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MyStateTaxOffice Quarterly is prepared by PwC – Washington National Tax Services SALT team. Our objective is to provide a quick reference to our recently issued key developments.

In this issue:

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SALT Perspective

A little privacy please! Private vs. public clouds

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Executive summary

In today's economy, companies are facing increased pressure to cut costs while still delivering the same level of service. Cloud computing has emerged as a potential solution to information technology (IT) cost cutting directives while improving overall operational effectiveness. However, cloud computing comes in many forms and sizes. For businesses that are considering a move to the cloud from an infrastructure point of view, cloud computing service offerings can be provided via a public or private cloud. Currently, many companies are contemplating building their own private clouds to replicate the functionality of the large public clouds and to have more control over security and data management. Both private and public clouds have advantages and disadvantages, including tax ramifications that should be evaluated before a company moves onto the cloud.

Did you know?

I really believe that we don't have to make a trade off between security and privacy.

I think technology gives us the ability to have both.

Ret. Admiral
John M. Poindexter
August 2004
www.csoonline.com

As profound as Mr. Poindexter's quote was when it was delivered, he might have said it differently if spoken in today's age of cloud computing. Mr. Poindexter's quote as applied to cloud computing might read, "I really believe that we don't have to make a trade off between security and privacy and mass quantities of computing power. I think technology gives us the ability to have both." As more and more businesses consider using cloud computing, the focus in 2011 appears to be not only on if and when to move to a cloud, but the virtues of public versus private clouds as well. According to a Harris Interactive study dated September 24, 2010 and sponsored by Novell, 83 percent of the more than 200 IT leaders at enterprise organizations surveyed said private clouds offer most of the advantages of public clouds without the security and compliance concerns of public clouds. Some believe the popular movement towards private clouds is just a stepping stone in the progression toward full integration into the public cloud for everyone and everything.

Fortunately, with today's technology, companies can choose between private or public clouds based on their individual needs and situations. However, to make the best choice, companies first should understand the advantages and disadvantages of both, why a business may want to choose one over another, and the various tax treatments for either option.

Definitions

Before discussing the merits and challenges associated with public and private clouds, it is important to understand cloud fundamentals. Cloud computing, as defined by the National Institute of Standards and Technology (NIST), is a:

> [M]odel for enabling ubiquitous, convenient, on-demand network access to a shared pool of configurable computing resources

(e.g., networks, servers, storage, applications, and services) that can be rapidly provisioned and released with minimal management effort or service provider interaction. This cloud model promotes availability and is composed of five essential characteristics, three service models, and four deployment models.

In layman's terms, "cloud computing" means unlimited, on-demand computing capability through the use of shared resources that can be accessed with minimal effort by the end user.

The five essential characteristics of cloud computing are on-demand self-service, broad network access, resource pooling, rapid elasticity, and measured service.

Cloud computing is provided using three service models: Software as a Service (SaaS), Platform as a Service (PaaS), and Infrastructure as a Service (IaaS):

- *SaaS* is defined as the capability provided to the consumer to use a provider's applications running on a cloud infrastructure. The applications can be accessed from various client devices through a thin client interface such as a web browser (e.g., web-based e-mail). The consumer does not manage or control the underlying cloud infrastructure including networks, servers, operating systems, storage, or even individual application capabilities, with the possible exception of limited user-specific application configuration settings.

- In *PaaS,* the consumer is allowed to deploy onto the cloud infrastructure consumer-created or acquired applications created using programming languages and tools supported by the provider. The consumer does not manage or control the underlying cloud infrastructure, including networks, servers, operating systems, or storage, but has control over the deployed applications and possibly application-hosting environment configurations.

- IaaS is defined as the capability provided to the consumer to provision processing, storage, networks, and other fundamental computing resources where the consumer is able to deploy and run arbitrary software, which can include operating systems and applications. The consumer does not manage or control the underlying cloud infrastructure but has control over operating systems, storage, deployed applications, and possibly limited control of select networking components (e.g., host firewalls).

While this discussion focuses on private and public clouds, NIST sets out four distinct cloud infrastructures: private clouds, public clouds, community clouds, and hybrid clouds.

- A *private cloud* infrastructure is operated solely for an organization. It may be managed by the organization or a third party and may exist on or off premises.

- A *public cloud* infrastructure is made available to the general public or a large industry group and is owned by an organization selling cloud services.

- A *community cloud* infrastructure is shared by several organizations and supports a specific community

that has shared concerns (e.g., mission, security requirements, policy, and compliance considerations). It may be managed by the organizations or a third party and may exist on or off premises. For example, a state government may set up a community cloud infrastructure for all of its separate organizations in order to pool resources.

- A *hybrid cloud* infrastructure is a composition of two or more clouds (private, community, or public) that remain unique entities but are bound together by standardized or proprietary technology that enables data and application portability (e.g., cloud bursting for load balancing between clouds).

While this discussion focuses on delivery of PaaS and IaaS services via public and private clouds, many of the issues addressed can and do apply to both community and hybrid clouds.

Deployment models: Private vs. public clouds

As more and more companies consider the use of clouds, one of the first decisions to be made is whether to use a private or a public cloud or a combination of the two (i.e., a hybrid cloud). In an online article published by channelinsider.com on October 6, 2010, Jim Ebzery, senior vice president and general manager of security, management, and operating platforms at Novell, stated, "The path to public cloud computing needs to begin with the private cloud, learning to leverage the public cloud within the safety of the enterprise network." Ebzery's statement clearly reiterates the current acceleration of companies to adopt private clouds before using public clouds. However, to make an informed decision about which cloud infrastructure to use, companies should understand all the advantages and disadvantages for both private and public clouds.

According to the noted Harris Interactive study, security concerns are one of the leading barriers to the switch to cloud computing. The survey found that 91 percent of the respondents are concerned about security in the cloud and that 50 percent say it is the primary barrier to implementing a cloud. Eighty-six percent felt that data is more secure in a private cloud, and 81 percent cited the difficulty in maintaining regulatory policies as a factor in choosing between a private and a public cloud. Therefore, a major advantage with a private cloud is the level of security that comes with having dedicated resources under complete control of one user. Private clouds use dedicated servers and equipment, either on premises or off, which are not shared and cannot be accessed by anyone else. Private clouds often appeal more to regulated entities that must certify that their information is protected under certain standards, such as in the financial or medical industries. However, it should not be overlooked that security is still a very important part of the implementation process whether a private or public cloud is used and must be built into either infrastructure.

A second benefit of private clouds is that private clouds offer the highest level of customization to a customer's needs. However, increased customization comes at a higher price when compared with standardized public cloud options. Companies need to consider this additional cost when analyzing the cost benefit ratio for moving onto the cloud.

Another advantage -- or disadvantage, depending on the viewpoint -- is that all of the decision-making resides with the company setting up the private cloud. With a private cloud, the company does not have a provider to set up firewalls, make hardware choices, or reassign resources. It is the company IT department's responsibility to efficiently automate its applications and resources. Further, the IT department also must guarantee unlimited computing power by setting up protocols that allow the company's resources to be deployed in the most efficient manner. With a public cloud, all of this would be handled by the provider and would be seamless for the end user.

Like private clouds, public clouds also have advantages and disadvantages. As mentioned above, public clouds consist of network resources hosted off premises that are shared with other public users. Their greatest advantages lie in their scalability and lower cost. However, since a public cloud consists of shared assets, minimal customization can be offered and the end user does not decide how and which resources are deployed. Additionally, security is dependent on the provider and therefore the reliability of any public cloud provider must be evaluated thoroughly. To address this concern, many providers offer certifications as to their security levels. However, it should be noted that turning over security of a company's data to a third party often requires additional certification by a company's auditors and/or applicable regulators.

Tax determinations

Though there are many technical and cost/benefit advantages and disadvantages for using either private or public clouds, tax concerns also should be considered. Often tax benefits, and more often tax consequences, are overlooked until after a cloud strategy has been implemented. As a result, a company can be blindsided by unintended tax assessments and a surprisingly expanded state tax footprint. In today's economy, companies are facing increased pressure to cut costs, driving many companies to consider cloud computing infrastructures. This same economy is driving state revenue departments to look for new ways to expand their tax bases without technically enacting new taxes. As a result, many states are looking closely at the developing cloud computing industry as a new source of revenue. Therefore, an analysis of state tax consequences should be conducted by any company moving into the cloud space, preferably before implementing a strategy.

A major challenge in the taxation of cloud offerings is in the tax classification of the cloud service itself. Is the offering a taxable or nontaxable service? Is it data processing or information services? Is it the sale or lease of tangible personal property? While a significant number of states have addressed cloud services from a SaaS point of view, very few states have addressed cloud classification from an IaaS or PaaS standpoint and very few states have updated their statutes and regulations to address this emerging use of technology.

When addressing the tax classification of IaaS or PaaS services, using a private versus a public cloud can have different tax consequences. With a private cloud (whether on or off premises) specific IT assets are assigned to only one end user. For an on-premises private cloud, this asset assignment does not create more tax issues than the ownership of general business assets within a state --

the assets are owned and reside on the company's property, thereby creating nexus in the location state. Most taxpayers already are aware of this tax consequence. However, for a private cloud that is operated and located on a third party's premises, the tax considerations are more complicated.

For an off-premises private cloud, a taxpayer must determine if the use of specifically assigned assets transforms what appears to be a service transaction -- the purchase of computing power -- into the lease of tangible personal property. If a state classifies private cloud services as a lease of tangible personal property, there can be multiple tax ramifications. For example, in many states service transactions generally are not subject to sales and use taxes; however, the lease of tangible personal property is subject to tax. Vermont, for example, recently issued a publication stating that computer memory is tangible personal property. As a result, the hosting or maintenance of a website on a server located in Vermont is subject to sales tax as a sale or lease of tangible personal property.

Of more consequence are the possible nexus implications that come from leasing tangible personal property in a state. Having the presence of leased property in a state can create both income and sales and use tax nexus in the state where the assets are located. As such, using a private cloud could create an income tax filing requirement and a sales and use tax collection responsibility on the company purchasing the private cloud services. The sales and use tax collection responsibility would apply to all of the company's transactions in the state, not just those dealing with the acquisition of private cloud computing services.

A few states have begun to address the possible nexus consequences of using a private cloud within their borders. Texas recently updated its regulation that defines a retailer engaged in business in Texas (34 TAC Sec. 3.286(a)(2)). A significant amendment to this regulation provides that a retailer that owns or uses tangible personal property located in-state, including a computer server or software, is considered engaged in business within Texas and may be responsible for collecting and remitting Texas sales and use taxes. Vermont could use its interpretation that computer memory is tangible personal property to expand its nexus position that the use of a server in Vermont is the use of tangible personal property, thereby creating income and sales and use tax nexus. Washington State (home to Microsoft and Amazon) has taken the opposite approach by stating in its regulations that the Washington State Department of Revenue may not consider a person's ownership of, or rights in, computer software, including master copies of software, digital goods, or digital codes, residing on servers located in Washington State in determining whether the person has substantial nexus with the state.

In addition to the classification complications and possible nexus issues involved with cloud transactions, taxpayers and states struggle with the difficulties of sourcing cloud transactions for both income and sales and use tax purposes. For off-premises private clouds offered by third parties, a taxpayer first would need to determine how the transaction was classified and then look to specific state statutes, regulations, cases, and rulings to determine how to source it. If the service is determined to be a lease of tangible personal property, the

transaction would be sourced for income and sales and use tax purposes based on the location of the servers. If the transaction is determined to be a taxable service, the transaction would be sourced on a cost of performance or market basis for income tax purposes based on the state's apportionment formula. However, for sales and use tax purposes, it could be sourced either where the service is performed or where it is received, depending on the state. Unfortunately, with cloud computing, either location may be difficult or impossible to determine.

Further complicating the classification and sourcing issues facing cloud providers and purchasers is the increased use of the PaaS delivery model. In PaaS, the consumer is allowed to deploy onto the cloud infrastructure consumer-created or acquired applications created using programming languages and tools supported by the provider. With the provision of programming language and tools by the provider, does the combination of these tools and infrastructure change the tax classification from the lease of tangible personal property to a service? Do PaaS services meet the definition of a bundled service?

Finally, many states now are offering credits and incentives to companies setting up data centers or server farms in their states. A company setting up its own private on-premises cloud should be aware of these credits and incentives and negotiate with local jurisdictions before deciding on a location for its private cloud. However, in the case of off-premises private clouds, such tax benefits may not be available.

What should you do?

For businesses that are considering an IT move, cloud computing has a number of advantages regardless of whether a public or private cloud is chosen. Currently, many companies are contemplating building their own clouds internally to replicate the functionality of the large public cloud computing services and to have more control over security and data management. Both private and public clouds have advantages and disadvantages, including tax ramifications that should be evaluated before a company moves onto the cloud.

Key State Developments

Enacted Connecticut budget increases income, sales-use taxes

On May 4, 2011, Governor Malloy signed the Connecticut budget package that increases and extends the corporate tax surcharge, increases personal income tax rates, adopts a "click-through" nexus provision, increases sales and use tax rates and expands the base, and increases other taxes. [S.B. 1239, enacted, 5/4/11]

Corporate tax changes

(Sections 76 and 79) The legislation extends the corporate tax surcharge through 2013 and increases the amount of the surcharge to 20 percent from the original 10 percent. Taxpayers whose gross income for the income year is less than $100 million are exempt from the surcharge. However, this exemption does not apply to companies that file a combined or unitary return. **Note**. A provision that would have imposed a sales factor throwback rule was removed from the legislation.

(Section 78) The legislation allows a business that adds employees a credit for an amount equal to its "average monthly net employee gain for an income year" multiplied by $6,000. For such business, the cap on credits is increased from 70 percent of tax liability to 100 percent. These provisions apply to income years beginning in 2011 and 2012.

Click-through nexus

(Section 128) The legislation creates a presumption that a person is a retailer if that person makes sales of tangible personal property or services "through an independent contractor or other representative if the retailer enters into an agreement with a resident" of Connecticut, who for a commission or other consideration, directly or indirectly refers potential customers to the retailer via a link on an Internet Web site or otherwise, if the cumulative gross receipts from such sales are more than $2,000 during the preceding four calendar quarters. The presumption can be overcome by proof that the resident with whom the retailer has an agreement did not engage in any solicitation in the state on behalf of the retailer that would satisfy the nexus requirements of the U.S. Constitution. The legislation applies to sales that occur on or after July 1, 2011.

Sales and Use Taxes

(Sections 93 through 127) The legislation increases the state sales tax rate from 6 percent to 6.35 percent (7 percent on a variety of deemed luxury items) and proposes to eliminate a number of sales tax exemptions, most notably the exemption for clothing and footwear under $50. The legislation subjects to tax services such as cosmetic surgery services, manicure and pedicure services, automotive storage, and pet grooming services. The legislation also increases the hotel occupancy tax rate and imposes a rental car surtax. These changes apply to sales occurring on or after July 1, 2011.

Personal income taxes

(Section 107) Presently, the state has a three-bracket personal income tax system, with rates ranging from 3 percent to 6.5 percent. The legislation replaces this with a six-bracket system, with rates ranging from 3 percent to 6.7 percent. Trusts and estates will be taxed at 6.7 percent. The lower brackets are phased out at certain income levels through a "benefit recapture" provision. In addition, a new earned income tax credit equal to 30 percent of the federal credit is allowed (Section110) and the current $500 personal income tax credit for property tax paid to a Connecticut municipality on a principal residence or motor vehicle is reduced to $300 and will be phased out at a steeper rate (Section 111). These changes apply to taxable years commencing on or after January 1, 2011.

Insurance companies

(Section 75) The legislation lowers, to 30 percent from 70 percent, the credit cap by which an insurer can reduce its premium tax liability. In addition, an insurer would be entitled to a new credit for an amount equal to $6,000 multiplied by its average monthly net employee gain for a calendar year, up to 100 percent of its tax liability depending on the increase in employment level.

Other

In addition, the legislation:

- Limits the transfer of film production tax credits (Section 77);
- Increases tax on cigarettes and tobacco products (Sections 80 through 83);

- Lowers estate and gift tax thresholds (Sections 84 through 87 and 119);
- Increases taxes on alcoholic beverages (Sections 98 and 99);
- Increases tax on diesel fuel (Sections 100 and 101); and
- Imposes a tax per kilowatt-hour of electricity generation through June 30, 2013 (Section 104).

PwC observes

"Despite the tax increases in the budget bill, the state still has a $2 billion shortfall that is supposed to be filled by concessions from state employees" notes Stephen LaRosa, SALT Director in Hartford.

"It remains to be seen how this budget gap will be resolved if the governor is unable to obtain the desired level of concessions from state labor. The administration has not been shy about openly discussing and taking the necessary steps to prepare for layoffs of state workers, which may prove to be the resolution of the budget deficit, instead of further tax or other revenue increases," LaRosa suggests.

Michigan replaces MBT with new corporate income tax

On May 25, 2011, Michigan Governor Rick Snyder signed a three-bill tax package that replaces the Michigan Business Tax (MBT) with a 6 percent corporate income tax, effective January 1, 2012, and makes other changes. The MBT will be repealed except for taxpayers electing to claim "certificated" credits under the MBT until those credits are exhausted, with certain exceptions. In addition, the Governor approved a measure that bars taxpayers from apportioning income under the Multistate Tax Compact, effective January 1, 2011. [H.B. 4361, H.B. 4362, H.B. 4479, enacted 5/25/2011]

Notably, "taxpayer" under the new corporate income tax is limited to C corporations. Thus, sole-proprietorships and other flow-through entities that are subject to the MBT will not be subject to the corporate income tax. The new corporate income tax retains some of the features of the business income portion of the MBT: income tax would be apportioned under a single sales factor formula; sales of other than tangible personal property would be sourced to the state based on a market-based sourcing standard; a *Finnigan* sourcing rule would apply to unitary groups; and unitary groups would have to file combined returns. Like the MBT, nexus is established if the taxpayer has physical presence in the state for a period of more than one day during the tax year or if the taxpayer actively solicits sales in the state and has gross receipts of $350,000 or more that are sourced to the state. Credits allowed under the MBT are not retained, with the exception of the "alternate tax credit" for taxpayers with gross receipts that do not exceed $20 million and adjusted gross income that does not exceed $1.3 million. Under H.B. 4362, the MBT repeal is effectuated by defining taxpayer under the MBT as "[t]hrough December 31, 2011, a person or a unitary business group liable for tax, interest, penalty...." House Bill 4362 allows taxpayers to remain subject to the MBT if they wish to claim certain "certificated" credits.

The tax regimes currently in existence under the MBT for insurance companies and financial institutions will effectively be retained. The

legislature used the MBT Act's language in the statutes and incorporated that into H.B. 4361. Thus, insurance companies will continue to be subject to the greater of a tax imposed at the rate of 1.25 percent of gross direct premiums written on property or risk located or residing in the state or the retaliatory tax. Insurance companies retain certain insurance-related credits. Financial institutions will be subject to tax based on net capital at a rate of 0.29 percent.

Note. Provisions of the new corporate income tax are imposed under H.B. 4361. Unless noted otherwise, "legislation" refers to H.B. 4361.

Taxpayers and nexus

The corporate income tax is imposed on every taxpayer, defined as a corporation, with "business activity" in the state or ownership interest in a flow-through entity that has business activity in the state, unless immune from tax pursuant to P.L. 86-272. Business activity means a transfer of legal or equitable title to or rental of property (real, personal, or mixed, tangible or intangible), the performance of services (or combination thereof), "made or engaged in, or caused to be made or engaged in, whether in intrastate, interstate, or foreign commerce, with the object of gain, benefit, or advantage, whether direct or indirect, to the taxpayer or to others, but does not include the services rendered by an employee to his or her employer or services as a director of a corporation." The tax is also imposed on "foreign persons" as explained below. **Note.** Under the existing Michigan Business Tax, a taxpayer means an individual, firm, bank, financial institution, insurance company, limited partnership, limited liability partnership, co-partnership, partnership, joint venture, association, corporation, S corporation, limited liability company, receiver, estate, trust, any other group or combination of groups acting as a unit, and a unitary business group.

Substantial nexus is established if the taxpayer has physical presence in the state for a period of more than one day during the tax year, if the taxpayer "actively solicits" sales in the state and has gross receipts of $350,000 or more that are sourced to the state, or of the taxpayer has an ownership interest or a beneficial interest in a flow-through entity (directly or indirectly through one or more other flow-through entities) that has substantial nexus in the state. Physical presence means any activity conducted by the taxpayer or on behalf of the taxpayer by the taxpayer's employee, agent, or independent contractor acting in a representative capacity; it does not include the activities of professionals providing services in a professional capacity or other service providers if the activity is not significantly associated with the taxpayer's ability to establish and maintain a market in the state. The legislation directs the Department of Treasury to prospectively define "actively solicits."

Income tax base

The tax is imposed on a taxpayer's business income, which would be defined as federal taxable income, as modified. Federal taxable income means taxable income as defined under I.R.C. Sec. 63. The statute would adopt the I.R.C. as in effect on January 1, 2012, or at the option of the taxpayer, in effect for the tax year. However, the statute decouples from Sections 168(k) and 199. In addition, the law requires that taxpayers add to federal taxable income:

- interest income and dividends from obligations or securities of states other than Michigan, in the same amount that was excluded from federal taxable income, less the related portion of expenses not deducted in computing federal taxable income because of I.R.C. Secs. 265 and 291;
- all taxes on or measured by net income (including this tax) to the extent deducted in computing federal taxable income;
- any carryback or carryover of a net operating loss to the extent deducted in computing federal taxable income; and
- any royalty, interest, or other expense paid to a related person for the use of an intangible asset if the person is not included in the taxpayer's unitary business group. (This addition has several safe-harbors.)

The law allows taxpayers to subtract:

- dividends and royalties received from persons other than U.S. persons and foreign operating entities, including but not limited to, amounts determined under I.R.C. Sec. 78 or Sections 951 to 964, to the extent included in federal taxable income;
- interest income from U.S. obligations, to the extent included in federal taxable income;
- any available business loss incurred after December 31, 2011. Business loss means a negative business income taxable amount after allocation and apportionment. The legislation would allow business losses to be carried forward for up to 10 years after the loss year.

The law requires the following to be eliminated from federal taxable income:

- income from producing oil and gas, and expenses of producing oil and gas, to the extent included in and deducted in arriving at federal taxable income, respectively; this elimination is required if the oil and gas is subject to the severance tax in Michigan.

Apportionment

Taxpayers with business activity that is taxable both in and out of the state would be required to utilize a single sales factor apportionment formula in apportioning the tax base. A taxpayer is deemed taxable in another state if either: (a) the taxpayer is subject to a business privilege tax, a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax or (b) the other state has jurisdiction to subject the taxpayer to one of the taxes described above, regardless of whether the other state subjects the taxpayer to the tax. The sales factor numerator is the total sales of the taxpayer in Michigan during the tax year; the denominator would be the total sales of the taxpayer everywhere during the tax year. The legislation adopts the *Finnigan* rule, meaning that, for a unitary group, sales include sales in the state of every person included in the group, without regard to whether the group member itself has nexus with Michigan. Sales between unitary group members are eliminated from the sales factor. The legislation states that "[i]t is the intent of the Legislature" that each tax base is apportioned under the single

sales factor "and that apportionment shall not be based on property, payroll or any other factor notwithstanding" the Multistate Tax Compact (MCL Sec. 205.581).

The legislation allows taxpayers to petition for, or allow the Department of Treasury to require, the use of an alternative apportionment formula if the standard formula would not fairly represent the taxpayer's business activity within the state. The petition may call for separate accounting, the inclusion of additional or alternative factors, or the use of any other method to effectuate an equitable allocation and apportionment.

The legislation provides extensive sourcing rules. Royalties and other income received for the use or privilege of using intangible property are attributed to the state in which the property is used by the purchaser. If the property is used in more than one state, the royalties or other income would be apportioned to Michigan based on that portion of the use that occurs in the state; if that portion cannot be determined, the amounts would be excluded from the sales factor altogether. Sales of services are attributable to Michigan if the recipient of the services receives all of the benefit of the services in the state. Where only a portion of the benefit of the services is in the state, receipts are attributed to Michigan to the extent the benefits are received in the state. Specific sourcing rules also apply to:

- receipts from the lease or rental of tangible personal property;
- receipts from the lease or rental of mobile transportation property;
- sales derived from securities brokerage services;
- receipts from loan origination or gains from the sale of a loans secured by in-state realty;
- interest from loans;
- gains from the sale of loans not secured by realty;
- receipts from credit card receivables;
- receipts from the sale of credit cards or other receivables;
- loan servicing fees;
- receipts from the sale of securities and other assets from investment and trading activities;
- receipts from transportation services;
- receipts from telecommunications services, including mobile telecommunications services; and
- programming and media receipts.

For a taxpayer that has an ownership or beneficial interest in a flow-through entity that has business activity in the state, the taxpayer's business income that is directly attributable to the business activity of the flow-through entity is apportioned to the state under the single-sales factor based on the activity of the flow-through entity.

All other receipts not otherwise sourced under the specific apportionment provisions are sourced based on where the benefit to the customer is received or, if the location where the benefit is received cannot be determined, to the customer's billing address.

Foreign persons

The legislation imposes the tax on a "foreign person," meaning "a person formed under the laws of a foreign country or a political subdivision of a foreign country, whether or not the person is subject to taxation under the internal revenue code." There is an exemption for foreign persons domiciled in a sub-national jurisdiction of a NAFTA country that does not impose an income tax on taxpayers domiciled in Michigan whose presence in the foreign country is the same as the foreign person's presence in the U.S.

Generally, the tax base of a foreign person is subject to all the adjustments and other provisions applicable to other taxpayers to the extent related to U.S. business activity. The tax base would not include proceeds from sales where title passes outside the U.S.

For a foreign person, "business income" means gross income attributable to the taxpayer's U.S. business activity and gross income derived from sources within the U.S. minus the deductions allowed under the I.R.C. that are related to that gross income. Gross income includes: (1) the proceeds from sales shipped or delivered to any purchaser within the U.S. and for which title transfers within the U.S.; (2) proceeds from services performed within the U.S.; and (3) a pro rata share of the proceeds from services performed both within and outside the U.S. to the extent the recipient receives benefit of the services within the U.S. The numerator of a foreign person's sales factor is the person's total sales in Michigan, where title passes inside the U.S., and the denominator is the person's total U.S. sales, where title passes inside the U.S. during the tax year.

Unitary groups

Under H.B. 4361, a unitary business group must file a combined return that includes each member that is a U.S. person and that is a C corporation under IRC Sections 1361(a)(2) and 7701(a)(3). Such members are treated as a single person and all inter-company transactions must be eliminated from the tax base and apportionment factors. A unitary business group means a group of U.S. persons, other than a foreign operating entity (defined in the statute), one of which owns or controls (directly or indirectly) more than 50 percent of the ownership interest with voting rights or ownership interests that confer comparable rights to voting rights of the other U.S. persons, and that has business activities or operations that result in a flow of value between or among persons included in the group or has business activities or operations that are integrated with, are dependent upon, or contribute to each other. The business income of a unitary business group is the sum the business income of each person, other than a foreign operating entity, a financial institution or a person subject to the tax on insurance companies, less any items of income and related deductions arising from transactions including dividends between persons included in the unitary business group.

Insurance companies and financial institutions

Insurance companies must pay a tax at the rate of 1.25 percent of gross direct premiums written on property or risk located or residing in the state. Excluded from direct premiums are premiums on policies not taken, returned premiums on canceled policies, receipts from the sale of annuities, and receipts on reinsurance

premiums if the tax was paid on the original premiums.

In addition, the legislation imposes tax on every financial institution with nexus in the state at the rate of 0.29 percent of the institution's net capital. Net capital means equity capital (determined under GAAP) less the average daily book value of U.S. and Michigan obligations. The tax base is apportioned to the state under a single "gross business factor." A "financial institution" is a bank holding company, national bank, state chartered bank, an office of thrift supervision, a chartered bank or thrift institution, a savings and loan holding company, a federally chartered farm credit system institution, or an entity directly or indirectly owned by one of these entities, and a unitary business group of these entities. **Note.** These provisions are similar to the existing taxes on insurance companies and financial institutions.

Filing requirements

Calendar year filers must file quarterly returns and make estimated payments (25 percent of the estimated annual liability, with exceptions) on the 15th of April, July, October, and January. Other taxpayers must file quarterly and make estimated payments on the appropriate due date in the fiscal year that corresponds to the taxable year. For a taxpayer filing an estimated tax return for the taxpayer's first tax year of less than 12 months, each estimated payment must be proportional to the number of payments made in the first year.

Withholding requirements

Under H.B. 4361, every flow-through entity with business activity in the state that has more than $200,000 of business income must, after allocation and apportionment, withhold an amount determined by multiplying the corporate income tax rate (6 percent) to the distributive share of the business income of each member that is a corporation or flow-through entity. Any member of such a withholding flow-through entity that is itself a flow-through entity must withhold in the same manner for each of its members, but the legislation allows for withholding taxes remitted at a lower tier flow through entity to be credited to upper tier flow through entities to alleviate duplicate withholding. Flow-through entities are still required to withhold on non-resident individuals and trusts.

Certificated MBT credits

Under H.B. 4362, taxpayers may elect to claim "certificated" credits currently allowed under the MBT if they continue to file MBT returns. "Certificated credits" include certain of the following credits: the early stage venture capital credit; brownfield redevelopment credits; Michigan Economic Growth Authority ("MEGA") credits for photovoltaic technology, employment, anchor company payroll, federal government employment, anchor company taxable value, polycrystalline silicon manufacturing, high-power energy batteries, hybrid technology research and development; media production and infrastructure; historic preservation; renaissance zone; natural resources and environmental protection; and motorsports entertainment complexes.

Taxpayers that properly elect to remain subject to the MBT in order to claim a certificated credit for that year must continue to file under the MBT until the credit or carryforward is exhausted, in certain instances. The proposed statute's language differs slightly for taxpayers with a certificated brownfield or historic preservation credit. H.B.

4362 also provides that an electing taxpayer's MBT liability (after all credits, deductions, and exemptions) will be the greater of: the calculated MBT liability, after all credits, deductions, exemptions, and unused credit carryforwards, and the amount of the taxpayer's computed liability under the corporate income tax, less any certificated credits the taxpayer was allowed to claim under the MBT. This calculation excludes certain MBT business losses and nonrefundable credits.

MTC election

House Bill 4479 provides that "[e]xcept beginning January 1, 2011, any taxpayer subject to the Michigan Business Tax Act....or the Income Tax Act....shall for purposes of that Act, apportion and allocate with the provisions of that Act and shall not apportion or allocate in accordance with" the multistate tax compact.

PwC observes

"There are many parallels between this new corporate income tax and the MBT as it relates to the taxation of C corporations, notes Eric Burkheiser, PwC SALT Partner in Detroit. "The legislature has retained unitary reporting with the exclusion of foreign operating entities, single factor sales with market sourcing and tax rates have effectively remained the same."

"The new tax system relieves flow-through entities from the corporate income tax in Michigan; however, flow-through entities withholding obligations have increased, so these entities still have compliance obligations. It's unfortunate that the legislature did not allow companies to carryover MBT net operating losses to the new tax, and the new law does not allow for any provision to deal with the financial reporting implications that many companies will face by switching to this new tax regime," Burkheiser explains.

"As it relates to the financial reporting implications of the new tax, the Governor is expected to sign these bills very soon and before the June 30 quarter close for calendar year companies, so companies will need to spend time reviewing this new law and making appropriate changes in their financial statements. For taxpayers that elect to continue to pay the MBT, the financial accounting analysis will be strained because of the 'greater of' calculation, which requires a taxpayer to compare its MBT liability (after all credits) to its hypothetical corporate income tax liability (less certificated credits) and pay the greater of these amounts."

"By providing that 'beginning January 1, 2011' taxpayers shall not allocate or apportion in accordance with multistate tax compact, one may argue that the state has implicitly acknowledged the availability of the election for prior years. Furthermore, the legislature's change to the compact provisions could be challenged, with the possibility that taxpayers may be able to continue to file utilizing the MTC election," Burkheiser explains.

If you missed our June 16 webcast ***Michigan-Motoring Back to an Income Tax*** you can access the archived version of this webcast at our website **www.pwc.com/us/tax/events**.

The archive will be available for 90 days from the date of the live webcast.

State Tax Practitioner Tip

Your local PwC state tax specialists may assist you with participation in these on-going or up-coming state tax amnesties:

- Arizona
- Colorado
- Illinois
- Ohio

Enacted legislation and issued court decisions and administrative guidance

Note: The parenthetical date is the MySTO published date for the development

Income/Franchise Tax

California

California releases guidance on LIFO and preferential ordering for CFC dividends (April 1, 2011)

California

California FTB issues new notice of listed transaction: "Circular Cash Flow" (April 28, 2011)

Distric of Columbia

D.C. Council Committee on Finance and Revenue holds hearing on Fiscal Year 2012 Budget Support Act (April 22, 2011)

Illinois

Illinois: Changes to franchise tax apportionment rules? (April 29, 2011)

Indiana

Indiana enacts multiple tax changes; important sales tax refund statute of limitations issue (May 12, 2011)

Massachusetts

Massachusetts DOR issues guidance on mitigation of 20 percent underpayment penalty (May 19, 2011)

Massachusetts

Massachusetts letter ruling: Security corporations must purchase credits at full face value or lose classification status (May 31, 2011)

Missouri

Missouri General Assembly approved franchise tax cap, phase-out (April 15, 2011)

New Jersey

New Jersey enacts single sales factor phase-in, modifies airline apportionment (April 29, 2011)

New Jersey Division of Taxation: State not bound by advance pricing agreements with IRS (June 10, 2011)

New York

New York upholds forced combination for income distortion (April 28, 2011)

North Carolina

Enacted North Carolina Legislation Sets Parameters for Combination (June 30, 2011)

Wisconsin

Enacted Wisconsin budget bill benefits combined return filers, creates new credit (June 27, 2011)

Sales & Use Tax

Illinois

Illinois Court addresses situsing of sales for local tax purposes (May 6, 2011)

Indiana

Indiana enacts multiple tax changes; important sales tax refund statute of limitations issue (May 12, 2011)

Texas

Texas Legislature passes legislation to expand sales tax nexus provisions (May 20, 2011)

Other

Arizona

Arizona amnesty enacted (April 14, 2011)

Colorado

Colorado enacts tax amnesty (June 9, 2011)

Michigan

Michigan business tax notice requires filing by federally disregarded entities; deadline extended to October 31, 2011 (May 5, 2011)

Pennsylvania

Pennsylvania DOR assesses post-amnesty penalties but fails to notify taxpayers in many cases (April 1, 2011)

Texas

Texas Supreme Court holds gross receipts from licensing of intangibles not sourced to place of use (June 10, 2011)

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