An Explanation of Combined Reporting

Combined reporting is a method of apportioning the income of corporations among the states in which they do business. Under combined reporting, the related corporations that are part of a "unitary group" are generally treated as one entity for tax purposes. Supporters of combined reporting say that this grouping of corporations eliminates distortions and tax planning opportunities caused by intercompany transactions, whether legitimate or otherwise, within the group. Opponents say that combined reporting creates other distortions by attributing income to the wrong jurisdiction, because the calculation simply averages the income and apportionment of all the businesses that actually have different economic profitability.

Currently, Maryland is a "separate entity" state, where every legal entity that is a C-corporation files its own tax return, generally without regard to the activities or tax returns of related entities. Maryland has also enacted several anti-tax avoidance laws, most notably the "addback" for intercompany transactions (aka "Delaware holding company"), the anti-captive REIT, and providing the Comptroller "section 482" authority to adjust income and deductions.

Because of the combining of apportionment factors as well as income, and also the opportunity of blending losses with income, the combined reporting calculation will produce increased tax liability for some corporate groups and decreased tax liability for other corporate groups. An example of the tax calculation under separate returns and combined reporting is as follows:

Corporation	Net Income	Apportionment factors: in MD / Everywhere
Parent	$20,000,000	30,000,000 / 100,000,000
Subsidiary A	30,000,000	10,000,000 / 500,000,000
Subsidiary B	10,000,000	Zero / 400,000,000
Total group	$60,000,000	40,000,000 / 1,000,000,000

Maryland Tax Calculation – Separate returns:

Parent	$20,000,000 x 30M/100M x 8.25% =	$495,000
Subsidiary A	$30,000,000 x 10M/500M x 8.25% =	$ 49,500
Subsidiary B	Zero apportionment (no Maryland business)	0
Group's total tax:		$544,500

Maryland Tax Calculation – Combined reporting:

Group's total tax:	$60,000,000 x 40M/1,000M x 8.25% =	$198,000

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Unitary Group

The first and most important step in the implementation of combined reporting is to define the characteristics of a "unitary group." Conceptually, a unitary group is composed of those related companies whose business activities are interdependent. The statutes and courts of the states that currently require combined reporting use varying definitions of "unitary." Typically, some combination of centralized control, economies of scale, and a flow of goods, resources or services demonstrating functional integration is used to determine whether a collection of entities is a unitary group. These concepts may require subjective application to the detailed facts of particularly complicated cases. There have been many court cases across the states that demonstrate the complexities of the issues and the varied results even when applying identically worded statutes.

A group of corporations will only be treated as unitary if there is a degree of common ownership among them; most states use a 50% common ownership threshold. Combination may or may not be limited to C-corporations and may include certain passive investment companies and certain captive real estate investment trusts. Often excluded are corporations that are subject to a different tax rather than the corporate income tax, such as insurance companies.

The Multistate Tax Commission (MTC), in its model statute for combined reporting, defines a "unitary business" as a single economic enterprise consisting of either separate parts of a single business or a "commonly controlled group" of entities that are organized to provide synergy and mutual benefit through functional integration, centralization of management, and economies of scale. MTC regulations stipulate that a "commonly controlled group" is that group of corporations where the parent corporation, directly or indirectly, owns more than 50 percent of the voting power of the other corporations. The MTC statute also requires the inclusion of pass-through entities to the extent of the corporation's distributive share of the pass through entity's income. Not all states use the MTC model statute.

"Corporate group" is currently defined in Maryland law for purposes of corporate information reporting. Insurers, regulated investment companies, and corporations that are not subject to federal income tax are explicitly excluded from a corporate group. One definition is based on federal definitions of "affiliated groups" (which, among other distinctions, requires 80% ownership) and "controlled groups," while the other is essentially similar to the MTC regulations.

Many states also include a provision explicitly allowing the tax administrator to adjust the membership of a unitary group to more appropriately reflect unity.

Determining the unitary group members may involve imposing geographic limitations, which affects the handling of foreign income and apportionment factors. This decision is commonly referred to as "worldwide vs. water's edge." Worldwide reporting is exactly what it sounds to be: inclusion of the unitary group's entire worldwide income and apportionment factors, regardless of the source, whereas water's edge reporting includes,

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with some exceptions, only entities with significant business operations within the United States.

“Worldwide” Unitary

Arguably, if a group is unitary, jurisdictional borders should be irrelevant. The group’s income can be summed and apportioned without regard to domicile or source of income. In practice, this concept becomes less straightforward.

Although the worldwide concept has been upheld in the U.S. Supreme Court, worldwide without a water’s edge election option has remained unpopular and mostly unused by the states (only Alaska requires worldwide combination and only for the oil industry). A 1984 report to President Reagan from the Secretary of the Treasury following the work of the Worldwide Unitary Taxation Working Group states that the worldwide concept is very unpopular with multinational businesses and foreign governments for several reasons, including:

- “that this method of taxation leads to state taxation of foreign source income and is at variance with the internationally accepted separate accounting method for avoiding double taxation;”
- “lump[ing] together income earned in numerous profit centers throughout the world and then divid[ing] the result on a formula basis distorts the attribution of income to any particular source or state since in some centers losses are incurred, while in others profits result;”
- “that distortion occurs because no deduction is allowed for foreign taxes or other payments to foreign governments;” and
- “that use of the method imposes substantial administrative burdens because of the need to translate accounts of their entire foreign operations into U.S. currency and to conform them to U.S. and state accounting rules; they note that there is no other requirement for such reporting by foreign nationals.”

The Working Group recommended that the states adopt legislative or administrative provisions that would limit combined reporting to the water’s edge method. The Treasury Secretary stated that if the states did not adopt this limitation themselves, then he would recommend federal legislation to do so. A year later, federal legislation was proposed, but in response the states amended their statutes to provide for water’s edge reporting or election.

Most foreign income is not taxed at the national level by the United States, and other governments generally do not tax their respective foreign income.

“Water’s Edge” Unitary

A pure water’s edge concept would include only domestic corporations and domestic international sales corporations (DISCs) for unitary group consideration; however, many states have added provisions that serve to include certain foreign corporations within the

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group. Those states have enacted provisions that incorporate some or all of the respective income and apportionment factors of some or all foreign entities including those which:

- have average apportionment factors (property, payroll, and sales) within the United States of 20% or greater (80/20 companies);
- earn at least 20% of their income from activities that are deductible by another group member;
- do business in a tax haven as defined by the Organisation for Economic Co-operation and Development;
- qualify as controlled foreign corporations (CFCs), as defined by the Internal Revenue Code, to the extent of their Subpart F income and apportionment factors attributable to that income;
- qualify as export trade corporations, as defined by the Internal Revenue Code.

<u>Election</u>

Often, combined reporting states require either worldwide or water's edge reporting as the default combination concept, though they allow the alternative as an election on timely filed returns. In order to avoid the possibility of a group shifting between water's edge and worldwide so as to minimize its tax burden, the election is typically binding for a fixed number of years.

<u>Affiliated Group</u>

As an alternative to the unitary group, some states have offered groups the option to file their combined report as an affiliated group, i.e., including the same members as shown on the federal consolidated return. Such a group does not require a worldwide or water's edge designation, though some states have allowed modifications to the federal affiliated group to include certain foreign corporations, DISCs, and S corporations. In addition to the excluded corporate types, the absence of an economic interdependence requirement serves to differentiate an affiliated group from the definition of a unitary group.

Some states allow for this election because of the inherent difficulties, in some circumstances, in determining the unitary relationships among the entities. Removing the administrative burden of having to identify which entities are unitary eases the compliance time and costs for the taxpayers (tax return preparation and audits) as well as for the state (audits and litigation). This type of election is also typically binding for a fixed number of years.

<u>Income and Apportionment</u>

Aggregating the unitary group's income is generally straightforward. The group's income is the total net taxable income of all members of the unitary group. Combining the income of all the group's members eliminates the effect of intercompany transactions.

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Generally, there are two methods available to apportion the combined income of a unitary group. These apportionment methods, "Joyce" and "Finnigan," derive their names from the California court cases in which they were sustained and are differentiated by their determination of the apportionment factor attributes (receipts, property, and payroll) of non-nexus entities in the numerator of the apportionment calculation. Under either apportionment method, the apportionment factor attributes included in the denominator are the same. The denominator includes all of the unitary group's total factors, regardless of nexus. A separate issue is the treatment of certain receipts that are not taxed in the destination state—whether these receipts should be "thrown back," "thrown out," or not considered.

Joyce apportionment includes all of the apportionment factor attributes in the numerator which were derived from entities that have nexus with Maryland. Finnigan apportionment includes the same numerator factor attributes as Joyce, plus all Maryland factor attributes from entities which do not have nexus with Maryland, although the receipts factor is almost always the only one significantly affected (i.e., include in the Maryland receipts factor numerator the sales of goods to Maryland customers made by entities that do not have Maryland nexus). The following examples illustrate the difference (for simplicity only, these examples use a single sales apportionment):

Joyce Example

Entity Name	M.D. Receipts	U.S. Receipts	Nexus
Entity A	50	100	Y
Entity B	100	200	Y
Entity C	100	200	N
Factor Total	150	500	

In the above Joyce example, the apportionment factor is 30% (150 ÷ 500). Entity C's Maryland receipts are not included in the total.

Finnigan Example

Entity Name	M.D. Receipts	U.S. Receipts	Nexus
Entity A	50	100	Y
Entity B	100	200	Y
Entity C	100	200	N
Factor Total	250	500	

In the above Finnigan example, adding entity C's Maryland receipts to the numerator would increase the apportionment factor to 50% (250 ÷ 500).

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Finnigan with “Throwback” Example

Entity Name	M.D. Receipts	California Receipts	U.S. Receipts	Nexus
Entity A	50	25	100	Y
Entity B	100		200	Y
Entity C	100		200	N
Factor Total	275		500	

Including a “throwback” provision apportions to Maryland the sales of goods delivered to a customer in jurisdictions where the entity is not subject to tax on those receipts. In the above Finnigan with “throwback” example, Entity A has also made $25 worth of sales into California (where the entity does not have nexus) from a Maryland warehouse; the $25 in California receipts would then be included in the Maryland numerator. In this example the apportionment factor is 55% (275 ÷ 500). The same technique would also apply to Joyce.

Finnigan with “Throw Out” Example

Entity Name	M.D. Receipts	California Receipts	U.S. Receipts	Nexus
Entity A	50	25	100	Y
Entity B	100		200	Y
Entity C	100		200	N
Factor Total	250		475	

Alternatively, “throw out” would eliminate the $25 from the group’s denominator and not include it in the numerator. The above example has the same entity information and method as the “throwback” example, except that the group’s U.S. receipts are reduced by $25 and there is no effect on the numerator. The apportionment factor becomes 53% (250 ÷ 475). Only Maine and West Virginia now utilize a “throw out” rule; New Jersey has repealed it effective July 1, 2010.

Allocation instead of apportionment

Some income, that which is earned outside of the ordinary course of business, need not be apportioned but rather is allocated in total to a single source location. Examples of this “nonoperational income” include profits realized on the sale of property not related to operations or interest received on assets that are set aside for nonoperational use. These types of income may be allocated 100% to the state in which those assets were located or were under management. This allocable income could be added to Maryland’s share of the apportioned income in determining Maryland taxable income. Currently,

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Maryland's statute makes no determination of allocable income, thus apportioning some of that income away to other states.

Special Apportionment

The use of special apportionment formulas, such as those in place for motion picture and television producers and distributors, certain transportation companies, and manufacturers, may necessitate the recognition of separate entities within the group in calculation of the group's taxable income. The mechanics involved in apportioning one entity's income differently from another's within the same group could not be accomplished without the use of either separate returns or a schedule. The alternative is to classify the group itself within one economic designation, which could be accomplished based on the NAICS code of the entity with the largest national payroll, sales, property, income, or any other designation that best reflects the activities of the group or the activities occurring only in Maryland.

Attributes of Group Members

Some combined reporting states maintain certain attributes, typically net operating losses (NOLs) and tax credits, for each of the members of the group. In other words, in some states NOLs may only be used by the member that realized the losses, and credits may be claimed only by the members that earned them. In these states, if a non-nexus member with carryforward losses is the only member of the group with losses in the current year, the group does not benefit from the losses. Similarly, if a member has earned a tax credit but has no tax liability to offset, even if the group has a tax liability, the group does not benefit from the credit. All else equal, maintaining these attributes of the separate members generally represents a timing issue, not a change to aggregate tax liability over time (although the attributes are lost if not utilized within the carryforward period). Such requirements, however, do complicate tax compliance for the taxpayer, and arguably, treating the members as separate taxpayers for these purposes contradicts the concept of a unitary group.

Transition Issues

With respect to Maryland, an NOL occurs when a corporation's expenses are greater than their income at the federal level and the resulting federal taxable income is negative. By piggybacking off of the federal NOL, companies are not required to separately track their losses for Maryland purposes. This practice stands in contrast to some other states which require companies to maintain NOLs specific to that state's return. That loss can then be carried back up to two years to reduce preceding years' liabilities, or it (or any remaining loss) can be carried forward up to twenty years to reduce future years' liabilities. Currently, when a member of a federal consolidated group files its Maryland return, it must calculate its NOL based on its separate federal taxable income as if the corporation were not a member in a consolidated group.

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A move from separate entity reporting to a combined reporting regime should involve a decision as to whether attributes of group members without Maryland nexus should be allowed to affect the determination of tax during combined reporting years. For example, without special consideration, losses of group members without Maryland nexus incurred prior to the imposition of combined reporting would presumably be allowed to be carried forward after combined reporting is in place. In other words, activity of the member before it was brought under Maryland tax law through combined reporting would have an impact on the group's taxes when combined reporting is in place. Maryland regulation currently follows a similar principle in that taxpayers new to the State are not allowed to carry forward losses incurred prior to the advent of activity in Maryland. A related question is whether losses of the group, or perhaps just those of members without nexus, should be allowed to be carried back to tax years in which separate entity reporting was the law.

The same issue holds, under the current language of the modifications, for the provisions decoupling Maryland tax law from certain recent federal changes. The decoupling provisions were intended to change the timing of certain adjustments to taxable income over time, but not the overall amount. Without explicit language, subtraction modifications from federal taxable income would be allowed without the corresponding addition modifications, for activity undertaken prior to the member being subject to Maryland tax law, ever having been made.

Effect of Combined Reporting on Financial Statements

Financial Accounting Standard 109 establishes accounting and reporting standards for the effects of income taxes. A publicly traded corporation that is required to report financial statements must create a liability or an asset for estimated taxes payable or refundable for the current year. Deferred assets and liabilities, such as those created by NOL carryforwards and temporary accounting differences, are also recorded for the expected impact on future tax returns. Given that combined reporting will be a benefit to some corporations and a detriment to others, affected publicly traded companies would immediately recognize their estimated increase or decrease in assets or liabilities, which would then result in an increase or decrease to profitability.

Massachusetts put a mechanism in place to mitigate the downside for those affected corporations. The state chose to allow a subtraction to the group's taxable income, to be taken over a seven year period, equal to the group's net increase in deferred tax liability.

Implementation

States have taken different paths with regard to the amount of time allotted between passing combined reporting legislation and the first effective tax year. For instance, Massachusetts allowed only six months between approval of the legislation and the beginning of the first tax year, while Vermont allowed nineteen months. While Massachusetts was able to implement much of their system in time, many of the details were still being worked out well into the first tax year. In both cases, though, not all

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issues were resolved before returns were due. It is important to note that while the first combined reporting tax returns are due several months after the end of the tax year, existing safe harbor provisions related to the current tax year may be inadequate for estimated payments made during the first year.

Vermont and several other states lowered their tax rates at the time combined reporting was implemented. Vermont made other substantial changes to their corporate income tax structure at the same time.

Transitioning to a combined reporting regime would require additional resources for the Comptroller's office. Other states have found the use of consultants very helpful in the development of regulations, training, and other implementation issues. Preferably, those individuals responsible for responding to taxpayer questions would be trained several months prior to the first effective tax year. The training of taxpayer services personnel and corporate auditors would come with both direct and indirect costs. Directly, the MTC and others offer training courses at some expense, and travel to other states who have recently implemented combined reporting would be very beneficial. Indirectly, time spent training auditors would result in a reduction of audits. While the value of future audits is very difficult to estimate, the loss in revenue could be substantial. Additionally, there would likely be a learning curve as auditors begin real combined reporting audits, further slowing the flow of revenue from audits. Experiences in other states show that many combined reporting audits involve significantly more time than the typical separate return audits, due to the fact finding and complex analysis involved in determining which entities are part of the unitary group.

Additionally, the Comptroller's tax system may require significant modifications, possibly with a cost. With the transition to combined reporting, Massachusetts required electronic filing of corporate income tax returns. Doing so may result in higher transition costs, but would likely result in lower ongoing costs and more complete, higher quality data.

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