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Mandatory Combined Reporting for State Income Taxes

Improving Tax Compliance to Manage Conflicting State Rules

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Mandatory Combined Reporting for State Income Taxes Seminar

Aug. 4, 2011

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Sylvia F. Dion, State and Local Tax Consulting

BACKGROUND TO THIS TREND

Combined Reporting Overview

General Concepts

- **Combined reporting:** A methodology for apportioning the business income of a corporate taxpayer that is a member of a commonly controlled group. A name given to a series of calculations by which a unitary business apportions its income on a geographic basis.
- Combined unitary reporting principle and formulary apportionment have existed for more than 100 years.
 - Initially applied as methodology to apportion property taxes of railroad companies that operated in various states
 - Based on the idea that a company's multi-state business activities should be treated as a single entity, as opposed to separate activities occurring in numerous states
 - Apportionment concept applied to state corporate income taxation in *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980), in which the U.S. Supreme Court declared the unitary principle to be the "linchpin of apportionability in the field of state taxation"

Combined Reporting Overview

Contrast To Federal Consolidation

- Despite resemblance to the federal consolidated return concept (followed by some states that allow consolidated filing), mandatory combined reporting differs in a number of significant respects.
 - **Apportionment methodology vs. type of return:** Federal consolidation involves the filing of a single return for a group of affiliated corporations, with the consolidated group's tax computed as if the group were a single economic entity. In contrast, combined unitary reporting is not a type of return but rather the name given to the calculation by which a unitary business group apportions its income.
 - **80% vs. 50% ownership:** Federal consolidation requires an 80%-or-greater ownership threshold (followed by certain states that allow state consolidated filing). Most states that permit or require inclusion in a combined unitary report use a lower, 50% ownership threshold.

Combined Reporting Overview

Contrast To Federal Consolidation (Cont.)

- Comparison of federal consolidated return concept to mandatory combined reporting (Cont.)
 - **Unitary business requirement:** Federal consolidated group members are not required to be engaged in unitary business operations (this is also the case in states that permit consolidated filing). In contrast, members subject to state unitary combination (because the state's ownership threshold has been exceeded) must generally also be engaged in a unitary relationship with other combined group members.
 - **Inclusion of foreign affiliates:** The taxable income of foreign country affiliates are not included in a federal consolidated return (this is generally also the case in states that permit consolidated filing). Depending on the state's rules, some mandatory combined reporting states require or permit the inclusion of foreign country affiliates in a combined unitary report, if such affiliates meet the ownership threshold and unitary business requirement.

Combined Reporting Overview

Unitary Business Concept

- Unitary business concept: *Has evolved largely through court decisions and legal interpretation over the years*
 - Three-unities test (*Butler Bros. v. McColgan, 315 U.S. 501 (1942)*): Unity or ownership, operation and use
 - Contribution or dependency test (*Edison Cal. Stores, Inc. v. McColgan, 176 P.2d 697 (Cal. 1947)*): An enterprise's in-state business operations contribute or depend on an enterprise's out-of-state business operations.
 - Flow-of-value test (*Container Corp. of America v. Franchise Tax Board, 463 U.S. 159 (1983)*): "Some sharing or exchange of value ... beyond the mere flow of funds arising out of a passive investment"
 - Factors-of-profitability test (*Allied-Signal, Inc. v. Division of Taxation, 504 U.S. 768 (1992)*): Looks to functional integration, centralization of management and economies of scale

Sylvia F. Dion, State and Local Tax Consulting

DIFFERENCES IN MANDATORY, ELECTIVE COMBINED REPORTING

Combined Reporting Overview

Comparison Of Group Reporting Methods

- State corporate filing options for controlled group members vary among the states.
 - **Mandatory separate-company return**
 - States that follow a mandatory separate company return approach do not permit or require consolidated returns or combined unitary reports.
 - Each member of a commonly controlled group, even those in a unitary relationship with each other, must file as a separate economic entity (e.g., Delaware, Maryland, Pennsylvania).
 - **Elective state consolidated return**
 - In these states, commonly controlled members may file a separate company return OR may elect to file a state consolidated return if the state's requirements for a consolidated filing are met.

Combined Reporting Overview

Comparison Of Group Reporting Methods (Cont.)

- Elective state consolidated return (*Cont.*)
 - About 20 states fall into this category, including Alabama, Florida, Iowa and South Carolina.
 - In some elective states, related corporations compute taxable income on separate basis, and the aggregate collective liability is reported on a single return.
 - Other states follow the federal consolidation method.
 - Greater-than-50% or -80% ownership requirement, depending on state
 - All filers must have nexus in the state (often referred to as a “nexus consolidation” approach).
 - Some states prohibit members with special apportionment formulas from joining in a state consolidated return.
 - Members joining in a state consolidation return are not required to be in a unitary relationship with other consolidated return group members.

Combined Reporting Overview

Comparison Of Group Reporting Methods (Cont.)

- **State mandatory combined reporting:** Not a group tax return per se but rather a methodology for apportioning the business income of a corporation that is a member of a commonly controlled group of corporations engaged in a unitary business
 - Generally based on a 50% ownership requirement
 - Generally requires the presence of a unitary relationship between group members (some exceptions, e.g., unitary relationship not required where a combined group based on a Massachusetts affiliated group election)
 - The total business income subject to apportionment may include the business income of unitary affiliates without nexus to the state.
 - If the state's requirements for combination are met, filing on a unitary combined basis is mandatory, not elective.
 - Foreign affiliates may be included in a mandatory combined filing.
 - As of 2011, approximately 24 states mandate unitary combined reporting.

Combined Reporting

Mandates Adopted In Recent Years

- Through 1985, 16 states followed a mandatory combined reporting approach including Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Minnesota, Montana, Nebraska, New Hampshire, North Dakota, Oregon and Utah.
- For almost 20 years, no state adopted mandatory combined reporting!
- In 2004, Vermont became the first state in almost two decades to adopt mandatory combined reporting (Vermont's statute became effective in 2006).
- Other states that have adopted mandatory combined reporting in recent years include:
 - Texas (in conjunction with adoption of the margin tax): Enacted in 2006, effective in 2008
 - West Virginia: Enacted in 2007, effective in 2009
 - New York (for related corporations that have substantial inter-corporate transactions): Enacted in April 2007, retroactively effective to 1/1/2007

Combined Reporting

Mandates Adopted In Recent Years (Cont.)

- Michigan (in conjunction with adoption of the Michigan Business Tax, or MBT): Enacted in 2007, effective in 2008
 - In 2011, Michigan enacted a corporate income tax to replace the short-lived MBT, effective 1/1/2012. Like the MBT, the corporate income tax mandates combined reporting; it will be covered in greater detail in this presentation.
- Massachusetts: Enacted in 2008, effective in 2009
- Wisconsin: Enacted in February 2009, retroactively effective 1/1/2009
- Additionally, on July 22, 2011, the District of Columbia's mayor, Vincent Gray, signed the FY 2012 Budget Support Act of 2011(B19-203), which adopts mandatory combined reporting effective for tax years beginning on or after Dec. 31, 2010.
- Why the resurgence in combined reporting mandates? Will more states adopt combined reporting in 2011?

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RECENT DEVELOPMENTS WITH COMBINED REPORTING

Massachusetts Combined Reporting

History And Highlights

- July 3, 2008: Gov. Deval Patrick signs H.B. 4904, *An Act Relative to Tax Fairness and Business Competitiveness*, into law mandating combined reporting for corporate taxpayers engaged in unitary business operations.
- The bill, originally filed in 2007, was intended to be a "corporate loophole closing bill"; Massachusetts' need to raise revenues prevailed.
- Comprehensive and sweeping tax reform with far-reaching impact
- Statute contained ambiguous and incomplete provisions, which have necessitated extensive regulatory and administrative explanation (through TIRs and DOR directives) and additional clarifying/modifying legislation.
- Effective for tax years beginning on or after Jan. 1, 2009
- Prior to adoption of mandatory combined reporting, Massachusetts permitted corporations which were included in a federal consolidated return, but which were not unitary, to file a "combined" return.
- Massachusetts' former "combined" return was in actuality an elective state consolidated filing.

Massachusetts Combined Reporting

History And Highlights (Cont.)

Observation

In the last three years, this comprehensive, complex and sweeping reform has resulted in the issuance of extensive regulatory (regulations) and administrative (technical information releases, DOR directives) guidance by the Massachusetts Department of Revenue, and the passage of additional legislation that has further modified and clarified the Massachusetts mandatory combined reporting law.

Massachusetts Combined Reporting

Overview: Corporations Subject To Combination

- Entities included in unitary group
 - Foreign and domestic corporations (Sub C and S corps)
 - Financial institutions
 - Utility companies
 - Captive insurance companies
 - REITs and RICs
- Entities excluded from unitary group
 - Non-profit organizations with UBTI
 - MA security corporations
 - Insurance companies other than captive insurers

Massachusetts Combined Reporting

Overview: Unitary Group Defined, Filing Elections

- **“Common ownership”** is broadly defined as more than 50% control of voting power of each member of the group, whether through direct or indirect ownership by a common owner or owners, regardless of whether such ownership is through corporate or non-corporate entities or whether such owner or owners are members of the combined group. *Mass G.L. Ch. 63, §32B(b)(2)*
- **Massachusetts uses a lower threshold of 50% of voting control**, as compared with an 80% of voting control or value standard (under IRC §1504) to more broadly define an "affiliated" corporation subject to combination.
- Thus, the Massachusetts combined reporting statute broadly defines a unitary group. However, combined groups can make one of two available elections to define their combined group:
 - **Worldwide**
 - **Affiliated group**
- Absent an affirmative election, a combined group must file on a water's edge basis.

Massachusetts Combined Reporting

Overview: Default Water's Edge Defined

Water's edge entities include:

- ✓ Members **incorporated or formed in the U.S.** (including a U.S. territory or possession)
- ✓ Members **incorporated or formed anywhere with at least a 20% average** of their property, payroll and sales factors within the U.S.
- ✓ Members **that earn more than 20% of their income from intangible property or service-related activities**, the costs of which generally are deductible for federal income tax purposes against business income of other group members

Mass G.L. Ch. 63, 32B(c)(3)(i), (ii) and (iii)

Massachusetts Combined Reporting

Overview: Filing Elections

- Combined groups filing on a water's edge basis may elect to treat as their Massachusetts combined group, all corporations that are members of its U.S. affiliated group. *Mass G.L. Ch. 63, 32B(g)(ii)*
- An “**affiliated group**” (for purposes of the election) is defined as:
 - An affiliated group that meets the requirements for affiliation under IRC §1504 (using a more-than-50% common ownership test) and,
 - Any company that meets the Massachusetts water's edge definition
- Excludes any corporation statutorily excluded from combination, even if it is part of the U.S. affiliated group
 - Note: Many of the developments in recent months have focused on the water’s edge provisions (covered in detail later in presentation); therefore an overview of these provisions is included to support the remainder of the presentation. For more on the Massachusetts combined reporting law, (e.g., special apportionment rules, NOL and credit sharing rules, etc.), see supplemental materials.

Massachusetts Combined Reporting

Regulatory, Administrative, Technical Corrections

- **July 3, 2008:** Massachusetts HB 4904, *An Act Relative to Tax Fairness and Business Competitiveness*, adopting mandatory combined reporting is signed into law.
- **Aug. 15, 2008:** DOR issues *TIR 08-11: An Act Relative to Tax Fairness and Business Competitiveness* (summary of the new law's major provisions)
- **Sept. 25, 2008:** DOR issues *Statement of Anticipated Regulatory Positions relating to Implementation of Combined Reporting* (offers first glance into Department's position on certain provisions).
- **Nov. 6, 2008:** DOR issues *Working Draft Regulation: 830 CMR 63.32B.2*
 - Taxpayer and practitioner comments solicited through 12/5/2008
 - This approximate 50-page draft regulation draws voluminous comments, both in terms of number and depth, which continue to pour in way beyond the Dec. 5, 2008 deadline.
- **Feb. 20, 2009:** DOR issues *Proposed Regulation: 830 CMR 63.32B.2* (The regulation has now expanded to approximately 70 pages!).

Massachusetts Combined Reporting

Regulatory, Administrative, Technical Corrections (Cont.)

- *March 6, 2009: DOR issues TIR 09-5: Payments of Estimated Tax by Business Corporations Participating in Combined Reporting under Amended G.L. c. 63, s. 32B for the First Taxable Year Beginning on or after January 1, 2009*
- *May 28, 2009: DOR issues TIR 09-8: Claiming the FAS 109 Deduction for Publicly Traded Companies*
- *May 29, 2009: Final Massachusetts Regulation 830 CMR 63.32B.2 is filed with the Massachusetts Secretary of State's Office and published in the Massachusetts Register.*
- *Jan. 13, 2009: H. 2694, "An Act Making Technical Corrections to the Combined Reporting Law," is introduced.*
- *Feb. 12, 2010: DOR issues TIR 09-18: Corporate Combined Groups, etc. Must File Returns Electronically.*
- *Feb. 25, 2010: DOR issues Directive 10-1: Extension of Time to File for Corporate Taxpayers Included in a Combined Group for the 2009 Taxable Year.*

Massachusetts Combined Reporting

Regulatory, Administrative, Technical Corrections (Cont.)

- Aug. 5, 2010: Gov. Deval Patrick signs *SB 2582, The Economic Development Reorganization Act*, into law.
- Sept. 9, 2010: DOR issues *Directive 10-5: Further Guidance Regarding the Application of the Combined Reporting Regulation, 830 CMR 63.32B.2.*
- Oct. 4, 2010: DOR issues *Letter Ruling 10-6: Application of 830 CMR 63.32B.2(8)(f), Limitation on Use of Pre-combination NOL.*
- Nov. 12, 2010: DOR issues *TIR 10-15, Certain Local Property Tax, Personal Income Tax, Corporate Excise, and Tax Administration Changes in "An Act Relative to Economic Development Reorganization."*
- Jan. 27, 2011: DOR issues *Directive 11:1: Limited Time Allowance for Withdrawal of Election Made in Connection with 2009 Combined Report.*
- April 4, 2011: DOR issues *TIR 10-16: Non-U.S. Corporation with U.S. Income Exempt from U.S. Tax Pursuant to a Bilateral U.S. Income Tax Treaty.*

Massachusetts Combined Reporting

Regulatory, Administrative, Technical Corrections (Cont.)

- July 11, 2011: Gov. Deval Patrick sign his FY12 budget bill, which includes provisions affecting combined filers.
- July 19, 2011: DOR issues *Working Draft Directive 11-XX: Seven-Month Extension for Combined Reporting Filers*.
 - **Technical information releases** (TIRs) inform taxpayers and tax practitioners of DOR's response to changes in federal or state tax laws or to court decisions interpreting those laws. A TIR states the official position of the Department of Revenue, has the status of precedent in the disposition of cases unless revoked or modified, and may be relied upon by taxpayers in situations where the facts, circumstances and issues presented are substantially similar to those in the TIR.
 - **Directives** concern current Department policy, practice or interpretation, and provide details or supplementary information, clarify ambiguities, resolve inconsistencies or explain and elaborate on issues. A Directive states the official policy of the Department, has the status of precedent unless revoked or modified, and may be relied upon by taxpayers in situations where the facts, circumstances and issues presented are substantially similar to those in the Directive.

Massachusetts Combined Reporting

Developments In Last 18 Months

- Feb. 12, 2010: DOR issues *TIR 09-18: Corporate Combined Groups, etc., Must File Returns Electronically*.
 - This requirement causes issues later, when problems discovered with certain tax preparation software (explained in DOR Directive 11-1).
- Feb. 25, 2010: DOR issues *Directive 10-1: Extension of Time to File for Corporate Taxpayers Included in a Combined Group for the 2009 Taxable Year*.
 - Recognizing first-year transition issues, DOR allows an additional month for combined group filers, or until Oct. 15, 2010.
 - As Oct. 15 deadline approaches, DOR acknowledges in taxpayer and practitioner forums that many combined group filers are struggling with first-year filing issues.

Massachusetts Combined Reporting

Developments In Last 18 Months (Cont.)

- Aug. 5, 2010: Gov. Deval Patrick signs *SB 2582, The Economic Development Reorganization Act*, into law. The purposes of the Act is stimulation of job growth and coordination of economic development activities within the Commonwealth.
- Certain key provisions:
 - Modifications to combined reporting water's edge reporting rules
 - Increase in net operating loss carryforward period
 - Decrease in capital gains tax rate for investments in start-ups
 - Expansion Of property tax exemption for manufacturing and R&D companies organized as LLCs
 - Revision and expansion of numerous economic credits

Massachusetts Combined Reporting

Developments In Last 18 Months (Cont.)

- SB 2582 modifications to water's edge combined reporting; exclusion of income exempt from federal income tax by virtue of a federal tax treaty
 - For tax years beginning on or after Jan. 1, 2009, the water's edge provisions were amended by the Act to ensure they are in line with federal income tax law with regard to foreign corporations.
 - More specifically, the Act provides that where a combined group determines its taxable net income or loss on a water's edge basis, an item of income of a non-U.S.-formed or -organized corporation that is exempt from U.S. federal taxation by virtue of a federal income tax treaty is to be excluded from the combined group's taxable income.
 - Items of expense associated with the treaty exempt income and apportionment factors related to the production of the treaty exempt income are excluded from the computation of the combined group's taxable income.

Massachusetts Combined Reporting

Developments In Last 18 Months (Cont.)

- SB 2582 modifications to water's edge combined reporting, treaty exempt income (Cont.)
 - The Act provides, however, that income exempt by virtue of a treaty will still be taken into consideration for determining whether a non-U.S. corporation is includable in a water's edge group. That is, treaty exempt income is still considered when determining whether:
 - A non-U.S. corporation has at least a 20% average of its property, payroll and sales factors within the U.S. (*Mass G.L. Ch. 63 32B(c)(3)(ii)*)
 - Or, earns more than 20% of its income from intangible property or service-related activities, the costs of which generally are deductible for federal income tax purposes against business income of other group members (*Mass G.L. Ch. 63 32(c)(3)(iii)*)
 - Non-U.S. corporations that are included in a water's edge group under either of the categories above are included in the combined group only to the extent of their items of income described in that category that are not exempt from federal income tax by virtue of a federal tax treaty.

Massachusetts Combined Reporting

Developments In Last 18 Months (Cont.)

- SB 2582 modifications to water's edge combined reporting, treaty exempt income (Cont.)
 - To the extent that a combined group member pays or accrues an expense (e.g., interest) to a non-U.S. corporate group member, and such expense results in income to the non-U.S. corporation that is exempt from federal income tax under a federal tax treaty, the income is not included in the combined group's taxable income, and the intra-group elimination provisions will not apply.
 - Thus, a deduction for the expense may be available to the combined group, but this deduction could be subject to Massachusetts' related party addback, arm's length pricing or sham-transaction provisions.
 - The changes to the water's edge provision relating to treaty exempt modified the combined reporting statute, 63 32B(3)(c), by adding new subsection (iv).
 - The combined reporting water's edge provision amendments are further explained a subsequent technical information release (TIR 10-16, issued 4/4/11 - covered later in presentation).

Massachusetts Combined Reporting

Developments In Last 18 Months (Cont.)

- SB 2582 modifications to net operation loss provision
 - The NOL carryforward provisions for NOLs generated in tax years beginning on or after Jan. 1, 2010 were extended to 20 years. NOLs generated prior to Jan. 1, 2010 remain subject to a five-year carryforward.
 - Massachusetts NOLs are carried forward on a post-apportionment basis, as determined by using the apportionment percentage for the taxable year in which the loss is incurred.
 - A corporation that incurs an NOL prior to becoming subject to Massachusetts taxation is not allowed to carry those losses forward.
 - No change was made to the Massachusetts provision disallowing a carryback of NOLs.
 - The NOL provision amendments are explained further in TIR 10-15, issued 11/12/10 (covered later in presentation).

Massachusetts Combined Reporting

Developments In Last 18 Months (Cont.)

- Sept. 9, 2010: DOR issues *Directive 10-5: Further Guidance Regarding the Application of the Combined Reporting Regulation, 830 CMR 63.32B.2.*
- In particular, **Directive 10-5** illustrates the application of the combined reporting regulation provisions that relate to a combined group's:
 - Reporting of REIT dividends [830 CMR 63.32B.2(6)(c)4]
 - Calculation of capital gains and losses and IRC Sect. 1231 gains or losses [830 CMR 63.32B.2(6)(c)8]
 - Calculation of the limitation that applies with respect to the use by a taxable combined group member (member with nexus) of a Massachusetts NOL carryforward that the member derived in a tax year prior to becoming a member of the combined group [830 CMR 32B.2(8)(f)]
- The directive also make corrections to Example 7 in the NOL carryforward provisions dealing with the relationship between allocable and apportionable losses and loss carryforwards [830 CMR 63.32B.2(8)(g) and 830 CMR 63.32B.2(8)(h)-*Example 7*].

Massachusetts Combined Reporting *Developments In Last 18 Months (Cont.)*

- Nov. 12, 2010: DOR issues *TIR 10-15, Certain Local Property Tax, Personal Income Tax, Corporate Excise, and Tax Administration Changes in "An Act Relative to Economic Development Reorganization"* in response to changes made to the combined reporting law by SB 2582.

- Although TIR 10-15 elaborates on several provisions affected by the Act, the sections of the TIR with combined reporting impact are as follows:
 - Sect. 8 (VIII), which focuses on NOLs of an “eligible business corporation”
 - Sect. 9 (IX), which deal with the combined reporting water’s-edge income inclusion/exclusion rules

Massachusetts Combined Reporting

Developments In Last 18 Months (Cont.)

- With regard to the NOL amendments, TIR 10-15 reiterates the increase in the carryforward period from five to 20 years for NOLs generated in tax years beginning on or after 1/1/10.
- The TIR also reminds that NOLs sustained by “eligible” business corporations prior to 1/1/10 will continue to be subject to the pre-law change five-year carryforward rule.
- TIR 10-15 also highlights that corporations that are subject to Massachusetts tax but are not “eligible” business corporations under the meaning of the Massachusetts NOL provisions are not eligible to claim a deduction for an NOL carryforward; nor are they eligible to share in the NOL carryforward of another taxable group member in a combined report.
 - This provision specifically affects financial institutions and utility companies, which are subject to inclusion in a combined report but which are considered “non-eligible” business corporations and therefore prohibited from claiming or sharing an NOL deduction.

Massachusetts Combined Reporting

Developments In Last 18 Months (Cont.)

- TIR 10-15 states that the Act makes two technical changes:
 - First, the Act amends the NOL provisions (under G.L. ch. 63 s. 3(5)) to make clear that regardless of whether an NOL carryforward deduction is claimed under the start-up corporation rules or the general NOL deduction rules, a corporation cannot carry forward a loss incurred in any tax year prior to its becoming subject to Massachusetts taxation.
 - Second, the Act changes the methodology for calculating an NOL carryforward from a pre-apportionment to a post-apportionment basis, for tax years beginning on or after Jan. 1, 2010.
 - NOL carryforwards are converted to a post-apportionment basis by applying the apportionment percentage applicable to the corporation in the year in which the loss was generated.
 - Finally, TIR 10-15 states that the DOR intends to issue further guidance, but does not indicate in what form the guidance will be.

Massachusetts Combined Reporting

Developments In Last 18 Months (Cont.)

- TIR 10-15 provides little in the way of substantive guidance regarding the Act's amendments to the combined reporting water's edge income inclusion/exclusion rules. The TIR simply states the following:
 - The Act amends the combined reporting statute to clarify that where a combined group determines its taxable income or loss on a water's edge basis, an item of income of a corporation organized outside of the United States is not included in the combined group's taxable income to the extent that the item is exempt from federal income tax due to a federal income tax treaty. Any items of expense and apportionment factors related to such item of exempt income will be excluded in the determination of taxable net income or loss.
- However, TIR 10-15 adds that this provision will be explained in more detail in a forthcoming TIR.
- On April 4, 2011, the DOR issued TIR 10-16, which provides detailed guidance and examples to further explain the Act's amendments to the water's edge provisions (covered later in presentation).

Massachusetts Combined Reporting

Developments In Last 18 Months (Cont.)

- Jan. 27, 2011: DOR issues *Directive 11-1: Limited Time Allowance for Withdrawal of Election Made in Connection with 2009 Combined Report.*
 - Directive was direct result of first-year combined reporting transition issue, which was affected by the DOR's prior issuance of TIR 09-18 requiring corporate combined groups to file electronically.
 - Following the Oct. 15 extended deadline for filing calendar-year 2009 combined reports, it was brought to the DOR's attention that certain combined group filers had inadvertently made either an affiliated group or worldwide election (the DOR also acknowledged in practitioner forums that more than 30% of the 2009 combined reports filed had elected one of the two optional filing methods).
 - Certain tax return preparation software programs forced users to make one of the two elections in order to complete their electronic filing.
 - The DOR also noted that the original 2009 Form 355U was potentially misleading (in particular questions 2 and 3, which asked if the combined group intended to make an election, along with the absence of a box noting that no election was to be chosen).
 - Combined groups were given until March 15, 2011 to withdraw either election on a no-questions-asked basis, even if the election was made intentionally.

Massachusetts Combined Reporting

Developments In Last 18 Months (Cont.)

- April 4, 2011: DOR issues *TIR 10-16: Non-U.S. Corporation with U.S. Income Exempt from U.S. Tax Pursuant to a Bilateral U.S. Income Tax Treaty*.
- TIR 10-16 represents the forthcoming guidance that is referenced in TIR 10-15 (issued 11/12/10) and, like TIR 10-15, provides additional guidance regarding amendments made to the combined reporting law by SB 2582.
- Specifically, TIR 10-16 provides detailed guidance which explains:
 - The corporate income tax consequences that arise when a non-U.S. corporation that is a member of a water's edge group has an item of income that is federally tax exempt by virtue of a bilateral U.S. income tax treaty
 - The corporate income tax consequences that arise when a non-U.S. corporation is subject to Massachusetts taxation (has nexus in Massachusetts) but that is not subject to combination (files on a stand-alone basis) has an item of income that is federally tax exempt by virtue of a bilateral U.S. income tax treaty
 - The determination of the net worth component, where a non-U.S. corporation is subject to Massachusetts taxation

Massachusetts Combined Reporting

Developments In Last 18 Months (Cont.)

Specific guidance in TIR 10-16 (Cont.)

- Similar to the language in SB 2582, the TIR provides an overview of the requirements for non-U.S. corporations to be subject to Massachusetts combination and inclusion in a Massachusetts combined report (it revisits the requirements for inclusion in a water's edge group of 80/20 companies (as defined in *Mass G.L. Ch. 63 32B(c)(3)(ii)*) and "income inclusion" companies (as defined in *Mass G.L. Ch. 63 32B(c)(3)(iii)*).
- Specific guidance included in TIR 10-16 is as follows:
 - Non-U.S. corporations that are included in a water's edge group as an 80/20 or "income inclusion" corporation are included in the combined group only to the extent of their items of income described in that category that are not exempt from federal income tax by virtue of a federal tax treaty.
 - Analytically, the determination as to whether a non-U.S. corporation not subject to taxation is includable in a combined report is made first, prior to considering the impacts of exempt income, expenses and apportionment factors on a combined group's taxable income.

Massachusetts Combined Reporting

Developments In Last 18 Months (Cont.)

Specific guidance in TIR 10-16 (Cont.)

- Treaty income must be completely exempt under the bilateral treaty. That is, income that is simply eligible for a reduced tax rate is not excludable from a combined report.
- Expenses attributable to exempt income and apportionment factors that contribute to the production of the exempt income are also excluded from the computation of the combined group's net taxable income.
- An outcome of claiming an exemption of treaty income on a combined report, where such income a result of income paid by a taxable member affiliate to the non-U.S. corporation is that the U.S. taxable member may be entitled to a deduction against taxable income for the amounts paid to the non-U.S. affiliate (e.g., inter-company interest, royalties).
- Taking this deduction may trigger the related party expense addback, arm's length pricing (under c. 63 s. 31I, 31J, 31K or 39A) and/or the sham transaction (s. 3A of c. 62C) provisions.

Massachusetts Combined Reporting

Developments In Last 18 Months (Cont.)

Specific guidance in TIR 10-16 (Cont.)

- With respect to the calculation of the non-income measure of the Massachusetts excise tax by a taxable combined group member, the TIR states:
 - Taxable combined group members are required to file a non-income measure return on a separate entity basis, using a separate company apportionment calculation (in addition to filing with the combined group for the income measure).
 - For the non-income measure of a taxable member, any apportionment factors that are allowed to be excluded from the calculation of the income measure of a combined group's taxable income (because such factors are associated with the production of treaty exempt income) are included in the computation of a taxable member's non-income measure.

Massachusetts Combined Reporting

Developments In Last 18 Months (Cont.)

Specific guidance in TIR 10-16 (Cont.)

- A non-U.S. corporation that is subject to Massachusetts taxation, but is not a member of a combined group, is entitled to apply the same rules with respect to excluding income exempt by virtue of a bilateral tax treaty, even though this provision is not codified outside of the combined reporting rules.
- A water's edge combined group that claims it includes a member that has one or more items of exempt treaty income that are to be excluded from a combined group's taxable income must complete a schedule stating this claim, and include the information related to this claim as part of the group's combined report.
- The commissioner has the right to deny any treaty income exemption that is not properly disclosed and reported.

Massachusetts Combined Reporting

Developments In Last 18 Months (Cont.)

- July 11, 2011: Gov. Deval Patrick signs his *Fiscal Year 2012 Budget Bill*, which includes provisions affecting combined filers.
- Most significant provisions in the budget bill affecting combined filers:
 - One-year postponement of the ASC 740/FAS 109 deduction
 - Purpose of the deduction - offset for any increase in “net deferred tax liability” that resulted from implementing combined reporting..
 - ASC 740/FAS 109 deduction available only to public companies that filed the required application and statement in July 2009; deduction to be taken ratably over a seven-year period
 - Deduction was to be taken starting in years that begin on or after 1/1/2012. The bill postpones the deduction for one year, such that public companies entitled to the deduction are not allowed to take this deduction until their tax year that begins on or after 1/1/2013.

Massachusetts Combined Reporting

Developments In Last 18 Months (Cont.)

- July 19, 2011: DOR issues *Working Draft Directive 11-XX: Seven-Month Extension for Combined Reporting Filers*.
- Currently, Massachusetts allows a six-month extension for filing a combined report.
- Directive would allow a seven-month extension for combined reporting filers.
- An additional month was proposed to let combined reporting filers incorporate information from the member corporations.
- Assuming the draft directive becomes final, taxpayers that have already made an extension request for the 2010 tax year need not take further action to obtain the additional month extension.
- Failure to pay 50% of the final tax due on or before the original due date of the return voids any extension request; a late filing penalty would apply.
- Practitioner comments accepted until 8/2/11

Massachusetts Combined Reporting

Conclusions And Critical Takeaways

- When Massachusetts adopted mandatory combined reporting, many in the practitioner and business community felt that the new law, which represented a dramatic change to the Massachusetts corporate taxation scheme, would produce significant uncertainty for taxpayers that had not been concerned with the combined unitary approach.
- Given the volume and depth of clarifying technical amendments and regulatory guidance that have been issued, it's clear that the Massachusetts combined reporting law is still evolving and has proven to be one of the most onerous combined reporting laws enacted.
- The Massachusetts combined reporting rules are complex, in particular for combined groups with multi-national operations. Key points to consider include:
 - ✓ Evaluating which controlled group members are subject to inclusion in the Massachusetts combined group report
 - ✓ Consider that Massachusetts statutorily excludes and includes certain types of corporations from combination (e.g., REITs and RICs are included, Massachusetts security corporations are excluded, etc.)
 - ✓ Consider that a combined report may include corporations that utilize different apportionment methods

Massachusetts Combined Reporting

Conclusions And Critical Takeaways (Cont.)

- ✓ For multi-national organizations, special attention should be given to whether related non-U.S. 80/20 and “income inclusion” companies are subject to combination under the water’s edge default or elected affiliated group filing methods.
- ✓ As changes made by SB 2852 relating to the exclusion of U.S. treaty exempt income earned by 80/20 or “income inclusion” combined group members are retro-actively effectively to Jan. 1, 2009, corporate groups that included what would have qualified as treaty exempt income in their 2009 combined reports should evaluate whether amending their 2009 combined report to exclude such treaty exempt income would be beneficial.
- ✓ Consider that the excluding treaty exempt income of non-U.S. group members may trigger the Massachusetts related party addback, arm's length pricing and sham transaction provisions.
- ✓ Consider the impact and application of Massachusetts' *Finnigan*-style apportionment rules (see supplemental material for detailed discussion)
- ✓ Note that the non-income component of the Massachusetts excise tax is subject to a separate company apportionment, which means two different apportionment calculations may be required.

Massachusetts Combined Reporting

Conclusions And Critical Takeaways (Cont.)

- ✓ Combined groups considering a worldwide or affiliated group election should thoroughly analyze and understand the impact of making an election.
 - Both elections are binding for 10 full years.
 - The affiliated group election in particular imposes additional restrictions. For example, all income is apportionable, instant unity for newly acquired members
 - A Massachusetts affiliated group will not necessarily include the same members included in a federal consolidated group.
 - Affiliated members are not required to be in a unitary relationship.
 - Water's edge members are included even if an affiliated group election is made.
- ✓ Analyze the application of the complex NOL and credit-sharing rules
- ✓ As the Massachusetts combined reporting rules are still evolving, consider registering to receive immediate notice of DOR pronouncements, if Massachusetts is a key combined reporting state for your corporate group.
- ✓ Direct technical inquiries can be sent to: rulesrulesandregs@dor.state.ma.us

Michigan

Michigan enacted House Bills 4361, 4362 and 4479 (Public Acts 38, 39 and 40) on May 26, 2011.

The bills made sweeping tax changes to the entire tax system for the state.

- Modifying and eliminating many tax credits
- Eliminating the Michigan Business Tax (MBT)
- Instituting a new corporation income tax
- Implementing single-sales-factor apportionment
- Imposing new withholding requirements for pass thru entities

Combined reporting remains in place under the new tax regime.

Michigan (Cont.)

- The new corporate income tax regime imposes a 6% tax on traditional C Corps and operates similarly to the income tax portion of the prior MBT.
- The new tax is effective beginning Jan. 1, 2012.
- Uses only single-sales-factor
- Pass-through entities and sole proprietorships will no longer be required to file returns.
- No filing requirement if apportioned gross receipts are under \$350,000 or the tax liability is under \$100.
- Insurance companies still face same gross premiums tax as MBT.
- Financial institutions still face net capital tax at a similar rate.

Michigan (Cont.)

The unitary business group definition is slightly altered under the new tax.

206.611(6)

"Unitary business group" means a group of United States persons that are corporations, insurance companies, or financial institutions, other than a foreign operating entity, 1 of which owns or controls, directly or indirectly, more than 50% of the ownership interest with voting rights or ownership interests that confer comparable rights to voting rights of the other members, and that has business activities or operations which result in a flow of value between or among members included in the unitary business group or has business activities or operations that are integrated with, are dependent upon, or contribute to each other.

Michigan (Cont.)

Pass-through entities are taxable entities under the MBT and are includible in the unitary business group.

The definition of unitary business group under the corporate income tax now specifies that the group includes "... persons that are corporations, insurance companies or financial institutions."

This would indicate that the corporate group no longer includes other business types such as pass-through entities.

Michigan (Cont.)

MBT and disregarded entities

Michigan does not follow the federal treatment of disregarded entities for MBT purposes. As such, disregarded entities are taxable separately from the parent entity. Each such entity should file its own MBT return or be included in a combined return with its unitary business group.

Entities that previously filed as part of the parent return are asked to amend their filings, even if there is no tax liability correction.

Failure to file penalties will be waived for corrected returns filed and paid by Oct. 31, 2011.

Michigan (Cont.)

MBT and disregarded entities (Cont.)

Returns filed pursuant to this program are to be mailed to the filing addresses:

With payment

Michigan Department of Treasury

PO Box 30113

Lansing MI 48909

Without payment

Michigan Department of Treasury

PO Box 30783

Lansing MI 48909

Michigan (Cont.)

MBT and unitary business group

A unitary business group consists of two or more taxable “persons” that satisfy BOTH:

- A control test, AND
- One or two relationship tests
 - a. Flow of value, OR
 - b. Contribution/dependency

Michigan has issued additional guidance on both tests.

Michigan (Cont.)

UBG control test, Michigan Revenue Administrative Bulletin 2010-1, Feb. 5, 2010

One “person” owns or controls, directly or indirectly, more than 50% of the ownership interests with voting or comparable rights or the other person(s).

More than 50% of total combined voting power of all ownership interests with voting or comparable rights, OR more than 50% of the total value of all ownership interests with voting or comparable rights

Includes all stock classes entitled to vote that possess power to elect board members; includes contracts and agreements conferring the power of the owner to vote in the selection of management of the company

Example: 10% owner with voting rights. 90% other owners with no voting rights. 10% owner holds 100% of voting rights and meets the control

Michigan (Cont.)

UBG control test, Michigan Revenue Administrative Bulletin 2010-1, Feb. 5, 2010 (Cont.)

Members that meet the control test are controlled groups, which can include sole proprietorships. Foreign entities are not included in the group.

Parent-sub: Chain of entities are connected through common ownership. Common parent owns more than 50% of the voting rights of at least one other entity, AND more than 50% of the voting interest of each other entity is owned by one or more of the other entities.

Foreign entities are included in the analysis of common ownership; however they are excluded from the ultimate UBG.

Michigan (Cont.)

UBG control test, Michigan Revenue Administrative Bulletin 2010-1, Feb. 5, 2010 (Cont.)

Brother-sister: Two or more entities connected through common ownership; one entity is deemed to indirectly own the other

Example: Individual owns 51% of two separate LLCs.

Example: Foreign company owns 100% of two separate U.S. Companies. U.S. Comp A is deemed to own 100% of U.S. Comp B and is part of a UBG. Foreign parent is excluded.

Combined controlled group: Three or more entities, each of which is a member of a parent-sub or brother-sister group, and one of which is a common parent in a parent-sub and a member of a brother-sister

Michigan (Cont.)

UBG control test, Michigan Revenue Administrative Bulletin 2010-1, Feb. 5, 2010 (Cont.)

Excluded interests: For purposes of determining ownership or control under the control test, the department will apply IRS excluded stock rules test (IRC 1563(c), other than (c)(2)(B)). Certain ownership interests will be excluded from determination of ownership and control, except that the state will apply the rules to all forms of ownership interest, not just corporate stock.

Rules of attribution may lead to controlled groups without true common control. In most cases, these groups would fail to satisfy the relationship tests. If, however, the group does satisfy the relationship test without true control, then the group is deemed to not satisfy the control test and files

Michigan (Cont.)

UBG control test, Michigan Revenue Administrative Bulletin 2010-1, Feb. 5, 2010 (Cont.)

Voting agreements: Voting agreements are respected as per the agreement and attributable to the true voter.

Non-stock non-profits: Control is present if more than 50% of the directors or trustees are representatives or controlled by the parent.

More than one controlled group: If an entity meets the control and relationship tests for more than one controlled group, it shall elect to be included as a member of only one group. The election will remain until the unitary relationship ceases or the state revokes it.

Michigan (Cont.)

UBG control test, Michigan Revenue Administrative Bulletin 2010-1, Feb. 5, 2010 (Cont.)

Attribution: Ownership and control includes indirect ownership through attribution.

- Family constructively owns interests owned by spouse, children, grandchildren, parents. Applies to siblings through parent/child attribution from partnerships, corporations, trusts and estates
 - Ownership interests of the PS are attributed to a 5% or more partner, in proportion.
 - Ownership interests of a corporation are attributed to a 50% or more owner, in proportion.
 - Ownership interests of trusts/estates are attributed to a beneficiary with a 5% or more actuarial interest.

Michigan (Cont.)

UBG control test, Michigan Revenue Administrative Bulletin 2010-1, Feb. 5, 2010 (Cont.)

- Attribution to partnerships, corporations, trusts and estates
 - Ownership interests of the partner are attributed to the partnership.
 - Ownership interests of a 50% or more stockholder are attributed to the corporation.
 - Ownership interests of a beneficiary are attributed to the estate.
 - Ownership interests of a beneficiary are attributed to the trust (other than an employee trust), unless it is a remote contingent interest.

Options: A person with an option to acquire any ownership interest in an organization will be attributed the ownership interest.

Michigan (Cont.)

*UBG relationship test, Michigan Revenue Administrative
Bulletin 2010-2, Feb. 24, 2010*

Two relationship tests

1. Flow of value: As evidenced by function integration, centralized Management and economies of scale
2. Contribution/dependency

Taxpayers need only meet one of the two tests to be included in the UBG.

Each member of the UBG only needs to satisfy the tests with one other member (not every member).

Michigan (Cont.)

UBG relationship test, Michigan Revenue Administrative Bulletin 2010-2, Feb. 24, 2010 (Cont.)

Flow of value test: Facts and circumstance are looked at in a cumulative effect. No one single fact is determinative.

Functional integration: Transfers between members, business activities that significantly affect the operations of the entities

Examples: Sharing of technical data, marketing, purchasing, distribution systems, intangibles, vertical or horizontal integration, inter-company sales, inter-company financing

Michigan (Cont.)

UBG relationship test, Michigan Revenue Administrative Bulletin 2010-2, Feb. 24, 2010 (Cont.)

Flow of value test (Cont.)

Centralized management: Centralized control over the overall operational strategy of the entities; management decisions that affect the business activities of the entities and that operate to benefit the operations of the group as a whole

Examples: Common officers or directors, shared management expertise or knowledge, integrated executives making major policy decisions; not the day-to-day management

Michigan (Cont.)

UBG relationship test, Michigan Revenue Administrative Bulletin 2010-2, Feb. 24, 2010 (Cont.)

Flow of value test (Cont.)

Economies of scale: Business activities that result in a significant decrease in cost of operations or administration, due to size

Examples: Pooling advertising for cost savings; centralized purchasing for cost efficiencies; volume discounts; centralized administrative functions such as legal, accounting, payroll, human resources

Michigan (Cont.)

UBG relationship test, Michigan Revenue Administrative Bulletin 2010-2, Feb. 24, 2010 (Cont.)

Contribution/dependency test (alternative to flow of value)

Business activities are integrated with or dependent upon each other; activities contribute to the value of the whole. May be many of the same indicators as the flow of value test

Examples: Financing of operations, inter-company transactions, loan guarantees

North Carolina

North Carolina

HB 619, signed June 30, 2011, effective Jan. 1, 2012

- If the secretary believes a return fails to accurately reflect NC income because inter-company transactions lack economic substance or are not at fair market value, the secretary can request additional information.
 - Economic substance requires “one or more reasonable business purposes” and “has economic effects beyond the creation of State income tax benefits.”
 - Fair market value requires the secretary to apply IRC §482 standards.
- A 90-day period is granted to the taxpayer to provide the information.
- Secretary must provide written statement to taxpayer with facts and reasons supporting belief that inter-company transactions either lack economic substance or do not represent fair market value.

North Carolina (Cont.)

North Carolina

HB 619, signed June 30, 2011, effective Jan. 1, 2012 (Cont.)

Results if no economic substance or if transactions are not at fair market value:

- DOR will add back, eliminate, or otherwise adjust inter-company transactions to accurately compute the corporation's state net income.
- If DOR's adjustments are inadequate to determine the state net income, the department can make the corporation and all members of its affiliated group operating as a unitary business file a combined return.
- Taxpayers may request written advice on whether combined reporting will be required under their specific facts and circumstances.
- The guidance must be provided within 120 days from the time DOR receives information it requested to make a determination.

Texas

Texas policy Letter Ruling No. 201007810L, July 21, 2010

The no-tax-due threshold applies to the combined group as a whole.

Texas policy Letter Ruling No. 201007808L, July 21, 2010

A passive entity cannot be included in a combined group.

However, a member of a combined group will include in total revenue the pro rata share of net income from a passive entity, to the extent it was not included in the margin of another taxable entity.

Texas policy Letter Ruling No. 201007807L, July 21, 2010

An entity meeting the ownership and unitary criteria is included in the combined group, regardless of whether the entity has nexus in Texas.

Texas (Cont.)

Texas policy Letter Ruling No. 201007784L, July 21, 2010

If any one member of a combined group receives notice that it is required to electronically transfer franchise tax payments, then the combined group is required to electronically transfer payments.

Texas policy Letter Ruling No. 201007783L, July 21, 2010

If an entity is part of a combined group report, it will not report its data on a separate initial report but will include its data with the combined group's report for the corresponding accounting period. The entity should send its initial return notification letter back to tell the comptroller the name of the reporting entity.

Texas policy Letter Ruling No. 201007778L, July 21, 2010

An individual constructively owns stock or interest that is owned by his or her spouse. There is no other attribution of ownership between family members.

Texas (Cont.)

Texas policy Letter Ruling No. 201007782L, July 21, 2010

If an entity ceases doing business in Texas and is a member of a combined group, the data that would have been reported on the final report will be included in the combined group's report for the corresponding accounting period. The entity should send its final return notification letter back to tell the comptroller the name of the reporting entity.

Texas policy Letter Ruling No. 201007781L, July 21, 2010

The determination of whether a combined group is eligible for the discount or the E-Z computation shall be made for the combined group as a whole, after eliminations. A combined group, if eligible, may file a no-tax-due information report.

Texas (Cont.)

Texas policy Letter Ruling No. 201007780L, July 21, 2010

To determine if the combined group is primarily engaged in retail or wholesale trade and therefore allowed the 0.5% rate, the combined group must meet all the qualifying criteria in Sect. 171.002(c), using the total revenue for the combined group as a whole after eliminations.

Texas policy Letter Ruling No. 201007779L, July 21, 2010

The reporting entity of a combined group selects an SIC code that is appropriate for the group based on the primary business activity of the combined group, as determined by the total revenue of the combined group after eliminations.

Texas (Cont.)

Texas policy Letter Ruling No. 201007788L, July 21, 2010

An entity acquired by a combined group is required to file a short-period, separate franchise tax report for the time period prior to becoming part of the combined group. It will then become part of the combined group report.

Texas policy Letter Ruling No. 201105045L, May 13, 2011

A combined group that originally filed separately, but that was subsequently combined, may elect any of the margin methods originally elected by any of the separate members of the group on their origin separate returns. The margin method is not limited to that of the reporting entity.

District Of Columbia

The District City Council passed legislation (again) calling for combined reporting, and it has been signed by the mayor.

Congress has 30 congressional days to approve the legislation before it can become effective.

We should know in October if there is combined reporting in D.C. for 2011. At this time, there are still many unanswered questions.

Other Updates

Colorado PLR 11-002: Colorado has special apportionment for financial institutions. The Revenue Department ruled that entities using different apportionment methodologies must be included in the same combined report.

Ray Stevens, Parker Poe

George Pretty, Parker Poe

RECENT DEVELOPMENTS WITH FORCED COMBINATIONS

Forced Combinations

Separate Return States

Relevant questions

- Does nexus exist?
- Over which entities?
- Entities permitted to file separately?
- If yes, does state possess the power to force a combined return?

	South	West/Mid-West	North/Northeast
	Alabama	Indiana	Connecticut
	Arkansas	Iowa	Delaware
	Florida	Missouri	New Jersey
	Georgia	New Mexico	Pennsylvania
	Kentucky	Oklahoma	Rhode Island
	Louisiana		
	Maryland		
	Mississippi		
	North Carolina		
	South Carolina		
	Tennessee		
	Virginia		

Forced Combinations (Cont.)

New York

Interaudi Bank (NYS Tax App. Trib.) Docket: 821659, April 14, 2011

Facts

- Interaudi is a commercial banking corporation.
- Formed BA Investments, a passive investment company, in Delaware
- Interaudi invested approximately \$100 million by “shifting” funds to BA Investments.

Issue

- Was the Department correct in forcing the combined reporting of petitioner and BA Investments?

Forced Combinations (Cont.)

New York

Interaudi Bank (NYS Tax App. Trib.) (Cont'd)

Analysis

The Administrative Law Judge properly noted that the Division is not required to attempt to correct any distortion by use of a discretionary adjustment pursuant to **Tax Law § 1462(g)** before requiring a nontaxpayer to be included in a combined report. Rather, to require that BA Investments be included in the combined group, the Division must demonstrate that there exists some agreement, understanding or arrangement between petitioner and BA Investments whereby the activity, business, income or assets of petitioner are improperly or inaccurately reflected. As we held in *Matter of U.S.*

The Administrative Law Judge properly concluded that petitioner created a distortion in its net income by claiming significant interest deductions in its combined report, while such expenses were attributable to assets held by a subsidiary corporation that was not included in the combined report. As a result, either its deductions were overstated, or its income was understated. By including BA Investments' income in the combined report, this distortion was properly eliminated.

Forced Combinations (Cont.)

Indiana

Rent-A-Center Docket: 49T10-0612-TA-106, Indiana Tax Court,
May 27, 2011

Facts

- RAC East ran 106 stores in Indiana plus 1,800 stores in the Midwest and East.
- RAC West licensed RAC's trademarks and ran 437 stores in the western U.S.
- RAC Texas ran 278 stores in Texas and employed the executive management for its affiliates.
- RAC East filed in Indiana as a separate taxpayer showing zero taxable income.

Issue

- Should RAC East be required to file a combined return with RAC West and RAC Texas (the RAC Group)?

Forced Combinations (Cont.)

Indiana

Rent-A-Center (Cont.)

Analysis: Two statutory limitations

- Ind. Code § 6-3-2-2(I)
 - Revenue Department must show the existing method fails to fairly represent the taxpayer's income derived from sources within Indiana AND must show that its alternative method is a reasonable method of fairly allocating or apportioning the taxpayer's income.
- Ind. Code § 6-3-2-2(p)
 - If the Department selects a combined return as the alternative method, it must show it is "unable to fairly reflect the taxpayer's adjusted gross income for the taxable year through use of other powers granted to the department."

Forced Combinations (Cont.)

Indiana

Rent-A-Center (Cont.)

Analysis

Accordingly, the information provided is insufficient to establish that the Department considered alternatives to assessing tax based on a combined return. More specifically, the statements in items 19 and 20 are general policy statements that invite speculation as to whether they did occur in this case. Item 21 posits a circumstance first raised post-assessment and therefore does not provide evidence that this inquiry was actually made by the Department before the case was in this Court. Item 21 also fails to substantiate the fact that it is offered to establish: i.e., disallowing two expense deductions would have resulted in a higher tax liability than forcing a combination); the conclusions drawn in the Affidavit, however, were based on disallowing three deductions. (See Resp't Des'g Evid. Ex. L ¶ 21(a)-(g).) Finally, Item 21 presents nothing more than a hypothetical situation.

Forced Combinations (Cont.)

North Carolina

Delhaize v. Lay, North Carolina Superior Court, 06 CVS 08416, 01/12/2011

Liability Issue

Facts

- The taxpayer transferred assets (including IP) to a related non-NC company.
- It began paying fees and royalties to the related company for use of the assets and created tax deductions in NC.
- The non-NC company returned cash to the taxpayer as tax-free dividends.
- The fees and royalties to the non-NC company produced no increase in income tax, because the non-NC company operated in a combined reporting state where inter-company payments were eliminated.

Issue

- Did the state abuse discretion by forcing combination of entities upon finding a return failed to disclose true earnings in North Carolina?

Forced Combinations (Cont.)

North Carolina

Delhaize v. Lay, North Carolina Superior Court, 06 CVS 08416, 01/12/2011 (Cont.)

Analysis as to tax liability

Wal-Mart also rejected Delhaize's assertion that the Secretary's administration of N.C. Gen. Stat. § 105-130.6 was unlawful. While implementing the Vision Project, Delhaize deliberately shifted its income to FLFL. This transfer resulted in a distortion of its income. The Secretary then determined through an audit that the true earnings of the company in North Carolina were not reflected in its 2000 tax return. Under the abuse of discretion standard reaffirmed in *Wal-Mart*, the Secretary's determination in this case was not clearly erroneous. Thus, based on these facts, Delhaize cannot establish that the Secretary's decision to combine its returns was arbitrary or unreasoned.

Forced Combinations (Cont.)

North Carolina

Delhaize v. Lay, North Carolina Superior Court, 06 CVS 08416, 01/12/2011 (Cont.)

Penalty Issue

Facts

- The Revenue Department failed to announce that taxpayers would not be permitted deductions for payments to an affiliated corporation when reasonable in relation to the goods and services received.
- Policies determining “true earnings” have not been consistent, and no guidance has been issued to auditors to determine what term means.
- The Department concealed the standards it was using for combining returns.

Issue

- When a forced combination produces an understated tax of 25%, does the 25% penalty of N.C. Gen Stat. § 105-130.6 apply under the circumstances of this case?

Forced Combinations (Cont.)

North Carolina

Delhaize v. Lay, North Carolina Superior Court, 06 CVS 08416, 01/12/2011 (Cont.)

Analysis as to penalty

While the Department's assessment of an automatic penalty here does not rise to a level of oppression that would "shock the conscience," and thereby violate substantive due process, *id.* at 848, 118 S. Ct. at [1717](#); see also *Eichenlaub v. Twp. of Ind.*, 385 F.3d 274, 285-86 (3rd Cir. 2004) (tax assessment), the assessment does raise serious questions concerning its comportment with procedural due process.

Because the Court determines that the Department's insufficient notice and coercive practices are themselves violative of due process, it does not consider whether taxpayers have a sufficient opportunity to be heard before the penalty is assessed.

When a corporation is charged a significant penalty for complying with the law, the result of which is an automatic, non-negligence, punitive penalty assessed by the Department of Revenue, the state's power of taxation is being exercised in a manner that is unjust and inequitable. For this reason also, the twenty-five percent (25%) penalty assessed by the Department is a violation of Article V, Section 2(1) of the North Carolina Constitution.

Forced Combinations (Cont.)

South Carolina

Media General, et.al. v. SCDOR, 694 SE2d 525, 06/14/2010

Facts

- The taxpayer, one of several affiliated companies, earned royalties and fees from licensing FCC authorizations, licenses and other IP.
- The royalties and fees were derived from activities of the taxpayer and its affiliates in South Carolina with the “owner” of the IP being outside the state.
- After a “Geoffrey” audit, the taxpayer claimed the right to determine its income under a combined reporting method via S.C. Code Ann. §12-6-2320(A)(4).

Issue

- Does S.C. Code Ann. §12-6-2320(A)(4) allow taxpayers to utilize (or be required to utilize) a combined return?

Forced Combinations (Cont.)

South Carolina

Media General, et.al. v. SCDOR, 694 SE2d 525, 06/14/2010 (Cont.)

Analysis

South Carolina's **statutory apportionment methodology** as utilized in the Department's assessments and the calculation of taxes on returns filed during the audit period **results in income taxes and license fees** for Media General, MG Broadcasting, MG Communications, and MGO in the amount of **\$3,758,320**. In contrast, the **combined apportionment methodology results in income taxes and license fees** for these same entities in the amount of **\$863,179**.

The Department's application of South Carolina's **standard apportionment formula** utilized in its proposed assessments **does not fairly represent petitioners' business activities in South Carolina**, thus resulting in a **statutory distortion** of petitioners' activities within South Carolina.

We agree with the ALC that the legislature enacted section 12-6-2320 as a relief mechanism, and hold that the plain language of subsection (A)(4) **clearly authorizes the Department to use "any other method"** to effectuate an equitable apportionment of the taxpayer's income, **including the combined entity apportionment method**. The authority cited by the Department predates the legislative enactment and therefore is not controlling on this issue.

Beverly Bareham, SC&H Group

STATES' INFORMATION- GATHERING EFFORTS

Maryland

During the 2007 special legislative session, the Maryland Business Tax Reform Commission was created to study and report on various tax change proposals, the primary focus of which was combined reporting.

For tax years beginning in 2006, 2007, 2008, 2009 and 2010, businesses were required to submit informational reporting, which allowed the state to gather statistics on the impact of proposed changes to combined reporting, *Joyce and Finnigan*, removal of single-sales-factor for manufacturers, throw-back and throw-out.

Information is still being gathered in anticipation that Maryland will again introduce legislation to implement combined reporting, and legislators will continue to want to know the revenue impacts of such changes.

Maryland (Cont.)

Revenue analysis provided was very detailed but showed mixed results over the different time periods. The revenue estimates also showed dramatic swings in revenue winners and losers between different industries and different-size companies.

Ultimately, the commission recommended against combined reporting for 2011. Some of the issues cited were: Combined reporting would introduce uncertainties at a time when the economy is already struggling, many of the tax avoidance measures businesses take have been closed due to other legislative measures, and increased volatility in the corporate income tax.

Rhode Island

HB 5894 implements new information reporting requirements for two years beginning with 2011, for purposes of a combined reporting study. September 1 is the due date, and there is a \$10,000 penalty for non-compliance.

Corporations will be required to file a pro forma corporate income tax return as if the state adopted combined reporting, and report the difference in tax due under combined reporting vs. current reporting.

Corporations will also report the difference in tax under a single-sales-factor vs. the current three-factor, sales volume in the state and worldwide, and taxable income in the state and worldwide.

The tax administrator will issue a report by March 15, 2014 to the Legislature on the policy and fiscal ramifications of combined reporting.

Rhode Island (Cont.)

- Unitary business: Two or more corporations under common control that are sufficiently inter-dependent, integrated or inter-related through their activities so as to provide mutual benefit and produce significant sharing or exchange of value among them or a significant flow of value between the separate parts. To be construed to the broadest extent permitted under the U.S. Constitution
- Members are corporations in a unitary business.
- 50% common ownership via voting control
- 80% foreign entities are excluded from the group.

Beverly Bareham, SC&H Group

Ray Stevens, Parker Poe

George Pretty, Parker Poe

FUTURE OUTLOOK

Legislative Forecast

Currently, there is a huge push toward combined reporting. It is seen by many as a “loophole closer” and a way to raise money for desperate state budgets.

Many states introduced combined reporting legislation in the past year. Although many did not pass, chances are that we will continue to see legislation introduced in the upcoming year, especially given that the states are grappling with revenue shortfalls.

Maryland

Iowa

Arkansas

Connecticut

Pennsylvania

Florida

Missouri

New Mexico

Future Developments

States whose legislatures considered combined reporting in 2011
and likely will revisit again in 2012

Alabama SB 351	Combined return
Arkansas HB 1495	Arkansas Small Business Tax Fairness Act
Connecticut HB 6628	Tax fairness act
Maryland SB 305	Corporate income tax - combined reporting
New Mexico SB 6	Combined returns
Pennsylvania SB 679	Tax reform act
Rhode Island HB 5894	Combined reports (but not tax) required for 2011 & 2012
Tennessee HB 1914	Tennessee Small Business Protection Act