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Mandatory Unitary Combined Reporting: Navigating Conflicting and Evolving State Rules

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Mandatory Unitary Combined Reporting

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Mandatory Unitary Combined Reporting: Navigating Conflicting and Evolving State Rules

- By: Jeffrey S. Reed and Mike Shaikh

- Presented to

Strafford

- September 29, 2016

Agenda

- Background
- Mechanics of Combined Reporting (Water's Edge vs. Worldwide)
- The Unitary Business Concept
- Determining Group Membership in a Combined Return
- Sales Factor Issues
- Computational Issues
- Forced Combination

Background

What Is Combined Reporting?

- Apportionment method.
- Return filing method.
- Related corporations are treated as "one taxpayer" (with exceptions) so long as they are engaged in a unitary business.
- May be contrasted with "separate entity reporting" and "consolidated reporting."
- Mandatory unitary combined reporting (MUCR) – not elective.

Trend Towards Combined Reporting

- Roughly 30 / 50 states (including DC) have adopted combined reporting in some form.
- Trend is increasingly in this direction.
- Recent examples:
  - Connecticut. MUCR effective 1/1/2016.
  - New York. MUCR effective 1/1/2015.
  - Rhode Island. MUCR effective 1/1/2015.

Why is this Trend Happening?

- The case for combined reporting:
  - States want to remain competitive with other states (economics).
  - Belief that combined reporting will increase tax revenues.
  - Method that companies are familiar with (familiarity).
  - More accurately measures income.
  - Makes it harder to shift income to related out of state companies (loophole closer).
  - United States Supreme Court has blessed combined reporting.
  - Likely easier for states to conduct combined reporting audits than separate entity audits.

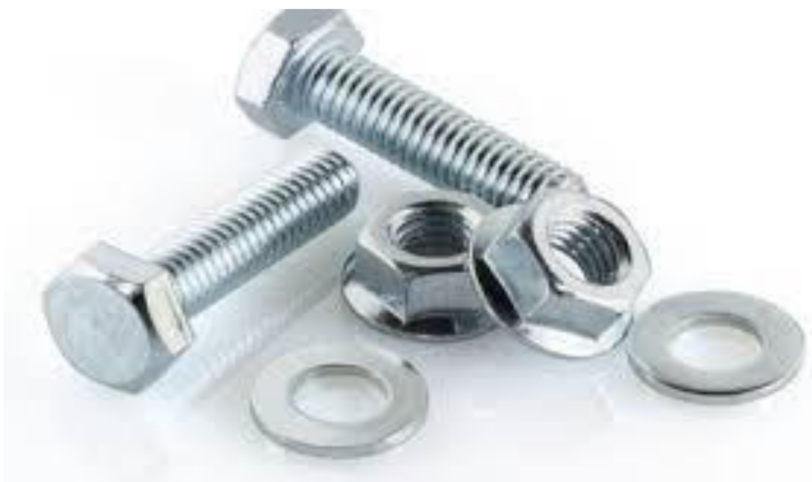
Case Against Combined Reporting

- Arguments
  - Revenue effect is difficult to predict (generally increased income in a combined return, but potentially much lower apportionment percentage).
  - "Unitary" is an amorphous concept that can easily be argued either way.
  - Brings income into a state's tax base that may be earned outside the state, causing potential distortions.

Current Battleground: New Jersey

- New Jersey S 982 (currently pending):
  - "Every taxpayer should have to play by the same rules. Closing this accounting loophole will level the playing field for all New Jersey businesses to play by the rules." - Sponsor of the bill.
  - Proponents estimate it will bring in $300 M in additional revenue.
  - "Nearly all of New Jersey's largest employers already use it when filing elsewhere." – Coalition of Small Business Owners.
  - Opposed by New Jersey Business and Industry Association.
  - "Arbitrarily assigns income to a state, negatively impacts the real economy, has an unpredictable effect on state revenue…and imposes significant administrative burdens on both the taxpayer and the state." - Council on State Taxation Testimony.

Mechanics of Combined Reporting (Worldwide vs. Water's Edge)



Mechanics (WW vs WE)

- Worldwide reporting includes all unitary members, regardless of domicile or where they do business
- Water's Edge reporting includes all members of a unitary group domiciled in the U.S., doing sufficient business in the U.S., or otherwise connected in some way to the U.S.

Worldwide reporting

- Steps:
  - Start with group income, regardless of where
  - Convert foreign income to U.S. dollars
  - Divide group income into "allocable" income and "apportionable" income
  - Separate apportionable income into in-state and out-of-state income, using apportionment factor(s)
  - Add in-state income to income allocable to the state
  - Apply tax rate
- Deferral of intercompany transactions (non-deferral treatment)

Water's-Edge—Who's In?

- Who's in?
  - U.S. Corporations
  - 80/20 Corps
  - U.S. Possessions corps
  - Corps incorporated in the U.S.
  - DISCs
  - FSCs
  - Tax Haven Corps
  - Corps with more than 50% voting stock owned/controlled by U.S. corp
  - Subpart F income
- Cousin corps in the same group?

Water's-Edge—Other Considerations

- Deferral of intercompany transactions
- Include Subpart F income and apportionment?
- Dividends received deduction/elimination
- Foreign dividend factor relief

The Unitary Business Concept

Tests for Unity

- Three Unities (ownership, use, operation)
- Contribution or Dependency
- Woolworth Test (centralized management, functional integration, economies of scale)

Woolworth

- Presumption of unity if
  - Centralized Management
    - Central control of the entities; contrast with autonomy of entities
  - Functional Integration
    - Indicia: vertical or horizontal integration, central purchasing, central manufacturing/warehousing, central accounting, central financing, central advertising, etc.
  - Economies of Scale
    - Look at the benefits of central purchasing, exchange of personnel, central management

Three Unities

- Unity of Ownership
  - More than 50% direct or indirect ownership
- Unity of Operation as evidenced by central purchasing, advertising, accounting, and management divisions
  - "Staff functions"
  - Examples: Sharing technology/information, transfers of equipment used in the business, common insurance policies, intercompany financing, shared use of brands
- Unity of Use in its central executive force and general system of operation
  - "Line functions"
  - Integration of executive control over major policy matters
  - Vertical/horizontal business relationships within the group
  - Look to group as a whole

Contribution or Dependency

- Who uses it?
  - California, Kansas, Oregon, Others
- "If the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary." (*Edison Cal. Stores v. McColgan*)
- Intercompany sales of TPP (vertical integration)
- Look also at policymaking, coordination of activities, centralized training of personnel,

Unitary Case Law

- Enterprise vs. Asset Unity.
  - Unitary corporation (enterprise) included in the return.
  - Income from unitary asset included in the return.
- Case Law.
  - *Exxon* (United States Supreme Court). Exploration and production; refining; marketing. United States Supreme Court held that all three functions were unitary.
  - *Dental Ins. Consultants* (CA). Dental insurance consulting business was unitary with a subsidiary that owned farms.
  - *ComCon Production* (CA). ComCast was not unitary with QVC, with which it held a 57% stake, because businesses were not integrated.
- Look to business or how business administered?
- Degree of integration important?

Unitary/affiliated group elections

- Consolidated groups are typically elective (as opposed to combined)
- Election to file combined only for "intrastating" in California *(Harley-Davidson)*
- State have relied on "equitable apportionment" provisions as authority for combined reporting (*Medial Genera* (SC))

Unitary Group Membership (Who is in? Who is out?)

Who is In / Out of the Group?

- Insurance companies.
  - Generally excluded, but in some states there may be a distinction between in-state and out-of-state insurance companies. *See Costco* (Oregon).
- Financial institutions.
  - May or may not be included. *See* Massachusetts regulation 830 CMR 63.32B.2(h) (making adjustments to default financial institutions apportionment rules if financial institutions are included in a combined return with non-financial institutions).

Combined Reporting and Pass-Through Entities

- If a partnership is unitary:
  - Income flows up.
  - Apportionment factors flow up.
- If a partnership is not unitary:
  - Use partnership income.
  - Apportion using partnership's factors.
- Issue: obtaining partnership apportionment.
- How do you determine if a partnership is unitary for combined reporting purposes?
  - Does Control Matter?
  - Does it matter who is the managing member?
  - Exxon (IL) case.

Instant Unity

- Timing issue: when do entities become unitary?
- Is a newly acquired company unitary at inception?
  - *Appeal of Atlas Hotels* (CA). Hotel business was unitary with fast food business it acquired immediately, where hotel business executives assumed positions as executives for the food business immediately.
  - *Appeal of Signal Companies* (CA). On audit, taxpayer failed to prove date when acquired company became unitary and SBE concluded that the acquired company became unitary in the middle of the year.
- Different approaches
  - TX (presumption of instant unity). Tex Admin. Code 3.590(b)(6)(C).
  - CO (two year requirement). Colo. Rev. Stat. 39-22-303(11)(a).

Holding Companies

- A pure holding company may have no business function at all (it could just receive dividends or investment income). When is it unitary?
  - Passive holding company that holds intangible assets used in a unitary business or holds an operating company subsidiary is deemed unitary. D.C. Mun. Regs 159.1.

Foreign companies

- Worldwide reporting: location doesn't matter
- Water's-Edge
  - Companies with less than 80% property/payroll assigned to locations outside the United States
  - *Agilent* (CO) – A corporation with no property or payroll cannot meet the 80/20 test; foreign subsidiaries disregarded for federal tax purposes should not be accounted when applying 80/20 test
  - Companies in Tax Haven jurisdictions

Sales Factor Issues

SalesFactor

86-272 and combined reporting

- Public Law 86-272 protects solicitation of sales of TPP and ancillary activities
- Are 86-272 protected entities part of the group? Is their income included? Are their activities included in apportionment factors?
- What about services related to sales of TPP? Can splitting services and TPP help?
- Effect of Joyce/Finnigan

Sales Factor – Joyce / Finnigan

- Joyce Rule – Only receipts from companies with nexus with the state are included in the sales factor numerator.
- Finnigan – Receipts from all unitary companies are included in the sales factor numerator.
- Constitutionality of Finnigan upheld.
  - *Disney Enterprises* (NY).
  - *Central Newspapers* (Arizona).
- Finnigan is the trend, but roughly half the states are still Joyce.

Computational Issues

Sharing tax attributes

- Types of attributes:
  - NOLS
  - R&D/AMT Credits
  - In-state incentives
- Unitary business theory
- California FTB interpretation: Each corporation is a separate taxpayer

State treatment of subpart F income of non-US members

- What is subpart F income?
- Worldwide combined reporting treatment
- Water's-edge treatment
  - Is Subpart F income included?
  - What about apportionment factors?
  - Difference between Subpart F and foreign dividends.

Statute of limitations issues (Turbodyne/Panavision)

- Effect of waivers
- Turbodyne (NYS) – Forced combination of corporations when a member's SOL had expired
- Panavision (NYS) – Forced decombination OK when only one corp signed waiver

Joint and several liability among group members

- Generally, one member can pay (or may be required to pay) the tax for all members
- In some states, each member may be primarily liable for its own share
- Each member of the group can be jointly liable for the whole group's tax

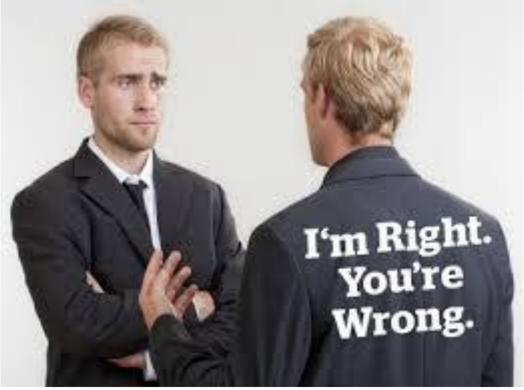
Computation of Income in California

- Start with business income of each member (nonbusiness income is allocable)
- Translate foreign income to US Dollar (or wherever the parent maintains its books and records)
- Determine total business income
- Determine group factor denominators
- Determine individual entities' numerators
- Entity's CA business income = Group income x

$$\left(Entity\ CA\ Bus.Inc. = \frac{Entity\ CA\ sales}{Group\ sales} + \frac{Entity\ CA\ Property}{Group\ Property} + \frac{Entity\ CA\ Payroll}{Group\ Payroll}\right) \div 3$$

- How to apply attributes?

Forced Combination



Forced Combination

- "Discretionary Combined Reporting."
  - New York Regime (Historic).
  - Indiana (Current).
  - South Carolina (Media General case).
- Can taxpayers take advantage of these rules?

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