Taxation of International Corporations Overview
Prepared for the Revenue and Transportation Interim Committee
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This document provides an overview of the taxation of international corporations for the study of the taxation of international corporations doing business in Montana.

Organizations Subject to Tax
Title 15, chapter 31 includes the laws governing the taxation of corporate income. Section 15-31-101 identifies which organizations are subject to the corporate income tax. A "corporation" is defined as:

"an association, joint-stock company, common-law trust or business trust that does business in an organized capacity, all other corporations whether created, organized, or existing under and pursuant to the laws, agreements, or declarations of trust of any state, country, or the United States, and any limited liability company, limited liability partnership, partnership, or other entity that is treated as an association for federal income tax purposes and that is not a disregarded entity."

The above definition can be unpacked by examining how the Internal Revenue Service sorts businesses into three categories:[1]

- *Sole proprietor:* informally organized business with an individual or a married couple as owner. The business is not treated as a separate entity for income tax reporting requirements and the owner files and pays taxes through the individual income tax system.
  - *Disregarded entity:* formally organized business that is treated separately from the owner. The business files a Montana information return and income tax withholding but still reports income on the owner's tax return and is taxed as part of the owner's income.
- *Pass-through entity:* includes partnerships, limited liability companies, and unincorporated businesses with more than one owner and corporations with no more than 100 shareholders, with a single class of stock, and with no shareholders that are business entities or nonresident aliens that elect to be treated as a pass-through entity (known as an *S corporation*). Pass-through entities pass through income (or loss) to the owners and do not pay tax at the pass-through entity level. Owners record the income (or loss) on their tax returns. A pass-through entity must file an annual information return showing the distribution of income (or loss) to owners.
- *Corporation (or C Corporation)*: does not meet the requirements to be treated as a pass-through entity or chooses not to be treated as a pass-through entity. A corporation is taxed on income at the business entity level.

Montana law generally requires the same treatment for state taxation as for federal taxation. Of the above business categories, the corporation is the only one subject to the corporate income tax. The

[1]For a thorough discussion of business structures and taxation see: Department of Revenue, "Biennial Report: July 1, 2012-June 30, 2014," p. 64-70.

number of corporations in Montana and nationwide is declining. Congress has revised pass-through rules over the years and now allows a pass-through entity to have up to 100 shareholders.[2]

Organizations Not Subject to Tax

Certain organizations are exempt from the corporate income tax as provided in section 15-31-102. Exempt organizations include:

- those operated for religious, charitable, scientific, or education purposes;
- labor, agricultural, or horticultural organizations;
- fraternal organizations;
- cemetery companies operated for the benefit of their members;
- business leagues and chambers of commerce not organized for profit;
- civic leagues not organized for profit;
- clubs organized for recreation or other nonprofitable purposes; and
- farmers' or mutual insurance companies for hail, cyclone, or fire purposes and mutual ditch, irrigation, or telephone cooperatives for which income is collected only to meet expenses.[3]

Unrelated business taxable income earned by an exempt organization that results in a federal unrelated business income tax liability of more than $100 must be taxed in Montana.

Tax Base, Apportionment, and Allocation

As provided in section 15-31-101, the corporate income tax is levied on a corporation "engaged in business" which means "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit." The tax is for the privilege of carrying on business in the state and is based on total net income in the previous year. A corporation with income from within Montana and outside of Montana must apportion or allocate its income.

Apportionment

Montana requires worldwide, combined reporting for a unitary business as provided in section 15-31-301. A business is considered unitary if:

- the operation of the business in Montana is dependent on or contributory to the operation of the business outside of Montana; or
- the units of the business within in and outside the state are closely allied and not capable of separate maintenance as independent businesses.

Apportionment is required by a unitary business. Section 15-31-305 provides for an equally weighted three-factor apportionment of property, payroll, and sales. Each factor described below is a fraction with the numerator attributable to Montana and the denominator including the total property, payroll, or sales:

- The property factor is defined in section 15-31-306 as a fraction in which the numerator is the average value of the taxpayer's real and tangible personal property owned or rented and used in

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[2]Department of Revenue, "Biennial Report: July 1, 2012-June 30, 2014," p. 68.

[3]For a detailed discussion of income tax exemptions see: Megan Moore, "Background Report on Income and Property Tax Exemptions," September 2011, p. 20-24.

Montana in the production of business income during the tax period and the denominator is the average value[4] of all the taxpayer's real and tangible personal property.

- The payroll factor, defined in section 15-31-308, has a numerator of the total amount paid in Montana by the taxpayer for compensation attributable to the production of business income and a denominator of the total paid everywhere for compensation attributable to the production of business income.
- The sales factor is defined in section 15-31-310. The numerator is total sales by the taxpayer in the state during the tax period and the denominator is total sales by the taxpayer everywhere during the tax period.

The three factors are averaged and the resulting apportionment factor is applied to adjusted federal taxable income to get Montana taxable income.[5]

Allocation

A corporation that is not a unitary business but that has income within and outside of Montana must allocate its business income by using separate accounting methods as long as its records of income and expenses in the state and outside of the state can be segregated from total income and expenses. If the records do not allow for segregation, the business income must be apportioned.

Tax Calculation, Rate, and Minimum Tax

As with the individual income tax, the corporate income tax is based on a federal income figure and Montana-specific additions, subtractions, and credits. Corporations operating in more than one state or country are also subject to apportionment of income as discussed above.

The starting point for determining net income is gross income for federal income tax purposes with additions provided for in section 15-31-113, which include certain interest and gains exempt from federal taxation. Deductions allowed in computing income and tax credits are contained in Title 15, chapter 31, part 1.

Corporations may also reduce taxable income by carrying back or forward net operating losses. Net operating losses may be carried back 3 years and carried forward 7 years.

Rate and Minimum Tax

The corporate income tax rate is 6 3/4% unless the taxpayer makes a water's-edge election. There is also a $50 minimum tax for each corporation subject to tax.

The current corporate income tax rate has been in effect since 1971 and the current minimum tax since 1969.

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[4]As provided in section 15-31-307, the average value of property is determined by averaging the values at the beginning and ending of the tax period but monthly averages may be required "to reflect properly" the average value of the property.

[5]For an example see, "Department of Revenue, "Biennial Report: July 1, 2012-June 30, 2014," p. 83.

Water's-Edge Election

Montana law provides for a water's-edge election in sections 15-31-322 through 15-32-326 that allows a corporation to primarily include only its United States income in the apportionment formula. The Legislature enacted the water's-edge election laws in 1987. A corporation making a water's-edge election is subject to a higher tax rate of 7%. Section 15-31-322 requires a corporation to include the income and apportionment factors of the following affiliated corporations only:

- a corporation incorporated in the United States in a unitary relationship with the taxpayer and eligible to be included in a federal consolidated return that has more than 20% of its payroll and property assignable to locations within the United States;
- domestic international sales corporations and foreign sales corporations;
- export trade corporations;
- a corporation incorporated outside of the United States if over 50% of its voting stock is owned directly or indirectly by the taxpayer and more than 20% of the average of its payroll and property is assignable to a location inside the United States; and
- a corporation that is in a unitary relationship with the taxpayer and that is incorporated in a tax haven listed in section 15-31-322(1)(f).

The Department of Revenue is required to report to the Revenue and Transportation Interim Committee each interim with an update of which countries may be considered tax havens. Changing the list of tax havens, however, takes legislative action.

Administrative Rule 42.26.302 requires a taxpayer wishing to make a water's-edge election to file a form with the Department of Revenue within 90 days of the start of the tax period for which the election is to be effective. The election remains in effect for 3 years, as provided in section 15-31-324, unless the Department consents to change the election.

Alternative Gross Sales Tax

Section 15-31-122 implements a provision of the Multistate Tax Compact that allows for an alternative tax for a corporation that does not own or rent real estate or tangible personal property in Montana, whose only activity in the state consists of sales, and with annual gross sales in Montana of $100,000 or less. These corporations may elect to pay a tax of 1/2 of 1% of gross sales instead of the corporate income tax.

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