COMBINED REPORTING

WITH THE CORPORATE INCOME TAX

Issues for State Legislatures

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Executive Summary

In recent years, states across the country have debated the merits of separate versus combined reporting for the corporate income tax. Advocates of combined reporting assert that its adoption will close loopholes and prevent other inappropriate tax planning options and significantly increase tax revenues by eliminating or neutralizing the effects of transactions between related parties. Advocates of separate reporting contest these revenue estimates, and also argue that combined reporting unfairly distorts the amount of income or loss earned in a state and could result in taxation of income from affiliates' activity that is more accurately attributed outside the state.

These claims and counterclaims are complicated and confusing. As a result, NCSL recognized the need for an objective review and commissioned this study. The core purposes of the study are to explain the features of combined reporting and to analyze the key issues that states should consider when determining corporate tax structures, and specifically the relative merits of separate and combined reporting. The four key issues are:

- Accurate measurement of the profit and loss attributable to a corporate taxpayer's activity in the state.
- Consequences for state tax administration and taxpayer compliance costs.
- Effects on state economic performance.
- Effects on state corporate tax revenues.

Background

Forty-four states raise revenue with a corporate income tax (CIT), as do a relatively small number of local governments. Most states begin with federal taxable income in defining the state tax base, but considerable variation exists in the ways that states determine the taxable base for multistate and multinational corporations. Tax rates are divergent and range from a low of 4.0 percent in Kansas to a high of 12 percent in Iowa. The median state has a 7.4 percent maximum marginal corporate income tax rate. State corporate income taxes have historically provided a modest share of state tax receipts – consistently less than 10 percent of total state tax revenues.

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The share of tax revenues provided by corporate income taxes has fallen over the past several decades, and corporate income taxes have declined relative to national corporate profits. There are a variety of causes for these changes, but numerous studies have not been able to isolate precisely the relative roles played by the various factors. Among the explanations that have been offered are reductions in the federal tax base, state choices to provide tax credits and reduce the corporate income tax base (for example through concessions and changes in the apportionment formula for economic development purposes), declines in the relative contributions that traditional C-corporations play in the economy as businesses have more frequently chosen other pass through institutional structures (such as partnerships, S-corporations, and LLCs), and business tax planning (i.e., state, national and international).[1]

The relative corporate income tax declines have caused policymakers to refocus their attention on all aspects of their respective state tax systems, and particularly the CIT. While a number of the identified causes go beyond decisions made by businesses, some states have assumed that the erosion is primarily due to state tax planning. As a result, many states have adopted policies to lessen the extent of actual or perceived tax planning, and particularly planning that uses multiple business structures and exploits cross state tax differences. Firms often have business purposes for creating complicated organizational structures, but these structures can also be used for tax planning. Among the policies that states have used to attack real or perceived tax planning are (i) rules that add back deductions associated with entity isolation strategies such as the use of passive investment companies (PICs), (ii) efforts to assert economic nexus over PICs and businesses with customers in the taxing state, but no physical presence, (iii) audits of firms for transfer pricing problems or to ensure that transactions between related parties have business purposes using rules similar to the IRC Section 482, and (iv) imposition of combined reporting. Combined reporting has received much of the attention in recent years based on a perception that combined reporting is an effective means of limiting tax planning. Six states have adopted combined reporting since 2006, after 30 years since any new state had adopted the policy. Today, 22 states require combined reporting as part of their corporate income tax compliance.

A fifth option that states have not considered in the context of combined reporting is the use of special audits. There may be circumstances in combined reporting states where the combined report does not accurately reflect income appropriately attributable to the state. In such circumstances, states could consider allowing certain taxpayers to use separate reporting,

[1] We have investigated these factors in several papers. For example, see William F. Fox and LeAnn Luna, "State Corporate Tax Revenue Trends: Causes and Possible Solutions," *National Tax Journal* 55: 491-508 (September 2002) for an understandable and detailed description of some of the causes of corporate tax revenue declines.

which might be informed with special private sector audits. The reporting system would be based on a separate return system, but companies would have internal accounting rules that ensure transfer prices between affiliated companies accurately reflect the actual income producing activity in the state. An independent third party, such as an auditing firm, would review and certify these results, and the corporation would bear the cost of such an audit. It is important to note that some states already require special tax audits to verify certain deductions and tax credits. For example, 20 states require an independent CPA review of the film production costs before a taxpayer may claim a film production credit, and six states require certification or taxpayer reimbursement of state expenses related to eligibility verification under certain circumstances. Similar private sector audits could also be undertaken to verify intercompany transfer prices. States would have to revise their statutes to allow for such an audit and would have to provide the detailed guidelines that state revenue departments, taxpayers, and independent auditors would be required to follow.

Combined Reporting in Practice

Combined reporting requires that a business effectively disregards the legal existence of affiliates and report on a combined basis the operations of all related entities involved in a *unitary* business. In theory, combined reporting should make the taxation of a group of entities comparable to the tax that would be paid if the business were conducted as a single entity, but in practice, the existence of different tax structures across states and industries can affect the tax burden.

Imposition of combined reporting can increase, decrease or leave the tax liability the same (both within a state and in total) for any particular combined group relative to its tax liability under separate reporting. Businesses that have both profitable and unprofitable entities that will be combined for income tax purposes are a likely set to see a reduction in total tax liability with combined reporting as the losses in unprofitable affiliates will reduce the income in profitable affiliates (something not possible under separate reporting). Firms that have used tax planning to exploit state tax differences may be most likely to experience tax increases from combined reporting.

A series of implementation options and decisions determine how combined reporting will work in any particular state. Among these issues are : (i) the definition of the unitary group, (ii) whether to use Joyce or Finnigan rules, (iii) how international businesses and income are included in the combined group, and (iv) transition concerns. Defining the combined group is surprisingly difficult. Consistent with relevant judicial decisions, states can only combine corporations that are part of a unitary group. However, there is no bright line test of “unitary,” and states have adopted different standards. A group of corporations may be considered unitary in one state but non-unitary in others and may be unitary in one year but not the next. Defining the unitary group is further made difficult by business ownership of interests in flow through entities (such as partnerships and LLCs) and business acquisitions or start ups of new businesses. Taxpayers face a significant amount of complexity and uncertainty in determining the members of the combined group, but they also gain some tax-planning opportunities because they can allow firms to enter and exit the unitary group by strategically altering the business activities conducted within each entity. This same complexity can work in favor of state tax administrators as well as they argue for inclusion or exclusion of certain businesses from the combined group based on the revenue results.

A key issue is whether firms must individually have nexus in the state before their apportionment factors can be included in the combined group's apportionment computation. Under Finnigan rules, the group as a whole is treated as the taxpayer, but under Joyce, each individual entity is regarded as the taxpayer.[2] Ten states currently use the Finnigan method, and the others follow Joyce rules.

The treatment of foreign affiliates is an important issue for states and for those firms with significant overseas operations. States elect to tax or exclude foreign entities as they permit or require businesses to make water's edge elections – an election to limit the combined report to operations within the U.S. In practice, water's edge elections or requirements only partially exclude foreign operations or entities from the combined report. For example, the foreign source income of domestic firms often is included and foreign affiliates with significant domestic activity can be included in the combined report despite a water's edge election. Further, elections to include or exclude foreign entities normally must be made for many years at a time, even though the firm's business conditions could be changing.

States that move from separate reporting to combined reporting must address a number of transitional issues. Relatively simple examples include how to treat prior year overpayments that should be reimbursed and how to calculate safe harbor estimated payments. More difficult questions involve tax attributes, including net operating losses and tax credits that were generated prior to combined reporting being enacted in a state. Should those tax benefits be available to the combined group as a whole, or only to the entity that created the benefit?

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[2] The terms refer to two California rulings that addressed this issue, *Appeal of Joyce, Inc*., California St. Bd. of Equal., SBE-XIV-215, 66–SBE-070 (Nov. 23, 1966) and *Appeal of Finnigan Corporation*, Cal. St. Bd. of Equal., 88-SBE-022, (August 25, 1988).

Evaluating Combined Reporting

We examine the effectiveness of combined versus separate reporting along four dimensions: (i) the capacity to develop a consistent, neutral measure of business profits, (ii) the effects on taxpayer compliance and state administration, (iii) the implications for output of state economies and (iv) the impacts on state corporate income tax revenues.

Corporate tax bases need to measure the taxable profits of corporate taxpayers accurately relative to one another so that the tax burden across taxpayers is distributed in proportion to their share of statewide corporate profits. The intent is to ensure that economic activity is taxed evenly across all sectors of the economy. Economists say that the tax burden is *neutral* across industries if the same tax burden is levied on all industries. Simply, this means that imposition of the tax does not favor one industry relative to another.

Separate reporting fails to measure profits properly if any of three conditions arise: (i) some related businesses earn profits and others experience losses, (ii) the combined group has shared costs (such as headquarters functions or shared inputs) and (iii) there are economies to producing different goods by related businesses (termed economies of scope). In the first case, separate reporting prevents profit making businesses from offsetting taxable income with losses from other entities, so that the amount subject to tax exceeds the combined profits of the overall business. The second and third cases are more complicated because firms may have no consistent basis for allocating costs and profits that are not uniquely linked to an individual entity. Also, the firm may not be able to determine the source of synergies between related firms. In practice, the costs and profits are separated between firms based on transfer prices if one related firm sells to another, but these prices can be subjective. These examples demonstrate that separate reporting may not result in an accurate measure of taxable corporate profits for multijurisdictional firms and in some cases for related firms within a single jurisdiction. Combined reporting is intended to overcome the problems by avoiding the need to separate shared costs or deal with economies of scope. Further, combined reporting can preclude certain tax planning strategies, such as the use of PICs to hold intangibles.

Combined reporting as it is generally imposed will not necessarily overcome the limitations of separate reporting. First, combined reporting, when used together with apportionment formulas, uses an averaging approach to determine the tax base for any state rather than trying to accurately measure the actual profits earned in a state. Apportioned combined reporting calculates an average income across both states and affiliated firms, rather than the actual profits of the businesses operating in the state. As a result, combined reporting could result in tax liability in a state where the actual company within the state is operating at a loss. Similar issues arise for attributing income across countries for corporate income tax purposes, and these are generally resolved using separate accounting.[3] Another reason is that the combined group may not include all related firms because of judicial or Congressional restrictions (e.g., PL 86-272) or state statutes that exclude some related affiliates. Water's edge requirements and states' tendencies to exclude some industries, such as insurance and finance, are examples of reasons why state statutes can prevent some firms from being in the combined group.

Lawmakers contemplating a move to combined reporting should consider the immense complexity the reporting regime will introduce for some firms. Further, the complexity comes with a great amount of uncertainty. The subjective nature of defining the unitary group guarantees that taxpayers will at times find themselves disagreeing with auditors, and there are no clear rules to resolve these inevitable differences of opinion. Complying with the rules will be most difficult for the largest taxpayers, who so often are the targets of recruiting efforts by state development offices. Complexity alone is an insufficient reason to dismiss combined reporting as a potential solution to perceived abuses, but decision makers should weigh the complexity of combined reporting as they consider other methods, such as rules against PICs and asserting economic nexus, that might achieve similar results with a smaller burden on taxpayers and revenue departments tasked with enforcing the law.

Our statistical analysis shows that combined reporting reduces private GDP in states that levy corporate income tax rates above the state median rate. Combined reporting does not harm economic activity in states with tax rates below the median and may enhance economic activity. The conclusion is drawn from an extensive analysis of the 48 continental states for the years 1993 through 2009 using appropriate econometric techniques. The method we use for this analysis is the best approach, and allows us to fully account for all of the changes that have occurred in state tax structures and economies over recent years and permits us to isolate the effects of combined reporting alone. The approach measures the influences of combined reporting based primarily on states that changed policy towards combined reporting during the study years, and specifically New York (2007) and Vermont (2006), but does so in the context of all 48 continental states.[4] Of course, other states including Massachusetts, Michigan, West Virginia, and Wisconsin have subsequently adopted combined reporting.

Combined reporting can potentially affect state tax revenues through several channels, and our goal is to measure the net of these effects. First, combined reporting can lead to a

[3] The U.S. requires firms to file consolidated returns domestically, but uses separate accounting rules internationally.
[4] New York forced combinations on a case by case basis before the new legislation that made combined reporting more mandatory.

more accurate measure of corporate profits. This should lead to greater tax liability for some combined groups but lower tax liability for other groups, meaning the influence on total tax revenues is uncertain. Second, combined reporting can help close or lessen the tax benefits from certain tax planning activities. This should increase tax revenues to the extent that combined reporting is an effective tool for closing loopholes. Third, tax revenues are expected to fall to the extent that adoption of combined reporting harms the state's economy or rise if combined reporting enhances the economy.

We find that combined reporting has no direct effect on state tax revenues, which means we find no evidence that combined reporting enhances tax revenues through the first two channels. A small decrease in tax revenues can be expected because of the fall in GDP in high tax jurisdictions and a small increase can be expected in lower tax rate jurisdictions. Further analysis of how combined reporting affects the economy and tax revenues is appropriate in coming years, and our expectation is that combined reporting will lead to a small increase in tax revenues, but at the cost of a modest decrease in the size of the state's economy.

Addback Requirements vs. Combined Reporting

We also investigated the effects of expense addback statutes on state GDP using the same statistical techniques. Addbacks are regarded as a partial replacement for combined reporting and are primarily intended to offset tax planning associated with the creation and use of single purpose entities, such as PICs, and other transactions among affiliates. Addback statutes apply to specifically identified intercompany expenses, such as royalties, interest, and management fees. When addbacks are required, the intercompany expense is disallowed for state income tax purposes. We find addback requirements have a very strong positive influence on tax revenues. That is, addback requirements are very effective at increasing state corporate income tax revenues. This is not surprising because the addback statutes increase tax bases by definition. Further, states with broader addback rules that disallow a greater number of expenditures increase revenues more than states with narrow statutes. The statistical results indicate that addback requirements are a more effective means of raising state tax revenue than is combined reporting. Addback statutes also have a strong negative effect on state GDP, and the results evidence that perverse effects on the state business climate explain at least part of the economic deterioration.

Addback statutes may result in a more accurate measure of income attributable to a state if the intercompany payments did not reflect real costs. Further, addback statutes will often bring a taxpayer's attention to the expenditure item, requiring the taxpayer to self assess whether the amount is reasonable and traceable. Otherwise, the addback provision may not improve accuracy.

The tax planning opportunities that remain with combined reporting, together with the difficulty of determining the unitary group, may make combined reporting a less effective means of generating revenue than the adoption of an addback statute. It is also possible that the effects of combined reporting on tax revenues and the economy will look more parallel to those of addbacks once statistical analysis covering a longer time period is possible.