COMBINED REPORTING UPDATE

1. Background

1.1. Current Methodologies for Taxing Corporate Income by States

1.1.1. **Separate Returns:** Perhaps the most common method is use of separate returns. Each company with nexus in a state files its own return. The separate-entity or noncombined-reporting states are Alabama, Arkansas, Connecticut, Delaware, Florida, Georgia, Indiana, Iowa, Kentucky, Louisiana, Maryland, Massachusetts, Mississippi, Missouri, New Jersey, New Mexico, North Carolina, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Virginia, and Wisconsin. The District of Columbia also is a separate-entity jurisdiction. (Nevada, South Dakota, Washington, and Wyoming do not have corporate income taxes, and Ohio is phasing out its corporate income tax.)

1.1.2. **Nexus Combination:** Under this approach, the members of an affiliated group that are doing business in a particular state combine or consolidate their income and losses and then apportion the result using the group’s combined apportionment factor. This is commonly referred to as pre-apportionment consolidation. However, some states require or allow post-apportionment consolidation, i.e., the income and losses of each taxpayer must first be multiplied by the respective member’s apportionment factor. Then the apportioned income and losses of all taxpaying members are consolidated (i.e., consolidation after apportionment).

1.1.3. **Consolidated Return:** This is analogous to how most corporations doing business in the US file at the federal level. Under this method, an affiliated group of corporations that files a federal consolidated return may elect to file on the same basis for state tax purposes. All corporations that are included in the federal consolidation also must be included in the state return. States that provide a consolidated return election include Arizona, Florida and Kentucky.

1.1.4. **Combined Reports:** This is the method used primarily in states in the Western portion of the United States, originated and popularized by California. In this case all affiliates (using an over 50% ownership test) that are “unitary” with one another are included in the combined report. All factors and income (after eliminating intercompany transactions) of the group are taken into account. Since the requirements for filing on a combined reporting basis differ from consolidated return requirements, the combined group may include some or all members of the affiliated group as well as other related corporations that do not qualify as affiliated corporations for federal tax purposes.
1.1.4.1. As of early 2008, twenty-two states require combined reporting by corporations that are members of a unitary group: Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Michigan, Minnesota, Montana, Nebraska, New Hampshire, New York (greatly expanded in 2007 from its historical reliance on dealing exclusively with intercompany pricing but requiring substantial intercompany transactions), North Dakota, Ohio, Oregon, Texas, Utah, Vermont and West Virginia. Effective for tax years beginning on and after January 1, 2005, Kentucky requires require certain taxpayers to file a nexus consolidated return. The latest of these are Michigan (gross receipts tax), Ohio (gross receipts tax), New York, Texas (gross receipts tax), and West Virginia (effective 2009).

1.1.4.2. Further, in the past few years, several separate return states have considered or are currently considering adoption of mandatory combined reporting legislation, including: Indiana, Iowa, Kentucky, Maryland, Massachusetts, Missouri, New Mexico, North Carolina, Oklahoma, and Tennessee.

1.1.4.3. At its August 17, 2006 annual meeting the MTC voted to adopt a model statute mandating unitary combined reporting. The statute requires worldwide combined filing with a waters-edge election although with substantial carve-outs (e.g., inclusion of income and factors of members that are “doing business” in a tax haven). It also states that the total income of the combined group is the sum of the incomes of each member of the combined group determined under the IRC. “Income separately determined” means starting with federal consolidated income and backing out federal consolidated adjustments. When West Virginia adopted combined reporting in 2007 it became the first state to adopt the MTC’s model statute. Montana has a similar statute.

1.2. Entity Isolation Strategies in Noncombined Report Tax Planning

1.2.1. Because many of the states, particularly on the East Coast, tax on an entity-by-entity basis, a common method for reducing state taxes involves creating additional entities that hold certain assets (e.g., trademarks, patents and other intellectual property) that are then licensed to the operating company. In other instances the operating functions are segregated so that only certain functions are taxable in a more limited number of states than if all the assets, or all the operations, were carried on in a single entity. The strategy then relies on reducing income in high tax states and increasing income in no or low tax states. The two key strategies follow.

1.2.2. Intellectual Property Company
1.2.2.1.1. This strategy relies on transferring, generally to a wholly owned subsidiary, certain intangible assets such as trademarks, tradenames, patents, manufacturing know-how, and other forms of intellectual property. The intellectual property company (“IP”) is located in a state that does not tax income from such activities such as Delaware, a state with no income tax such as Nevada, or a unitary state that will combine the entity so that there is no tax impact in that unitary state. The same effect is sometimes created by establishing intercompany debt between the IP company (or any nonoperating company) and the operating affiliate.

1.2.2.1.2. IP companies have been around for decades and in recent years have come under attack in a variety of ways that can be summarized as statutory challenges, challenges based on an expanded interpretation of nexus, and challenges based on judicial doctrines.

1.2.2.1.3. The statutory challenges include challenges to the arms-length pricing of the royalty charged between the IP and the operating entity; forced combination (e.g., *In re Tropicana Product Sales Inc.*, DTA Nos. 815253 and 815564 (N.Y. Div. Tax App ALJ Div. Nov. 25, 1998), *aff’d*, No. 815253 (N.Y. Tax App. Tribunal, June 12, 2000)); a statutory rule disallowing the operating companies royalty, interest, etc expense deduction (e.g., Ohio Revised Code §5733.052(C); relief under UDITPA Section 18 (*Unisys Corp. v. Commonwealth of Pennsylvania*, 726 A2d 1096 (1999))).

1.2.2.1.4. The challenges based on expanded nexus or economic nexus are based on *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 SE2d 13 (1993).

1.2.2.1.5. Finally, there are a series of judicial doctrines, generally established outside the state tax arena, which are finding increasing use. The most difficult is the challenge that these are tax-motivated transactions that lack appropriate business purpose. One difficulty is even knowing the circumstances when business purpose is necessary and, if so, how much. Compare *Syms Corp. v. Comm’r of Revenue*, 765 NE2d 758 (2002) (purported business purposes “must be more than theoretical musings” with *The Sherwin-Williams Company v. Commissioner of Revenue*, 778 NE2d 504 (2002) (royalty deduction disallowed with court accepting the Department’s challenges to the taxpayers asserted business purposes for establishing the IP company) and *Ex Parte Sonat, Inc.*, 752 So. 2d 1211 (1999) (dividends received deduction permitted despite no business purpose for leasing of property in the state except to qualify for the deduction). Other possible
challenges based on judicial doctrines involve a sham entity, or step transaction doctrine.

1.2.2.1.6. These difficulties are of course avoided in combined reporting states where the royalty company and the operating company are combined, eliminating the deduction and related income. Note that a taxpayer might be able to avoid combination in those states that exclude foreign corporations from a combined report by establishing the royalty company in a tax-friendly foreign jurisdiction.

1.2.3. Contract Manufacturing, Sales and Distribution Companies

1.2.3.1.1. This involves the separation of certain operating functions of a taxpayer’s business into components. The advantage is that it typically results in limiting the profit in those entities with nexus in the separate return states. Arm’s-length pricing among the affiliated entities is essential. The consequence is that, for example, the profits associated with the valuable trademarks of a company remain with the parent company which itself, under this structure, may not be present in the states where the contract manufacturing and/or sales and distribution activities are taking place. Assuming the pricing is appropriate, the profit in the manufacturing state, although it will be subjected to a much greater apportionment percentage than before, will still result in a lower tax because the tax base will be substantially smaller.

1.2.3.1.2. Except for attacking the arm’s-length pricing, this structure is more difficult for a state to upset. The one exception is to force the various affiliates to combine. Whether the price at which intercompany transactions are carried out is at arm’s-length is generally immaterial. In the separate return states, at which this strategy is aimed, an attack on the pricing would typically result in a modest change even if the state were successful.

1.2.4. Insurance Companies, REITs and Nexus Isolation

1.2.4.1.1. A recent article also noted the existence of captive REITs and captive insurance companies, and certain nexus isolation strategies, as reasons that states have moved, and in the author’s view should move, to combined reporting. Mazerov, “State Corporate Tax Shelters and the Need for Combined Reporting,” 46 State Tax Notes 621 (November 26, 2007), 2007 STT 228-2 (November 27, 2007).
1.2.4.1.2. The REIT strategy generally is that the REIT will hold real estate used by the affiliated operating company that pays rent to it, taking a rental deduction. While that creates income to the REIT, special REIT rules permit (actually mandate) that it pay at least 90% of its income out as a dividend for which it receives a dividend paid deduction, thus eliminating its taxable income. At the federal level this situation is handled by denying the dividends received deduction to the recipient. A number of states have not adopted the same rule. Even in noncombined reporting states that have adopted the rule, interposition of a holding company above the REIT that is located in a state without an income tax (e.g., Nevada) results in no tax being paid at that level. The dividend from the holding company to its parent is not from a REIT and so the special rule denying the dividends received deduction for dividends from a REIT would not apply.

1.2.4.1.3. The captive insurance company isolates in the insurance company certain income producing assets. Since virtually all state tax insurance companies on a gross premiums received basis, rather than taxing net income, the income in the insurance company is not taxable.

1.2.4.1.4. The nexus isolation strategy generally relies on Public Law 86-272 and takes those activities that are beyond the protected “solicitation” and puts those in a separate entity. Mazerov, supra argues that even though the state to which the product is shipped is able to tax the entity that is involved in the nonsolicitation activities, the major profit “likely would be retained by the manufacturing arm of the corporation because manufacturing is likely to be much more complex and involve more proprietary, technical know-how than marketing-related functions.”

1.2.5. Foreign Corporation

1.2.5.1.1. Most states that require combined reporting have adopted the “water’s-edge” reporting method under which foreign affiliates are excluded from the unitary group. Many of these states follow an “80/20” rule whereby a company will be excluded from the unitary group if it conducts 80% or more of its business outside the United States. The 80/20 test is typically applied by using quantifiable factors such as a company’s property and/or payroll.

1.2.5.1.2. The 80/20 rule presents multiple issues for taxpayers, including determining who qualifies as an 80/20 company (see Zebra Technologies Corp. v. Department of Revenue, 344 Ill. App. 3d 474, 799 N.E.2d 725 (1st Dist. 2003)) and whether the
apportionment factors of an 80/20 company should be included in the water’s-edge group’s combined factors if royalties, interest or dividends paid by the foreign affiliate are included in the domestic group’s combined tax base. *Caterpillar v. Commissioner of Revenue*, 568 N.W.2d 695 (Mn. 1997). For an intriguing, recent 80/20 issue, see *Tax Court Manpower v. Commissioner of Revenue*, Minnesota Supreme Court No. A06468 (December 7, 2006) (foreign LLC did not lose its status as an excluded foreign entity for Minnesota reporting purposes merely because it elected to be classified as a partnership for federal income tax reporting purposes).

1.2.5.1.3. California makes the water’s edge filing method elective. If a taxpayer chooses this methodology under CR&TC sections 25110 through 25114, a taxpayer is allowed to make a water’s-edge election, for an initial period of 84 months (7 years) to exclude some of the members from the combined group. Most, but not all, of the excluded members are foreign corporations.

1.3. Formulary Apportionment

1.3.1. All income-taxing states generally use one or more of three basic methods in dividing income earned by a multijurisdictional corporation: separate (geographical) accounting, formulary apportionment and specific allocation.

1.3.2. Separate (geographical) accounting is the method least used by the states in determining the amount of income, which is taxable to the state. Under separate accounting, each state considers the activities occurring within its borders as separate and distinct from that company’s activities outside its borders. Thus, separate geographical accounting requires each corporation to account separately for each item of its revenue and expense, which the state deems to have taken place within its jurisdiction. Overhead expense items are generally allocated to the different states’ share of revenue, based on some agreed-upon and acceptable accounting method.

1.3.3. Formulary apportionment is primarily relied upon by the states to divide a corporation’s income among the states where it does business. Unlike separate accounting, formulary apportionment does not purport to identify the precise geographical source of the corporation’s income; rather, it is used only as a rough approximation of the income “earned” in a particular taxing jurisdiction.

1.4. Delineation of a Unitary Business

1.4.1. By state statute and the US Constitution, a state may not apply its formulary apportionment method to a non-unitary business. A “unitary business” is defined as a business in which there is a high degree of
interrelationship and interdependence. See, e.g., Butler Bros. v. McColgan, 315 U.S. 501, 62 S. Ct. 701 (1942) (for purposes of determining the state tax liability, California permitted to look to the income of the entire entity, both within and without the state, rather than following the taxpayer’s approach that determined the income earned in the state on a separate accounting basis).

1.4.2. Originally, the formulary apportionment method was applied only when the unitary business was a single corporation. In time, however, states came to expand their definition of a unitary business to include corporate groups. Edison California Stores, Inc., 30 Cal.2d 472, 183 P.2d 16 (1947). In applying the formulary apportionment method to unitary business groups, including multiple affiliated corporate entities, “combined reporting” is a method used by some states to determine the amount of the group’s taxable income. (As will be seen below, combined reporting can be applied on either a domestic or international (worldwide) level.)

1.4.3. Determining what is a unitary business is an extremely difficult task. The facts that may be relevant to such an inquiry are all encompassing and the legal principles quite imprecise. This has led taxpayers to take aggressive positions in concluding which of their businesses are part of the unitary group. It has led to similar, revenue-driven conclusions on behalf of Departments of Revenue. Even within a single jurisdiction like California, it appears that the pendulum occasionally swings between broad and narrow definitions of unitary businesses. Among the states, there are also different approaches so that for State A a group of businesses might be unitary, and State B might reach a different result. Although there are no reported cases where states have reached opposite conclusions on the appropriate composition of the unitary group of affiliated entities for the same years, there have been situations where that has occurred and one or both of the cases settled. (In the related area of what constitutes business income, which is apportionable, and nonbusiness income, which is allocable, as indicated above there are reported decisions reaching opposite conclusions with respect to the same transaction.)

1.4.4. No state has specifically adopted any single one of the following tests to the exclusion of the others. Neither has the US Supreme Court (which becomes involved when it is a question of whether a state is taxing income beyond its borders by taking into account the income and factors of a nonunitary business—a purely constitutional question). Rather the tests are general guidelines articulated by courts or state regulations. The tests apply to business activities of a multi-entity business group or a multi-business entity.

1.4.5. The three unities test
1.4.5.1.1. Unity of ownership requires some type of common ownership between the entities engaged in a unitary business, generally a greater than 50% voting control test

1.4.5.1.2. Unity of operation evidenced by central purchasing, advertising, accounting and management divisions.

1.4.5.1.3. Unity of use evidenced by centralized executive force and general system of operation.

1.4.6. The contribution or dependency test

1.4.6.1.1. The question is whether 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.

1.4.6.1.2. In Edison California Stores, supra, the court first determined that the three unities test was met, and then went on to develop the contribution/dependency test, which is obviously a more generalized statement of the three unities test.

1.4.7. It is apparent that with these general descriptions, the task is difficult: “A final point that needs to be made about the unitary business concept is that it is not, so to speak, unitary: there are variations on a theme, and any number of them are logically consistent with the underlying principles motivating the approach.” Container Corporation, 463 U.S. 159, 167 (1983).

1.4.8. Consistent with this observation, there have been an astonishing number of state court decisions attempting to define a unitary business. In addition to the “three unities” and the “contribution and dependency” tests described above, courts have offered various other articulations. See, John I. Haas, Inc. v. Ellis, 227 Or. 170, 361 P2d 820, 822 (1961) and Crawford Mfg. Co. v. State Comm’n of Revenue and Taxation, 180 Kan. 352, 304 P2d 504, 510 (1956). However, as the leading treatise points out:

“Such generalizations, however, offer little practical guidance in deciding unitary business controversies, and, indeed, they have been repeated both by courts whose implementation of the doctrine has been highly restrictive and by others that have applied it on a very broad basis….It is often more fruitful to analyze the cases in light of their factual patterns and the attitudes of various state courts toward unitary apportionment, although from the outset one must recognize that any effort to reconcile all of the cases in this area will be futile.”
See generally 1 JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION, (hereafter

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1.4.9. Cases have ranged from the very narrow, Texas Co., 236 La. 380, 107 S2d 676 (1959) (production and purchase of crude oil in Louisiana is not unitary with refining, distribution and sales outside Louisiana), to the broad, Dental Insurance Consultants, Inc v. Franchise Tax Board, 1 CalApp4th 343 (1991) (dental insurance consultancy business found unitary with subsidiary which owned farms). For an excellent discussion, endorsing a middle ground that asks that businesses only be unitary if their basic operations are substantially interdependent, thereby providing a more quantifiable objective test, see HELLERSTEIN, supra at para. 8.09[4]. See also, State ex rel. Arizona department of Revenue v. Talley Industries, Inc., 182 Ariz. 17, 893 P2d 17 (App. 1994).

2. Adoption of Combined Reporting

2.1. With the foregoing out of the way, let us now turn to the questions that may arise when a State adopts mandatory combined reporting. While a number of the issues involved with formulary apportionment and unitary businesses are frequently issues even when only a single corporation is involved, many become larger, more frequent, more dear (in terms of the dollars at issue) when combined reporting is involved.

3. Definition of a Unitary Business

3.1.1. Obviously the question of the definition of a unitary business can arise within the context of a single business. That is, a single entity could have two divisions that despite the obvious centralized management (after all, there will be a single CEO, a single CFO, a single Chairman of the Board, etc), the divisions could be so unrelated as to not be “unitary.” The various approaches, broad or narrow definition of unitary, taken by the states are summarized above.

3.1.2. However, in the context of the adoption of combined reporting, this threshold question of what constitutes a unitary business will arise with very substantially more frequency when the question of whether affiliated companies are to be combined on a mandatory basis.

3.1.2.1. To take an extreme example, a very significant unitary combination case in California involved Tenneco and the question was whether the four main lines of business were unitary: shipbuilding, farm equipment and construction, packaging, and automotive parts. Tenneco West, Inc. v. Franchise Tax Board, 234 Cal. App. 3d 1510, 286 Cal. Rptr. 354 (4th Dist. 1992). The taxpayer alleged that the existence of strong centralized management made these otherwise disparate businesses unitary. The court agreed with the Franchise Tax Board that they were
not. At least in a state the size of California, most of the divisions had some presence in California. In a smaller state it might well have been that, for example, only the automotive parts subsidiaries operated in the state, making even more difficult and onerous gathering the necessary factual information to make the determination.

3.1.2.2. On the other hand, California courts have concluded that some very diverse businesses were unitary, in cases difficult to reconcile with the decision in Tenneco, supra.

3.1.2.2.1. For example, a corporation that provided review and advice regarding dental insurance claims for insurance companies was held to be unitary with its wholly owned subsidiary which operated a number of fruit farms. Evidence showed it was formed to provide diversification from its dental insurance business. The farms had losses and the taxpayer was successful in arguing the two corporations were unitary, enabling it to offset the consulting income with the farming losses. The court relied on intercompany financing, the centralization of certain “staff” functions and the overlap of officers and directors. Dental Insurance Consultants, Inc. v. Franchise Tax Board, 1 Cal App. 4th 343, 1 Cal. Rptr. 2d 757 (1991).

3.1.2.2.2. Similarly, a corporation engaged in manufacturing and selling lighting equipment for motion picture studios and television studios was held to be unitary with farm and ranch operations entirely outside of California that also had, surprise, significant tax losses. Mole-Richardson Co. v. Franchise Tax Board, 220 Cal. App. 2d 889, 269 Cal. Rptr, 662 (2d Dist. 1990).

3.1.2.2.3. Both cases have been criticized by the leading commentator in the state tax field as taking “too sweeping a view of a unitary business.” HELLERSTEIN, supra at para. 8.10[3]. The point, however, is not whether the cases are correct, but that there is great difficulty in making this determination, no matter how bright and fair-minded are the taxing authorities, taxpayers and adjudicatory tribunals.

3.1.2.2.4. These cases require substantial development of the facts. Especially in jurisdictions that take a liberal (or “sweeping”) view, and where strong centralized management in conjunction with some centralized departments can be sufficient to require combination without a flow of products between the affiliates, these inquiries are very time-consuming and not altogether satisfying.
3.1.2.3. In the late 1980s the California Franchise Tax Board embarked on a regulation project to flesh out the definition of a unitary business when the entities did not fit into either of the two presumptions, specifically steps in a vertical enterprise (think of oil and gas exploration, refining and sale) or entities in the same line of business (think retail stores). While the draft regulation (which was never finalized) was not of surprising length, the “white paper” that became its explication was nearly 200 pages in length.

3.1.2.4. Regardless of the exact unitary definition that a state has adopted, the following factors will almost certainly be taken into account in determining whether companies are engaged in a unitary business: vertical and/or horizontal integration; overlapping officers and directors; intercompany sales, loans and personnel transfers; centralized cash management system including daily cash sweeps; centralized expenditure approval process; common departments for accounting, tax, human resources, information technology, legal, purchasing, marketing, etc.; common pension, insurance and stock option plans; contract and budget approval.

3.1.2.5. A recent decision from the Oregon Tax Court discusses many of these factors. *Schuler Homes v. Department of Revenue*, Oregon Tax Court No. TC-MD 021243C (February 13, 2006). Another recent case held that corporation that owned timberlands in Florida, oil and gas reserves in Louisiana, securities portfolio in Illinois, and a tree farm in Oregon were unitary based on sufficient centralized management, administrative services, and financing. The court did permit adjustment in the property factor to include intangible property because of the significance of intangibles to the business. *Miami Corp. v. Oregon Dep’t of Revenue*, No. TC-MD 021295C (Feb 17, 2005).

3.1.2.6. Illinois is a combined reporting state that requires the following three elements for a unitary business: 1) common ownership; 2) same line of business (either vertical or horizontal integration); and 3) functional integration through the exercise of strong centralized management. In *The Dow Chemical Company v. Department of Revenue*, 359 Ill. App. 3d 1, 832 N.E.2d 284 (1st Dist. 2005), the Illinois Appellate Court suggested in dicta that a commonly owned group of companies that are centrally managed and functionally integrated might not be unitary if they are not in the same line of business.

3.1.2.7. A very recent Arizona case also illustrates the difficulties. Arizona is a state where the standards are slightly different that many others, certainly including California. A printing business was not required to file a combined report with two subsidiaries that provide management services, but was required to file a combined report with a trademark.
holding subsidiary. While statutory law (A.R.S. §§43-942 and 43-947) gave the Department of Revenue the authority to require combined reporting when necessary to accurately reflect Arizona source income, the decision in *Arizona Dept. of Rev. v. Talley Industries, Inc.*, 182 Ariz. 17 (Ariz. App. Ct. 1994) provided the tax court with guidance on determining whether related companies should be treated as unitary. In *Talley*, the Court of Appeals focusing on transfer pricing, found that in general, management functions could be accounted for by GAAP. In instances where a valid arm's length prices could not be established, combined reporting is appropriate. In this case, the Department tried to force the printing business to file a combined report with three of its subsidiaries -- an accounts receivable company, a factoring/investment services company and a trademark holding company that hold the printing business's trademarks.

3.1.2.7.1. On appeal the Arizona Tax Court found that the accounts receivable company and the factoring/investment services company provided management services and, therefore they do not create a unitary relationship because their value -- being equivalent to services available in the market -- can be ascertained using GAAP. In regard to the trademark holding company, the court found that it could be combined with the printing business. Because the holding company's trademarks have no value independent of the printing business's products to which they are attached, the trademarks act more as a material incorporated into the product than an ancillary service and as such can properly be treated as material transferred between the two entities. Accordingly under regulatory law (R15-2D-401(G)), the trademark holding company can be combined with the printing business. *RR Donnelley and Sons Co. v. Arizona Department of Revenue*, No. TX 2005-050288 (Ariz. Tax Ct. June 29, 2007).

3.1.2.7.2. It seems very likely that California would reach a conclusion consistent with what the DOR was attempting, namely, to combine all three of the subsidiaries.

3.1.2.8. New York modified its standards for a determination of unitary by 2007 legislation. New York continues to consider itself a separate return state but like many separate return states will combine when it deems it necessary. Over the years the DOR tried to combine taxpayers based on substantial intercompany transactions. It lost those cases when taxpayers could show that such transactions were at arms-length. For example, *Matter of Standard Manufacturing Co*, DTA No. 801415 (N.Y. State Tax App. Trib., Feb. 6, 1992).
3.1.2.8.1. The new legislation reverses those cases by determining combined reporting is necessary, merely from the existence of substantial intercompany transactions. There is no standard for substantial in the legislation but the DOR issued a Technical Service Bureau Memorandum providing for substantiality if “as little as 50% of the corporation’s receipts or expenses are from one or more qualified activities.” 20 N.Y.C.R.R. section 6-2.3(c). TSB-M-07(6)C states that the department is preparing regulations addressing the legislation's combined reporting amendments.

3.1.2.8.2. This standard differs from that in the cases described above, and that is likely to lead to some challenges. However, based on unitary cases from other jurisdictions it seems difficult to challenge combination when there has been a 50% intercompany product flow, regardless of pricing.

3.1.2.8.3. For taxpayers without substantial (i.e., 50%) product flow, apparently there is no ability to file on a combined basis.

3.1.2.9. A subset of the definition of unitary issue involves holding companies. In states that adopt a test requiring the existence of some operational connection, it is arguable that holding companies will fail this standard because, by definition, they have no operations. HELLESTEIN, Para. 8.11[3][d].

3.1.2.9.1. This issue was addressed in Appeals of PBS Bldg. Sys., Inc. and PKH Bldg. Sys., Inc., Cal. State Bd. Of Equaliz., No. 94-SBE-008 (Nov. 17, 1994) (finding that shared tax benefits, loan guaranty or loans and covenants not to compete given the holding company by the sellers were sufficient to find unity).

3.1.2.9.2. Absent this conclusion, in many instances the tax consequences could be quite harsh and surprising; for example, the interest expense incurred by the parent, and repaid by operating income of the subsidiary might not be deductible against such operating income. In addition, dividends received from the operating company might not be eligible for a dividends received deduction.

3.1.2.9.3. This theme was elaborated in two legal rulings of FTB, concluding that the parent holding company would be unitary with its operating subsidiary or subsidiaries; that an intermediate holding company would be unitary with its unitary parent and subsidiary or subsidiaries, but leaving no inference as to the resolution if the holding company had operating subsidiaries below it that were not unitary with each other. Legal Rulings 95-
3.1.2.10. Worldwide combination has been an historical thorny issue but the states right to require the inclusion of a taxpayer’s worldwide unitary affiliates was affirmed by the Supreme Court in *Container Corp. of Am. V. Franchise Tax Bd.*, 463 US 159 (1983) and *Barclays Bank PLC v. Franchise Tax Board*, 512 US 298 (1994). Ironically, the victory of the states in these two cases did not lead to an increase in the use of worldwide combination from the 12 states that employed it in 1983, but just the reverse. Responding to pleas (pressure?) from multinational corporations, as well as the threat of federal legislation, states legislatively repealed worldwide unitary apportionment. At the present time, it is seems very unlikely that a state would return to worldwide combination and so the unique issues presented in that context will not be addressed.

3.1.3. Should a state adopt a particular approach to unitary?

3.1.3.1. First, it is clear that there is no single “correct” definition of a unitary business, either under the Constitution or under case law in the states. Numerous cases from other jurisdictions make clear that each state’s taxing authority has broad latitude under the Constitution and, generally, from the very limited definition provided in the statutes. The broad definition exists outside California as well. *Earth Resources Co. v. State Department of Revenue*, 665 P.2d 960 (Alaska 1983) (road paving unitary with oil refinery, river barges, retail gasoline, and mining); *Silent Hoist and Crane, Inc. v. Director of Taxation*, 494 A. 2d 775 (N.J. 1985) (manufacturing held unitary with commercial real estate).

3.1.3.2. There is one approach that is hard to justify, namely the historic New York approach that as played out in the cases had required the party seeking to force combination to prove distortion, leading to a battle over the existence or nonexistence of nonarms length transactions. See HELLERSTEIN, para. 8.11[3][c][i]. This led in recent years to the cases requiring a sophisticated analysis of the IRC section 482 rules. See also *In the Matter of the Petition of Hallmark Marketing*, New York Division of Tax Appeals No. 819956 (January 26, 2006) for a recent application of the New York combination approach. Presumably this led the legislature to change the law in 2007 as described in paragraph 3.1.2.7 above. For an excellent discussion of this history and the new legislation, see Faber, “New Combined Report Rules for New York State,” 45 State Tax Notes 225, 2007 STT 142-1 (July 5, 2007).

3.1.3.2.1. The Hellerstein treatise adopts what it characterizes as the “intermediate view” i.e., one in between the broad California view...
and the restrictive view adopted in the Louisiana and Mississippi cases noted above. HELLERSTEIN, para. 8.09[4]. This is characterized as the “operational interdependence” test of a unitary business and, perhaps importantly, has been adopted in Arizona. State ex rel. Arizona Department of Revenue v. Talley Industries, Inc., 182 Ariz. 17, 893 P2d 17 (App. 1994).

3.1.3.2.2. The authors assert that “minor or insubstantial transactions or interrelations between segments of the business should not suffice to render a business unitary.” Id. at para. 8.09[4][c].

3.1.3.2.3. The authors believe this approach “provides a quantifiable, objective test of the unitary business.” Id. at para. 8.09[4][d].

3.1.3.2.4. An obvious argument for uniformity would be based on the MTC regulation. In 2004 MTC adopted Reg. IV.(b), “Principles for Determining the Existence of a Unitary Business.” It defines a unitary business as follows:

“A unitary business is characterized by significant flows of value evidenced by factors such as those described in Mobil Oil Corp. v. Vermont, 445 U.S. 425 (1980): functional integration, centralization of management, and economies of scale. These factors provide evidence of whether the business activities operate as an integrated whole or exhibit substantial mutual interdependence. Facts suggesting the presence of the factors mentioned above should be analyzed in combination for their cumulative effect and not in isolation. A particular business operation may be suggestive of one or more of the factors mentioned above.”

3.1.3.2.5. There are many examples and further development in the regulation. It seems to adopt the liberal definition of a unitary business followed (not altogether consistently) by the California courts.

3.1.4. In light of these differences, how correct is the following: “The uniform act, if adopted in every state having a net income tax or a tax measured by net income, would assure that 100 per cent of income, and no more or no less, would be taxed.” Pierce, “The Uniform Division of Income for State Tax Purposes,” 35 Taxes 747, 749 (1957).
4. Procedural Issues to Resolve When Adopting Combined Reporting

4.1. Does the statute of limitations run against the group or taxpayer by taxpayer?

4.1.1. Without some specific assertion in the statute to create special rules, general unitary theory would suggest that the answer is that it would be resolved entity by entity. Combination is being used to determine the income of each member of the combined group, but does not treat the separate corporate boundaries of the group as if they do not exist. However, how to determine each taxpayer member’s share of the income of the unitary group that will be subject to tax in the state, generally referred to as intrastate apportionment of the income, remains and is discussed below.

4.1.2. The theme described in para. 4.1.1 is very important to fully appreciate. Combination is only a methodology for determining the income of each member of the group over which the taxing state has jurisdiction to tax. The entities remain separate. Accordingly, the taxpayers will need to file protective claims for refund for each nexus entity in order to preserve their ability to obtain refunds and the state will have to assess each entity for its share of any deficiency.

4.1.3. California has attempted to solve the many problems that arise from this point by adopting an annual election permitting the combined reporting group to designate a “key corporation.” Cal. Rev. & Tax. Code Reg 25106.5-11. The introduction to the regulation states as follows:

"General. Every taxpayer subject to the California Corporation Tax Law is required to file its own tax return, including taxpayers that are members of a combined reporting group. Taxpayers subject to the California Corporation Tax Law that are members of a combined reporting group are required to attach a combined report to their tax returns. Notwithstanding these requirements, taxpayers subject to the California Corporation Tax Law that are members of a combined reporting group that includes another taxpayer that is also subject to the California Corporation Tax Law may annually elect to be included in a "group return" as provided for in this regulation. (See Regulation section 25106.5, subsections (b)(1), (3) and (13))."

4.1.3.1. Among other things, the regulation provides that the key corporation is

- agent for the other members,
- files a group return on behalf of all members that satisfies their obligation to file,

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1 Procedural issues are described in this paragraph 4. These are essentially the same types of (nonprocedural) issues that are described below as part of “who is the taxpayer.”
• can execute extensions of the statute of limitations,
• notices to the key corporation constitute notices to all,
• refunds or credits can be made to the key corporation.

4.1.3.2. Specific rules are provided for dealing with corporate affiliates who are not believed to be unitary, or are subsequent determined to be in or out of the combined group.

4.2. Are claims for refund filed for the group, or taxpayer by taxpayer? See 4.1.1.

4.3. Is the tax liability of the group individual or joint and several? The latter applies under specific federal consolidated return rules, as a consequence of making the election to file a consolidated return. Unitary theory would suggest that absent a specific provision in the statute, there would not be joint and several liability. Texas recently went to some form of combination and this issue has already arisen (the statute is silent), although, as mentioned, it is arguable that there cannot be joint and several liability unless there is a statute establishing it, or it is agreed to as a condition of an election and/or entering into a contract.

4.4. Can an audit of the combined group deal only with the single group or must it be with the individual taxpayers? See 4.1.1.

4.5. Must a unitary group receive permission to file a combined report? In Indiana, the answer is yes. But see Kohl’s Department Stores v. Indiana Department of State Revenue, Indiana Tax Court, No. 49T10-0209-TA-110 (February 9, 2005) (holding that permission was not required to discontinue the filing of a combined report).

4.6. All of the above issues can be complicated by the fact that there will be circumstances where, in the time interval between the tax year and the conclusion of audit or litigation, some of the members of the group may no longer be in existence, may be in existence but no longer related by ownership, may be in bankruptcy.

5. Accounting methods, elections etc.

5.1. How are accounting methods, installment sales, and other elections to be treated? By group or entity by entity? See 4.1.1

5.2. Do all members have to make the same election?

5.3. Rules are needed to deal with “fiscalization” issues, i.e., entities that leave or join the group part way through the year, entities that are not on the same tax year. Again, California has an elaborate regulation dealing with this and many other issues, specifically, Rev & Tax Code Reg 25106.5-5.
5.4. As will be described below, a significant issue is dealing with intercompany transactions, i.e., transactions between members of the unitary group. That will also include issues when the entities breakup and are no longer unitary with each other. Resolution of this depends on the approach taken to the intercompany transactions in the first place.

6. Possible need for special formulas.

6.1. One consequence of combination is that entities that are on different formulas may nevertheless be included in the combined report. The MTC and other states have numerous special formulas that deal with industries such as trucking companies, pipelines, contractors, banks and financials, franchisors, commercial fishing, air transportations companies, motion picture and television producers and television networks, railroads, print media.

6.1.1. California has a special regulation addressing the problem of combining entities otherwise on separate formulas, Reg. 25137-10 Combination of General (Non-Financial) and Financial Corporations.

6.1.1.1. These rules provide that when a general corporation is predominant (greater than 50 percent of gross income), the financials in the group have their intangible property reduced to 20% of its federal tax basis. Without this, the financial would dominate the property factor. There are also sales factor assignment rules for transferred receivables that seek to maintain the reflection of the market for the underlying tangible property sold by the general and then transferred to the financial.

6.1.1.2. What should be done in situations where the general is not predominant? Examples include banks that own broker/dealers. In this situation, the general has a sales factor that includes all of its gross receipts, but the financials only include receipts to the extent of income. When they are combined, this leads to a sales factor that reflects very little other than the general’s business and thus needs to be adjusted. Similarly, the property factor may need to be adjusted due to the financial rules.

6.1.2. One issue that has troubled a number of states is whether insurance companies can be included in the combined group. It can be argued that there is no reason insurance companies cannot be included. A methodology will have to be developed, as with any entities in the combined group to determine, how much of the taxable income of the entire group is to be included in each entity. If the insurance company were not subject to income taxes (usually because they pay taxes only on gross premiums) then the income apportioned to the insurance company would not be taxes. Arguably, this is no different from the income of a general corporation that is a member of the combined group but not taxable in a particular state. The MTC’s combination regulation ducks this issue, possibly in response to
submissions of insurance companies asking not to be included, or perhaps because California, often a significant player in MTC projects, does not include insurance companies in its combined returns.

7. Who is the Taxpayer?

7.1. Many of the issues that arise with combined returns may be characterized as variations of the “who is the taxpayer?” question. Certainly the procedural issues described in paragraph 4 above and the accounting issues and elections in paragraph 5 would fit here. This section looks at those that relate to substantive issues.

7.1.1. Credits.

7.1.1.1. An issue unresolved after more than 50 years of combined reporting in California was resolved recently. General Motors v. Franchise Tax Board, 39 Cal. 4th 773, 139 P3d 1183 (2006), involving the utilization of research and development credits, although most or all other credits raise the same issue. The question is whether the credits are limited to the entity that performed the research that generated the credit, or whether the credit is spread among all entities in the unitary group.

7.1.1.2. The facts illustrate this issue particularly nicely. Delphi, a subsidiary of G.M., operates in California and engaged in substantial research activities there. On a separate basis Delphi had sufficient income to utilize all the credits. On a combined basis, Delphi and GM had sufficient California income to utilize the credits. However, after Delphi was combined with GM, and then the combined income allocated back to the California nexus entities, Delphi alone did not have sufficient income to soak up the credits generated by its activities.

7.1.1.3. The court concluded that the credits were trapped at the level of the particular entity that performed the activities that lead to the credit. However, the decision was not based on unitary theory but the court’s reading the federal rules for the research and development on which the California credit was based, and a negative inference regarding legislative intent based on the fact that the legislation covering a different credit specifically permitted its sharing by the California taxpayers in the unitary group.

7.1.1.4. The solution is to provide an answer by statute or regulation. Arguably, it is not consistent with the general approach of unitary taxation to leave the credits trapped in the entity that did the requisite activities to generate the credit, particularly when the credits involve activities so central to the unitary business as research and development.
7.1.1.4.1. Although apparently there has been no litigation, the Florida DOR has historically taken the same position taken by FTB and sustained in General Motors, supra. Georgia does the same by statute. Ga. Comp. R. & Reg. 560-7-3-13. Illinois takes the opposite approach. Ill. Adm. Code Sec. 100.5270(d)(1). Further, any combined credit carryforward is available to the combined group for the next return year. Ill. Adm. Code Sec. 100.5270(d)(6).

7.1.1.4.2. An alternative is to have the Legislature consider each credit it enacts, case by case, as to whether the credits would be trapped or not. See, for example, Cal. Rev & Tax Code section 23612.5(q)(1)(A) permitting a corporation to elect to assign any portion of the low income housing credit to any affiliated corporation (in this case affiliation is defined by ownership and not by unitary standards). Since corporate taxpayers investing in low income housing projects would be likely to want to use a separate, single purpose (limited liability) entity to make such an investment, this was probably necessary to encourage the desired investment in such projects.

7.1.1.4.3. If a member leaves or enters the group how are credit carryforwards handled? Are they an asset of the group, or of the member who generated it, or the members to whom it was allocated?

7.1.2. Intrastate Apportionment.

7.1.2.1. An issue most likely to arise regarding apportionment of credits involves the methodology for determining the taxable income of those taxpayers doing business in the taxing state. While the general three factor (or other) formula will determine how much income is apportioned to the taxing state, it may not lead to a satisfactory result regarding the apportionment of that state income among the entities with nexus in the state. This may be critical for determining whether there is sufficient income to absorb a credit, if that credit trapped at the entity engaged in the credit producing activity.

7.1.2.1.1. To take an extreme example, suppose a state uses a single factor sales formula and that there are two entities doing business in the state. One entity engages in research and development and sells its technology to the instate affiliate. If its sales are eliminated, as such sales would normally be done for determining how much income is apportioned to the state, its factor would be...
zero and the taxable income apportioned to it would be zero. Thus it could never utilize the credit it generated.

7.1.2.1.2. A similar example would happen if one entity manufactured a product and sold it to a distribution company. If intercompany sales are eliminated its intrastate apportionment percentage would be zero and its share of the instate income zero. Thus any manufacturing related credits would not be utilizable.

7.1.2.1.3. Query: Could these problems be avoided by simply adjusting the corporate structure? Could this be a trap for the unwary? In states where credits are clearly determined on an entity specific basis, care should be taken when choosing to isolate research and development in a separate entity.

7.1.3. Nonbusiness gains and losses

7.1.3.1. The same issue arises with regard to nonbusiness gains and losses, especially the latter. Is the loss only deductible against the apportioned of the entity that generated the nonbusiness loss? This is the approach consistent with unitary theory and generally, if not universally, followed.

7.1.4. Nonbusiness interest

7.1.4.1. A somewhat odd but knotty problem. Suppose a private equity (PE) fund purchases an operating company (ABC) and debt is used (as usual) to payoff the departing shareholders. Is the interest on the debt business or nonbusiness interest? Does it matter how it is structured? Here are some relevant authorities.

7.1.4.1.1. If operating company ABC buys unitary subsidiary XYZ and incurs debt, no one would argue that it is not a business expense as a cost of expanding ABC’s unitary business.

7.1.4.1.2. If HoldCo, a holding company buys XYZ and they become (instantly) unitary the interest would be a business expense per *Appeal of PBS Building Systems*, 94-SBE-008 (Nov. 17, 1994), FTB Legal Ruling 95-7.

7.1.4.1.3. If Private Equity Fund Inc. (PE) purchases a single share of EFG and EFG borrows funds to redeem all the other shareholders, apparently the interest is non business because it relates not to an operating function but a corporation/shareholder function. *Robert Half Int’l Corp. v. Franchise Tax Board*, 66 Cal. App. 4th 1020 (1st Dist. 1998). (Although the Half court reached this decision because it related to an “extraordinary” transaction, the California
Supreme Court “clarified” that *Half* was correctly decided, not because it was an extraordinary event, but because “control of the warrants [which were repurchased at a loss] did not contribute materially to the production of any business income.” *Hoechst Celanese v. FTB*, 22 P.3d 324, 341 (2001). In Kansas interest expense from borrowing money to defend against a hostile takeover was nonbusiness. *Appeal of The Kroger Co.*, 12 P.3d 889 (Kan. 2000).

7.1.4.1.4. As an alternative to the preceding paragraph, suppose PE borrows funds and buys out all the shareholders of EFG? Result? Does form govern?

7.1.5. Earnings and profits

7.1.5.1. The question here is whether the earnings and profits are treated as part of the unitary group, and then apportioned the way taxable income would be, or captured at the entity that generated the earnings and profits on a separate return basis. California case law concluded that latter, that the earnings and profits are at the level of the individual entity that earned them even though that entity was part of a combined group and even though the California taxable income arising from the business would have been apportioned among the members.

7.1.6. Capital gains and losses and IRC section 1231 gains and losses, involuntary conversions and other preferentially treated items.

7.1.6.1. Anytime there is preferential treatment for certain taxable transactions, a similar question will arise: Is the item in question to be treated as trapped at the level of the entity that generated it? For example, if a business capital gain is generated by an entity with no nexus with the taxing state, but the income is taken into account in the apportionment to the taxing state, is preferential treatment available. In general, it would seem the answer should be yes. If the item is business income, following apportionment to the entities with nexus in the state some piece of that capital gain will be treated as if it were allocable to the nexus entities, and preferential treatment should be available. Greater difficulty may arise when deciding how to offset, for example, business capital gains with nonbusiness capital losses.

7.1.6.2. California Reg. Section 25106.5-2 deals elaborately with this question. It requires first distinguishing between nonbusiness gains and losses (which are trapped where they occur) and business gains and losses which are aggregated for the entire group, and then apportioned to the members, and then offset against nonbusiness gains and losses.
7.1.6.3. The MTC model statute adopts the California approach. Section 3.C.(g).

7.1.7. Sales factor and throwback rule (the Joyce/Finnigan question): Does nexus in the destination state by an affiliate of a seller that does not have nexus in that state treated as nexus in order that the throwback rule does not apply?

7.1.7.1. For states with a throwback rule, it must be determined if nexus by a unitary affiliate is treated as nexus for the seller such that there is no throwback. Most states currently have the Joyce rule (described below). Arizona, Kansas and Utah employ the Finnigan rule (described below).

7.1.7.2. California has had both positions as part of its (judicially created) law for substantial periods of time. The controversy is routinely referred as the Joyce/Finnigan issue after the two lead cases.

7.1.7.2.1. Joyce concluded that only the nexus of the selling entity could be considered. Thus if entity X sold goods and shipped into State A, the throwback would operate even if affiliated entity Y did have nexus in State A. Finnigan reversed that position, holding that the nexus of any unitary affiliate could be taken into account in making that determination. This had the effect, with respect to incoming sales of tangible personal property, of implicating Public Law 86-272 that exempts from income taxes sellers of tangible personal property whose only activities in the taxing state are solicitation.

7.1.7.2.2. Suppose that an out-of-state seller sells into a state in which it is protected by P.L. 86-272, but it has a unitary affiliate that has nexus in that state. If the conclusion is that those sales are not thrown back, what is to be done? During the era when Finnigan was the law in California, the FTB added those sales to the numerator of the affiliate (not the seller), thereby hoping to avoid violating P.L. 86-272 since the seller that enjoyed the federal law’s protection was not being taxed. The FTB’s use of Finnigan was subsequently upheld in Citicorp N. Am. v. Franchise Tax Bd., 83 Cal. App. 4th 1403 (2000).

7.1.7.2.3. Eventually, California returned to the Joyce approach and did so by regulation. Reg 25106.5(c)(7)(B)(3) states that in applying the sales factor “the term ‘taxpayer’ refers to the specific member of the group which transferred title to tangible personal property to the purchaser.”
7.1.7.2.4. Recently, California adopted regulation 25137-14 to address the apportionment of income for the mutual fund industry. As part of those regulations, the mutual fund industry was put back on the Finnigan methodology to more clearly reflect the activities of these companies in the state.


7.1.8. Intercompany Sales

7.1.8.1. One of the most significant issues is the treatment of intercompany sales. Since no income has been earned by the unitary group until the product is sold outside the group, it is appropriate that the income from the sale should not be included (yet), and that the receipts from the sale not included in the sales factor. Both results should be made clear.

7.1.8.2. The two primary alternatives for dealing with the sale are elimination of the sale, or some deferred intercompany sale regime similar to the federal consolidated return regulations.

7.1.8.3. How to handle this issue will also be complicated by how closely a state ties the definition of taxable income to federal taxable income. If so, there is a complexity as to whether any adjustments required by the federal consolidated return regulations have automatically been taken into account. In general, it would seem that the appropriate approach is to disregard the federal consolidated return adjustments, except to the extent a state chooses to adopt them. This is because they are generally inconsistent with unitary theory or, at the least, are utilized by a system that is very different from combined reporting. Elimination is also the system used by the federal government prior to the adoption of the elaborate consolidated return rules in 1966.

7.1.8.3.1. For example, current federal consolidated rules require a parent to adjust its stock basis up or down to account for the income or loss of the subsidiary. Unitary theory, at least as interpreted by California, would not require those adjustments. Thus the sale of the stock of a unitary affiliate may result in a significantly greater (or lesser) gain on the sale of stock than existed for federal

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2 Even in California that has a freestanding income tax regime, the issue has arisen where taxpayers could not believe that some adjustment taking place for federal purposes under the consolidated return regime was not being taken into account for California tax purposes.
purposes. (In California, this is a very common issue, often inuring to the taxpayer’s substantial benefit or detriment depending on whether the net adjustments have been up or down.)

7.1.8.3.2. As part of the same regime, federal rules treat the earnings and profits of the subsidiary as if they were dividended up to the parent, that is earnings and profits tier up to the ultimate parent of the consolidated group. Since no cash actually changed hands, the rules pretend that the cash from the hypothetical dividend is contributed back, accounting for the increase in stock basis. Where are the earnings and profits for combined reporting? See section 7.1.3 above.

7.1.8.4. The correct theory under combined reporting is that intercompany sale items are eliminated. That is a sale from ABC corp. of an item it manufactured for $60 to its unitary affiliate for $100 should not result in $40 of income. The transaction should be eliminated and the affiliate should take a carryover basis of $60.

7.1.8.4.1. However, one must recognize that this too leads to problems since the gain of $40, when sold by the affiliate for $100 or more outside the unitary group will seem to be in the wrong entity.

7.1.8.4.2. Additionally, what if the affiliate is no longer a member of the combined reporting group. (Issues such as this arise on a larger scale in states that permit worldwide combined reporting and electing out from it, since at the time of the election out one must consider how to deal with the assets with a carryover basis or, as it is often referred to, as the “profit in inventory.”)

7.1.8.5. In California taxpayers and tax administrators operated in a bit of confusion for many, many years, although the large issues did not seem to arise, at least publicly, until taxpayers had the ability to elect out of worldwide combination.

7.1.8.6. The elaborate regulation referenced so often above, Reg. Section 25106.5 has as its longest and most difficult subsection, 25106-1, to provide answers to dealing with intercompany transactions. In general it conforms to Treasury Regulation section 1.1502.13 (intercompany transactions), with due regard for differences commanded by combined reporting, and nonbusiness gains and losses, items not at issue at the federal level.

7.1.8.7. The rules in the California regulation are effective, accomplish their purpose but very complex and not for the faint of heart. They introduce new tax terms such as the DISA (deferred intercompany stock account),
“recomputed corresponding items,” the “matching rule,” the “acceleration rule” and so on).

7.1.8.8. Aside from the definition of the unitary business, this is perhaps the most complex problem. For those desirous of “getting it right” the California regulations provide a terrific headstart. Other states have generally ignored the problem, perhaps because of being tied to federal taxable income and concluding that the federal consolidated returns are picked up automatically and perhaps because of not thinking about it at all.

7.1.9. Net Operating Losses

7.1.9.1. Net operating losses present a state with several alternatives.

7.1.9.1.1. One is to treat the loss as a preapportionment loss, that is, the entire unitary group had a loss in a particular year, and that loss is carried forward to the subsequent years (or back if state law so permits).

7.1.9.1.2. Second is the treat the loss as an aggregate postapportionment loss, i.e., the loss is apportioned back to the taxing state and the combined group carries the aggregate loss forward to subsequent years (or back).

7.1.9.1.3. Third is to treat the loss as postapportionment loss to each entity. This is the approach California adopted without benefit of legislation as, theoretically at least, consistent with unitary theory. In general this approach is probably the least favorable to taxpayers. For example, if the group had a $100 taxable loss, and there were two nexus entities, each with 10% of the overall factors of the combined group in the taxing state, each would have a $10 NOL. If the next year the group had $100 of taxable income, and still had 20% of its overall factors in the state but they had changed so that three fourths of those factors were in one affiliate and one-fourth in the other, either of the first two approaches would result in zero taxable income

- $100 overall NOL offset by $100 of overall net income;
- $20 of state specific NOL offset by $20 of state specific apportioned income).

However, the third approach under these facts would only permit utilization of $15 of the NOL. The entity with three-fourths of the state income of $20 would have $15 of taxable income but only a
7.1.10. Application of the cost of performance rules in determining the sales factor of “other than tangible personal property.”

7.1.10.1. These rules, found in UDITPA Section 17 are of course full of problems that are an issue for separate return states as well. However, there is one particular issue that arises and may lead to surprising results for combined reports.

7.1.10.1.1. These rules require that in determining where to treat a sale as taking place, one must look to the “costs of performance.” These require, in part, that one exclude activities performed “on behalf of” the taxpayer with a key example of these being activities performed by an independent contractor.

7.1.10.1.2. This rule is problematic for unitary groups since it is not uncommon for one member of a group to perform work for another member of the group. If these activities are excluded as being activities performed “on behalf of” the taxpayer there could be a surprising assignment of the receipt. For example, a contract partially performed by the contracting member in California, and by another member of the combined group in New Mexico, could be assigned entirely to California even though the predominant costs (the key question under the statute) are incurred in New Mexico.

7.1.10.1.3. However, recently California issued Legal Ruling 2006-2 which concludes that the activities of the affiliate can be taken into account (the ruling assumes agency nexus between the unitary affiliates). This seems like a sensible approach and a state would be well served by taking either approach but making it clear as to which it is. (The California ruling only takes this approach regarding activities conducted by unitary affiliates. There are many other circumstances where such activities by third parties probably should be taken into account but those are problems with the current cost of performance sales factor rules that are the subject for another day, or another panel.)

7.1.10.1.4. The MTC recently adopted a change to the model regulations for Section 17 that eliminates the “on behalf of” distinction in the assignment of receipts. The FTB has approved staff to hold an interested parties meeting to receive public input on the adoption of this change for California.

7.1.11. How are dividends between unitary members treated? Some might treat this the same as how any dividends are treated, but unitary theory tends to

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suggest (but not command) a different result, namely elimination of the dividend. This raises many issues especially in circumstances where substantial dividends are paid from a unitary affiliate out of earnings and profits from prior years. This will require understanding the rules for determining from what years the earnings and profits from which dividends were paid (LIFO?); rules for dealing with the possibility of a portion of the dividend being from “unitary” earnings and profits of the payor and some being from nonbusiness income generated by the payor. In those few states permitting worldwide combination, taxpayers that sometimes filed worldwide and sometimes not will have another particularly thorny set of issues. See Appeal of Apple Computer, Inc. Cal. State Bd. Of Equaliz. (2006)

8. Coordination with Federal Consolidated Return Rules

8.1. The consolidated return rules deal with many of the same issues that crop up in combined returns and they are covered in an elaborate set of regulations.

8.2. One key point is to remember that those rules often vary significantly from the combined report rules. (They can raise similar issues even for separate return states.) The question is to what extent, when a state starts with “federal taxable income” as its base, do the adjustments made as a result of the consolidated return rules have to be made (or reversed) for state purposes.

8.2.1. The MTC model statute addresses this issue expressly:

“Except as otherwise provided, the total income of the combined group is the sum of the income of each member of the combined group determined under federal income tax laws, as adjusted for state purposes, as if the member were not consolidated for federal purposes.”

8.3. A recent New York case illustrates the issue. New York generally starts with federal taxable income, but also provides that “each corporation included in a Federal consolidated group must compute its Federal taxable income for purposes of Article 9-A of the Tax Law as if such corporation had computed its Federal taxable income on a separate basis for Federal income tax purposes.” N.Y.C.R.R. section 3-2.2. For federal purposes, in certain circumstances when a taxpayer sells a member of its federal consolidated return that has an NOL, the NOL can be reattributed to the parent corporation under IRC Reg. section 1.1502-20T. The question was whether that reattribution also occurred for New York purposes. In the Matter of the Petition of Univisa, Inc., DTA No. 820289, Sept. 20, 2007. The Tribunal concluded it did not.

8.4. Even where there is a clear “as if not consolidated” rule as in New York and in the MTC model, questions will remain. For example, “If the section 338(h)(10) election is premised on the target's being sold by a 'selling consolidated group,'
what exactly does it mean to posit that, for purposes of New York's article 9-A, the members of the group determine their income without regard to federal results that can occur only if there is a consolidated group?” Carolyn Joy Lee, “New York Weighs in, Twice, on what Combined Reporting Means,” 47 State Tax Notes 261 (January 31, 2008).

9. Partnerships and Pass Through Entities

9.1. If a partnership is in a unitary relationship with a corporate partner, should the activities of the partnership be included in the combined report of the partner?

9.1.1. In California, the answer is yes, the partnership’s activities are included in the combined report of the partner to the extent of the corporate partner’s ownership percentage in the partnership.

9.1.1.1. Regulation section 25137-1 addresses the specific rules for this inclusion. A corporate partner of a partnership is considered as if directly engaged in the trade or business of the partnership, but limited to the extent of the corporation’s partnership interest. The regulation provides that the corporate partner’s distributive share of income, as well as apportionment factors, will be included in the combined report of the corporate partner.

9.1.1.2. What about intercompany sales?

9.1.1.2.1. The regulation provides that sales between the partnership and its corporate partner will be eliminated from the sales factor to the extent of the corporate partner’s interest in the partnership.

9.1.1.2.2. If sales are not made directly to the corporate partner but are instead made to other entities of the combined group, arguably the same result should occur, but the regulation is silent on this point.

9.2. If the partnership and the corporate partner are not engaged in a unitary business, then the partnership is treated as a separate trade or business.

9.2.1. If the general apportionment rule provides for a payroll, property, and sales factor, the partnership would compute the numerators and denominators of its factors the same way as if it were a corporation, and multiply its business income by its own apportionment percentage. The partner’s distributive share of the business income apportioned to a particular state will be deemed to be business income from a separate trade or business for that partner. That business income will then be added to the partner’s other income subject to tax in the particular state.
10. Miscellaneous

10.1. Are any transition problems created when, for example, a state adopts combined reporting and in early years a member of the unitary group not in the new state sells another affiliate also not in the state. Should the state receive an apportioned piece of the gain or suffer an apportioned piece of the loss when the appreciation/depreciation occurred prior to adoption of combination.

11. General Principles

11.1. Settlement Authority

11.1.1. My personal belief is that all states should have the authority to settle tax disputes based on the “hazards of litigation.” This is particularly true with combined returns and, especially, as the practical solution to the somewhat intractable problem of the definition of a unitary business.

11.1.2. No matter which approach is adopted to defining a unitary business (and lack of a clear approach will only make matters worse) there will be many controversies about what entities should be included in the combined return. Often there will be no correct answer. California is certainly a case in point. Prior to 1994 legislation providing the FTB with the authority to settle based on hazards of litigation, disputes had to be “resolved,” meaning with respect to each issue there was no splitting the baby and there had to be a determination as to who was correct. This led to unitary disputes stacking up and going back many, many years. The single best contribution of the Settlement Bureau has been to cut through the backlog of these cases. Settling these remains a significant part of the business of the Settlement Bureau.

11.2. Decide and publicize you position on the issues described herein to the extent possible. Be given authority to issue “legislative regulations.”

11.2.1. For the most part it doesn’t matter what the answer is to the various issues raised in this outline, only that there is a clear answer. Business will learn the rules and accommodate to them. The Department of Revenue will do the same. Ambiguous rules will help the taxpayers and harm the fisc since taxpayers will be entitled, and will, resolve such ambiguities in their favor. All parties are better off with a certain set of rules.

11.2.2. Whether this guidance is provided by statute, regulations or legal rulings will be a matter of state statute and practice. However, it would seem very advisable for the Legislature to provide the Department with the authority to issue legislative regulations, and it would behoove the Department to address the issues described herein as quickly as possible.
11.3. “Don’t let the perfect drive out the good.”

An old adage, very appropriate here, and consistent with my view that rules and direction, almost any rules and direction, will be better than none.