The taxable margin is computed based on the lesser of:

- 70% of the taxable entity’s total revenue from its entire business; or
- The taxable entity’s total revenue from its entire business less—at the election of the taxable entity—either cost of goods sold (COGS) or compensation.

The Texas margin tax is assessed on S corporations, partnerships, limited liability partnerships (LLPs), limited liability companies (LLCs), and single-member LLCs (SMLLCs) at the entity level.5 Several states (including Texas in its own legislative history) have opined on whether the Texas margin tax is an income tax, with inconsistent results. The Texas Legislature’s Enrolled Bill Summary6 makes clear that the restructured franchise tax is not an income tax and that the federal law concerning state taxation of income from interstate commerce (i.e., P.L. 86-272) does not apply. In addition, the bill analysis states that the attorney general indicated that the plan would not constitute an income tax and likely would be upheld in court.7 These assurances were necessary to address concerns that the Texas margin tax would run afoul of Article VIII, Section 24(a), of the Texas constitution, which prohibits enactment of a law that imposes a tax on a person’s net income, including a person’s share of partnership and unincorporated association income, unless a majority of Texas voters approve such a tax in a statewide referendum.8

Texas Margin Tax Is Not an Income Tax: Minnesota, Virginia, Massachusetts

Several states have rendered an opinion on whether the Texas margin tax is a tax measured by net income for purposes of deductibility on the state income tax return or eligibility for the credit allowed for income taxes paid to other states. The Minnesota Department of Revenue (DOR) has taken the position that the Texas margin tax is not an income tax because certain deductions such as interest, depreciation, and most other business expenses generally associated with a computation of net income are not allowed.9 Using a similar analysis, Virginia and Massachusetts have taken similar positions.10

Texas Margin Tax Is an Income Tax: Kansas, South Carolina, Missouri

In 2008 the Kansas DOR issued Opinion Letter No. O-2008-004,11 stating that the revised Texas margin tax is an income tax that must be added back in the computation of the
corporate income tax and that it can also be claimed as a credit for taxes paid to another state. However, it later refined its response in Opinion Letter No. O-2009-00512 by stating that the Texas margin tax is only an income tax (and not deductible) if it is determined by deducting COGS or compensation.

The South Carolina DOR ruled that the Texas margin tax is an income tax that must be added back to the tax base. The Missouri DOR held in Letter Ruling LR 5309 that the Texas margin tax is an income tax. This finding was based on Herschend v. Director of Revenue,15 where the Missouri Supreme Court found that a Tennessee excise tax was an income tax paid to another state and was creditable against Missouri income tax under two tests—the based-on test and the object test. Under the based-on test, the court looked to determine if the tax was based on net earnings earned within Tennessee, defined by reference to federal taxable income. The court determined that the tax was calculated just like the Missouri income tax, as a fixed percentage of total income. The Missouri DOR found that the Texas margin tax is also based on various types of income reported on the federal income tax return and that it meets the based-on test in Herschend and therefore meets the standard of based-on income.

The object test addresses the critical distinction between an income tax and a franchise tax. An income tax is imposed to compensate the state for benefits already received, while a franchise tax is imposed and payable in advance for the privilege of exercising the right to do business in the state in the future. An income tax is imposed even if a corporation ceases to do business during a particular year in which it has generated income. A franchise tax is not imposed, as there is no business activity contemplated in the future. The Texas margin tax is compensatory in nature and will apply to compensate the state for public benefits such as roads, schools, police and fire protection, and so forth, so it is classified as an income tax.16

Facts-and-Circumstances Analysis: California

In FTB Notice 2010-02,17 the California Franchise Tax Board (FTB) stated that the determination of whether the Texas margin tax is an income tax is highly fact specific and must be analyzed on a case-by-case basis, determined largely by the different types of taxpayers (and various types of revenue) that may be subject to the margin tax. The ruling concludes that if the tax is determined to be a gross receipts tax, it would be deductible on the state income tax return (as a fee). The ruling defines a gross receipts tax as a tax imposed on gross income (without allowing a deduction for costs of goods sold, referred to in the notice as a return of capital). The tax would not be deductible on the California return if it were considered a gross income tax or a net income tax.

Although FTB Notice 2010-02 appears to give California the ability to make such determinations on the Texas tax as needed, it would also appear, based on numerous opinions and rulings spanning several decades regarding the determination of a gross receipts tax, that it would be difficult for California to ever rule that the Texas tax is an income tax. Cases such as Beamer v. Franchise Tax Board,18 Appeal of Dayton Hudson,19 and Appeal of Kelly Services20 all determined that various state taxes such as the Texas occupation tax (a tax on oil and gas production) and the Michigan single business tax are gross receipts taxes because they do not allow for a complete deduction of COGS.

The Texas margin tax includes its own computation of COGS.21 Although the computation tends to follow federal law, there are exceptions, particularly with the definition of capitalizable overhead.22 All the Texas margin tax computations deny the deduction of expenses commonly deducted in computing net income. The definition of COGS limits the deductibility of overhead, and, even if overhead is fully deductible, based on Appeal of Kelly Services, the mere possibility of this deduction’s being limited would compel California to deem the tax a gross receipts tax. The definition of compensation limits the compensation deduction to $300,000 per employee per 12-month period.23 Thus, there does not appear to be any scenario in which the Texas margin tax would qualify as a net income tax for California purposes.

FASB Opinion

Despite these varied opinions by the states, the FASB determined that the Texas margin tax was an income tax to be accounted for in accordance with FAS 109, Accounting for Income Taxes.24 ASC 740 does not specify what type of deductions must be allowed to qualify the assessment as an income tax; it only implies that some deductions must be allowed to qualify the assessment as an income tax.

Ohio CAT

Beginning with the tax period that commences July 1, 2005, Ohio levies a commercial activity tax (CAT) on each person with taxable gross receipts for the privilege of doing
business in the state. Taxpayers subject to the CAT include all businesses conducted for the purpose of generating gain, profit, or income. This includes partnerships, LLPs, LLCs, S corporations, and any other entity engaged in business in Ohio.

Gross receipts subject to the CAT are broadly defined to include most business types of receipts from the sale of property or realized by the performance of a service. Specifically, “gross receipts” means the total amount realized by a person, without deduction for the COGS or other expenses incurred, that contributes to the production of the person’s gross income, including the fair market value of any property and any services received, and any debt transferred or forgiven as consideration.

Although the Ohio Supreme Court held in Ohio Grocers Association v. Levin that the tax operates like an income tax on the privilege of doing business in the state, many other states have ruled differently for purposes of determining whether an addback is required or whether a credit is allowed for taxes paid to other states. Based on the rationale that the computation of the tax does not allow for any deductions from income or receipts, states such as Minnesota, Massachusetts, South Carolina, and Wisconsin all treat the CAT as a tax on gross receipts rather than a tax on income.

Observation: Although the FASB has not directly opined on the nature of the Ohio CAT, ASC 740 should not apply to the Ohio CAT because the tax base is not reduced by deductions.

Michigan Business Tax

There are three components to the Michigan business tax (MBT): the business income tax (BIT), the modified gross receipts tax (MGRT), and the annual surcharge. The BIT and the MGRT are based on an income base similar to federal taxable income. The total of the two is then multiplied by the surcharge rate. The BIT starts with business income and, being based on federal taxable income, is clearly an income tax.

The law states that the MGRT is imposed on the privilege of doing business and not upon income or property. It is computed based on the taxpayer’s gross receipts less purchases from other firms before apportionment.

The annual surcharge is based on a percentage of the taxpayer’s MBT liability after allocation or apportionment to Michigan. The MBT is imposed on S corporations, partnerships, LLPs, LLCs, and SMLLCs.

The MBT Is an Income Tax: Missouri

In Letter Ruling LR 5309, the Missouri DOR held that all three components of the MBT are income taxes. Pursuant to Herschend, the MBT was held to be an income tax because it is essentially based on federal income tax.

Gross Receipts Portion of the MBT Is Not an Income Tax: South Carolina and Kansas

Alternatively, the South Carolina DOR and the Kansas DOR have both ruled that the modified gross receipts portion of the MBT is deductible because it does not qualify as a net income tax, while the business income tax portion is not deductible because it is an income tax.

The FASB has not ruled on the MBT, but since the base of all three components is taxable income after certain deductions, it should be subject to the ASC 740 analysis.

Oklahoma BAT

Oklahoma has enacted a business activity tax (BAT) for the 2010–2012 tax years. In addition, the state has placed a moratorium on the franchise tax for periods beginning July 1, 2010, and ending before July 1, 2013. For the 2010–2012 tax years, the BAT is imposed on all persons doing business in the state in an annual amount of $25. In addition to that annual tax, persons doing business in Oklahoma are subject to a tax in the amount of 1% of the net revenue derived from business activity that is allocated or apportioned to the state. However, for the 2010–2012 tax years, those subject to the Oklahoma franchise tax are liable for the amount of their franchise tax liability from the period ending prior to December 31, 2010, rather than the tax based on
 Corporations, partnerships, and LLCs are all subject to the BAT.44

The imposition of the BAT is in response to the case of Southwestern Bell v. Oklahoma State Board of Equalization,45 in which the Oklahoma Supreme Court ruled that intangible personal property was subject to the state’s ad valorem tax unless specifically exempt by the state constitution. Since the ruling resulted in a significant tax increase for many Oklahoma taxpayers, the BAT was enacted as a temporary solution because it is imposed in lieu of all other taxes on intangible personal property (with a few exceptions).46 The BAT is curious in that it is set to expire after 2012 unless it is reenacted by the legislature, yet it contains a provision for a tax on net revenues that cannot statutorily be imposed during the current expected life of the BAT.

Given the recent enactment of the BAT, other states have not yet offered an opinion as to whether it would constitute an income tax for purposes of state tax addback or credit for taxes paid to other states. Furthermore, Oklahoma has not yet offered an opinion on whether the BAT is considered an income tax when applying P.L. 86-272. However, Oklahoma has expanded its definition of “doing business” for purposes of the BAT to incorporate a factor presence standard,47 which leads one to believe that the state might consider P.L. 86-272 to be inapplicable to the BAT. For tax years 2010–2012, since the BAT is limited to a flat fee of $25 and the amount of the taxpayer’s franchise tax liability from the period ending prior to December 31, 2010, it does not seem likely that the BAT would be considered an income tax. However, assuming the BAT continues to exist after 2012 and is truly based on net revenue, its classification could certainly change.

In order to calculate net revenue for purposes of the BAT, taxpayers start with total revenue, which is defined as revenue reported on the federal income tax return or total revenue received or accrued if a federal income tax return is not required to be filed less specific exclusions, including certain items of interest, dividends, real estate rentals, royalty interests, net capital gains, and compensation.48 Total revenue is then reduced by all ordinary trade or business expenses other than interest, income taxes, depreciation, and amortization in order to arrive at net revenue.49

Given that the law allows numerous deductions in order to arrive at the tax base, the BAT has many characteristics of a typical income tax. However, as noted above, states have gone in both directions with similar taxes, with some ruling that they constitute income taxes and others deciding the opposite. When reviewing the FASB’s rationale that the Texas margin tax is an income tax because some deductions are allowed in arriving at the tax base, it seems reasonable that the FASB would draw the same conclusion for the BAT.

Conclusion

It is clear that the categorization of state payments assessed on flowthrough entities as an income or gross receipts tax depends on the purpose for which the question is asked. For purposes of ASC 740 and the analysis of uncertain tax positions, the definition found in ASC 740-10-20, which defines taxable income as the excess of taxable revenues over tax-deductible expenses and exemptions for the year as defined by the governmental tax authority, means that state assessments with some allowance for deductions would fall under the scope of this analysis.

This means that the ASC 740 analysis must be completed for flowthrough entities publishing financial statements under GAAP and doing business in states such as California, the District of Columbia, Illinois, Kentucky, Massachusetts, Michigan, New Hampshire, Tennessee, Texas, and Wisconsin.50 This makes the extension of ASC 740 to flowthrough entities a much more extensive reporting requirement than most practitioners initially thought; many had considered only the very limited situations in which a flowthrough entity might be subject to a federal income tax as the scope of this new reporting requirement.

About Dixon Hughes Goodman:

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1 In June 2009, FASB issued FAS No. 168, FASB Accounting Standards Codification and Hierarchy of Generally Accepted Accounting Principles, effective for financial statements issued for interim and annual periods ending after September 15, 2009. Following the issuance of FAS 168, the FASB will now issue Accounting Standards Updates that will update the codification, provide background information about the guidance, and give explanations for the changes made to the codification. FAS 109, Accounting for Income Taxes, is now published in the codification at ASC 740. FIN 48 [FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes] is located at ASC 740-10-05 to 740-10-55.


3 See ASC 740-10-55-139–144, Example 17.


5 TX Tax Code Ann. §§171.001(a) and 171.0002.

6 TX State Legislature, Enrolled Bill Summary, House Bill 3 [3rd C. S.], Legislative Session 79(3).

7 House Research Organization, Bill Analysis: Restructuring the Texas Franchise Tax, p. 12 [4/24/06].


9 MN Revenue Notice 08-08 [7/21/08].

10 VA Dep’t of Tax’n, Ruling of the Comm’r PD 08-186 [9/11/08]; MA DOR Directive 08-7 [12/18/08].


13 SC Rev. Rul. 09-10 [7/17/09].

14 MO DOR Letter Ruling LR 5309 [12/12/08].

15 Herschend v. Director of Rev., 896 S.W.2d 458 [Mo. 1995].

16 MO DOR Letter Ruling LR 5309 [12/12/08].

17 CA FTB Notice 2010-02 [12/3/10].


19 Appeal of Dayton Hudson Corp., 94-SBE-003 [Cal. State Bd. of Eq. 2/3/94].

20 Appeal of Kelly Services, Inc., 97-SBE-010 [Cal. State Bd. of Eq. 5/8/97].

21 34 TX Admin. Code §3.588.

22 The instructions to the Texas Franchise Tax Report state that “[g]enerally COGS for franchise tax reporting purposes will not equal the amount used for federal income tax reporting purposes or for financial accounting purposes. . . . It is a calculated amount specific to the franchise tax” [Form 05-395, 2011 Texas Franchise Tax Report Information and Instructions, p. 15 (December 2010)].

23 TX Tax Code Ann. §171.1013(c). This amount is adjusted annually for inflation beginning in 2010 §171.306(b)].

24 FASB, “Minutes of the August 2, 2006 Board Meeting on Potential FSP: Texas Franchise Tax” [8/2/06].

25 OH Rev. Code §5751.02.

26 OH Rev. Code §5751.01(A).

27 OH Rev. Code §5751.01(F).

28 Ohio Grocers Ass’n v. Levin, 916 N.E.2d 446 [Ohio 2009].

29 MN Notice 08-08 [7/21/08].

30 MA DOR Directive 08-7 [12/18/08].

31 SC Rev. Rul. 09-10 [7/17/09].

32 WI Dep’t of Rev., Wis. Tax Bull., No. 147, p. 21 [April 1, 2006].

33 MI Comp. Laws §201.1201.

34 MI Comp. Laws §208.1203(2).

35 MI Comp. Laws §208.1281.

36 MI Comp. Laws §§208.1201(1) and 208.1203(1).

37 MO DOR Letter Ruling LR 5309 [12/12/08].


40 OK Stat. tit. 68, §1212.1.

41 OK Stat. tit. 68, §1218(A).

42 OK Stat. tit. 68, §1218(B).

43 OK Stat. tit. 68, §1218(C).

44 OK Stat. tit. 68, §1217(7).


46 OK Stat. tit. 68, §1218(F).

47 OK Stat. tit. 68, §1218(H).

48 OK Stat. tit. 68, §1217(10).

49 OK Stat. tit. 68, §1217(6).

50 See the online appendix for a summary of the entity-level tax payments assessed by these states.

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