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
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.
  - “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?)

BECOME A MEMBER
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
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
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 \( x \)
  \[
  \left( \frac{\text{Entity CA sales}}{\text{Group sales}} + \frac{\text{Entity CA Property}}{\text{Group Property}} + \frac{\text{Entity CA Payroll}}{\text{Group Payroll}} \right) \div 3
  \]
- 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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