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Rhode Island State Tax Updates

Rhode Island enacts combined reporting, single sales factor apportionment, market-based sourcing and reduces corporate tax rate.

SUMMARY

On June 19, 2014, Rhode Island Governor Lincoln Chafee signed into law H.B. 7133, the budget bill for the fiscal year ending June 30, 2015, which implements combined reporting, single sales factor apportionment, and market-based sourcing of receipts from the sales of services. In connection with the enactment of these provisions, Rhode Island will reduce the corporate income tax rate from nine percent to seven percent, repeal the franchise tax, subject S corporations to the $500 minimum tax, and require the Rhode Island Division of Taxation (the "Division") to create a non-binding, independent appeals process to resolve disputes concerning the method of allocation applied. These changes to the law apply to taxable years beginning on or after January 1, 2015.

DETAILS

Unitary combined reporting

Under the new law, Rhode Island will require combined reporting with respect to two or more corporations, wherever incorporated, that are directly or indirectly more than 50-percent owned by a common owner(s) and are engaged in a unitary business. The new law extends the term "unitary business" to the broadest extent allowed under the United States Constitution but generally defines the term to mean two or more commonly owned corporations "that are sufficiently interdependent, integrated or interrelated through their activities so as to provide mutual benefit and produce a significant sharing or exchange of value among them or a significant flow of value between the separate parts."

While a corporation, wherever incorporated, may be included in the combined return, Rhode Island will exclude a non- United States corporation from the combined group if more than 80 percent of its sales factor is outside the United States. Rhode Island will also exclude the income (and attributed expenses and apportionment) of an included non-United States corporation to the extent that such income is subject to the provisions of a comprehensive income tax treaty between the United States and a foreign jurisdiction, unless the foreign jurisdiction is a "tax haven" jurisdiction.

Very generally, a "tax haven" for this purpose means a jurisdiction that imposes no or a nominal effective tax rate on the income at issue and:

(1) has laws or practices that prevent the exchange of tax information;
(2) has a regime that lacks transparency;
(3) explicitly or implicitly excludes its residents from taking advantage of the tax regime benefits or prohibits enterprises that benefit from the regime from operating in the jurisdiction's domestic market; or
(4) has created a tax regime which is favorable to tax avoidance.

Federal consolidated group election

Rhode Island will allow an affiliated group of corporations (as that term is defined under section 1504 of the Internal Revenue Code) to make a five-year, irrevocable election to file a consolidated return in lieu of a unitary combined report.

Computation of taxable income

Under the new combined reporting regime, Rhode Island will no longer require the addition of related member intangible expenses. In addition, Rhode Island will allow the deduction of a net operating loss ("NOL") arising from a taxable year beginning before January 1, 2015, but only to the extent that the corporation that created the NOL has income. Rhode Island will then subject the NOL to the same pre-combined return era rules. Similar rules will apply to tax credits created during a taxable year beginning before January 1, 2015.

The new law also provides for a pre-apportioned NOL deduction for an NOL arising from a taxable year beginning on or after January 1, 2015. The NOL may be carried forward five taxable years. However, the NOL deduction may not exceed the federal NOL and no deduction shall be allowed with respect to an NOL generated during a year the taxpayer was not subject to Rhode Island tax.

Rhode Island State Tax Updates

Single sales factor apportionment and market-based sourcing of sales of services

The apportionment of income under the new law will be based upon a single sales factor where the numerator of the factor includes the following:

(1) gross sales of tangible personal property where shipments are made to Rhode Island or made from Rhode Island to a state where the corporation is not taxable;
(2) gross receipts from the sale of a service to the extent the recipient of the service receives the benefit in Rhode Island;
(3) gross income from the rental of property located in Rhode Island;
(4) net income from the sale of real and personal property located in Rhode Island;
(5) net income from the sale of securities and financial obligations; and
(6) gross income from all other receipts within Rhode Island.

Further, the new law provides that the numerator should include all Rhode Island receipts without regard to whether a member has nexus with the state, i.e., the *Finnigan* approach[1] to determining whether receipts from a unitary member are included in the numerator of the apportionment factor. Receipts between members of the unitary group should be eliminated.

INSIGHTS

The enactment of combined reporting follows a two-year study conducted by the Division, which is based on information gathered from pro forma combined returns that taxpayers were required to file for the 2011 and 2012 taxable years.[2] The results of the study show that Rhode Island would have collected more tax revenue had taxpayers reported using combined reporting and collected still more tax revenue had taxpayers reported using single sales factor apportionment (rather than three factor apportionment) using the *Finnigan* approach (rather than the *Joyce* approach[3]). Thus, it is no surprise that Rhode Island adopted combined reporting, single sales factor apportionment, and the *Finnigan* approach.

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[1] See Appeal of Finnigan Corp., Cal. State Board of Equalization, 88-SBE-022 (Aug. 25, 1988).
[2] See Rhode Island Division of Taxation, Tax Administrator's Study of Combined Reporting (Mar. 15, 2014).
[3] See Appeal of Joyce, Inc., Cal. State Board of Equalization, 66-SBE-070 (Nov. 23, 1966).

The Division notes in its study that its present staff of six people who oversee more than 50,000 returns filed annually would be unable to take on additional duties and responsibilities that would arise from combined reporting without at least doubling its staff. The Division also notes in its study that Rhode Island's full sovereignty membership in the Multistate Tax Commission (the "MTC") would need to be restored to enable the Division to take advantage of the MTC's expertise in combined reporting and related areas. Thus, Rhode Island's transition from separate company reporting to combined reporting could be rough, especially if the transition coincides with the Division's current, multi-year project to install and implement an integrated tax system, which the Division notes is "commanding a substantial portion of the agency's time and personnel."

Inasmuch as Rhode Island will no longer require the addition of related member intangible expenses, a Rhode Island taxpayer may benefit from the deduction of such expenses if paid to a corporation which is not included in the combined or consolidated return. Presumably, a payment to a member of the combined or consolidated group would be eliminated in combination or consolidation, as the case may be.

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