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District of Columbia tax changes effective September 14, 2011- third quarter event for most taxpayers

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As noted on the District of Columbia website, legislation that mandates unitary combined reporting, adopts a double-weighted sales factor, increases the business minimum tax and makes other tax changes is enacted September 14, 2011, rather than late October as originally anticipated. Accordingly, calendar year taxpayers need to consider the financial statement impact of the changes in computing third quarter tax provisions for the 2011 tax year. [A19-0098]

The legislation makes the following changes, most of which are effective October 1, 2011, unless otherwise noted:

- mandates the use of water's edge combined reporting by corporations engaged in a unitary business operation, effective for tax years beginning on or after December 31, 2010;
- requires the use of a three-factor apportionment formula that includes a double weighted sales factor, effective for tax years beginning after December 31, 2010;
- establishes a two-tier minimum tax structure, which applies as of December 31, 2010;



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- imposes income tax on non-District municipal obligations, effective January 1, 2011;
 - limits itemized deductions in computing taxable income, effective for the 2011 tax year;
 - expands the list of services subject to sales tax and makes permanent a temporary sales tax rate increase;
 - increases the parking tax rate to 18 percent from 12 percent;
 - increases to 110 percent from 100 percent the prior year tax liability estimated tax safe harbor;
 - requires sales/use tax collection by "nexus" and "remote" vendors selling via the Internet to District purchasers;
 - increases the hospital "bed tax" to \$2529 in 2011, and to \$3,788 in 2012 through 2014; and
 - modifies property tax rate calculations, among other changes.

The legislation was signed by District of Columbia Mayor Grey on July 22, 2011, and transmitted to Congress on August 2, 2011. Based on a Congressional recess, originally scheduled to run from early August until the Labor Day holiday, it was anticipated that the mandatory Congressional review period would not end until after October 20, 2011. However, because Congress did not formally recess as scheduled, in part to prevent recess appointments, the 30-day mandatory Congressional review period ends, as noted on the District website, on September 14, 2011.

Corporate income tax changes

The most notable corporate income tax change is the shift from separate return filing to mandatory unitary combined reporting. In addition, the shift to a double-weighted sales factor formula, the inclusion of non-District municipal interest income in taxable income, and the increase in minimum taxes may significantly impact corporate and unincorporated business taxpayers.

Combined Reporting. The enacted legislation mandates the use of combined reporting for any taxpayer engaged in a unitary business with one or more other corporations that are part of a water's edge combined group. While the statutory combined reporting provisions generally mirror the Multistate Combined Reporting statute, there are a number of notable changes, including the use of water's-edge, rather than world-wide, combined reporting, unless the taxpayer elects or the District requires an alternative filing method.

Like the model act, the legislation requires the use of a Joyce methodology in apportioning income of the group. In addition, the legislation limits the use of credits and net operating loss carryovers to the member that earned such credits or losses. The legislation allows a charitable deduction incurred by one member of a group to be used by the combined group. The legislation gives the Mayor broad discretion to

adopt regulations necessary to ensure that income derived from sources in the District as reflected on a combined report is properly reported.

The legislation provides that where a combined group includes or a member owns an unincorporated business that "would be subject to [the District unincorporated business tax]" the group or member excludes from District taxable income its pre-apportioned distributive share of unincorporated business income in computing District taxable income. The group or member then makes an addition modification to include in District taxable income its distributive share of post-apportioned unincorporated business income.

ASC 740 Fix. The legislation provides that if the enactment of combined reporting requirements for unitary businesses result in an increase to a combined group's net deferred tax liability, the combined group is entitled to a deduction, claimed ratably over the seven-year period beginning in 2015, in an amount equal to 1/7th of the net increase in the taxable temporary differences that caused the increase in the net deferred tax liability, as computed at the time of enactment in accordance with either generally accepted accounting principles or international financial reporting standards. The amount of the deduction may not exceed the amount necessary to offset any increase in net deferred tax liability, as computed in accordance with either generally accepted accounting principles or international financial reporting standards that would result from the imposition of all of the provisions included in the legislation, but for the ASC 740 deduction.

The bill defines "net deferred tax liability" as the net increase, if any, in deferred tax liabilities minus the net increase, if any, in deferred tax assets of the combined group, as computed in accordance with either generally accepted accounting principles or international financial reporting standards.

The ASC 740 deduction is only available to publicly traded companies, including affiliated corporations participating in the filing of a publicly traded company's financial statements prepared in accordance with either generally accepted accounting principles or international financial reporting standards, as of the effective date of the legislation.

The legislation provides that to the extent the ASC 740 deduction would produce a net operating loss in any tax year, the unused deduction may be carried forward to each succeeding tax year indefinitely by the combined group and deducted without regard to any limitation.

The legislation requires that the Chief Financial Officer, after two full years of combined reporting, determine the economic effects of the combined reporting requirements on affected taxpayers.

PwC Observes

"The earlier effective enactment date is likely to catch many taxpayers by surprise," says Steve Arluna, State and Local Tax Partner with PwC in Tyson's Corner. "In addition, while the 'ASC 740 fix' provisions may temporarily mitigate the impact of the effect of combined reporting from a financial statement perspective, the lack of guidance from the District Office of Tax and Revenue in the form of regulations or

other policy statements, will create challenges for taxpayers during this provision season."

"Office of Tax and Revenue representatives are busily working on regulatory guidance and plan to have something available as quickly as possible," Arluna notes. Until that time, taxpayers should speak with their advisers about specific concerns. Those concerns may include the apparently different tax treatment of unincorporated business income based on whether a pass through entity is owned by a combined group. A simple reading of the law indicates that if an unincorporated business is owned by an entity that is part of a combined group, its income is taxed at the combined group level. In contrast, if an unincorporated business is owned by an entity that is not part of a combined group, the income is taxed at entity level. That difference in tax treatment may lead to unintended consequences in certain situations.

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