HISTORY AND CONSIDERATIONS FOR COMBINED REPORTING: WILL STATES ADOPT A MODEL COMBINED REPORTING STATUTE?

Joe Huddleston[1]

Shirley Sicilian[2]

I. INTRODUCTION

Recent years have witnessed a second wave of separate entity states re-considering a move to combined reporting. The trend is pronounced, it survives despite increasing opposition from important sectors of the tax community, and it shows little sign of slowing. As legislators in separate entity states take up the issue, and administrators in newly christened combination states struggle with the learning curve, the first question is "what is a combined report?" Section II of this paper defines combined reporting, in contrast to separate entity reporting, in the context of fundamental unitary business and formulary apportionment concepts. Section III gives a brief history of the development and adoption of combined reporting as an extension of these fundamental concepts.

---

[1]Joe Huddleston is Executive Director for the Multistate Tax Commission.

[2]Shirley Sicilian is General Counsel for the Multistate Tax Commission.

Once we've defined combination, the second question is "why use it?" Section IV of this paper explores some of the contemporary reasons separate entity states are again considering combined reporting.

A third question deals with the details of existing and new combined reporting structures: "when is combined reporting required, who is required to be combined, and how is combination accomplished?" In answering these questions, the second generation of combined reporting states is reconsidering some of the details adopted by first-generation states. Section V considers the level of uniformity in states' answers to these questions as things now stand, whether the trend is one of increasing or decreasing uniformity, and the impact of the Multistate Tax Commission's model combined reporting statute.

II. WHAT IS COMBINED REPORTING?

When a taxpayer does business in more than one state, the question arises as to how a state may tax its income. The dormant commerce clause jurisprudence of the U.S. Supreme Court requires the income to be fairly apportioned.[3] States have different ways for meeting the "fairly apportioned" requirement, but virtually all use some type of formulary apportionment. The two components of a formulary

[3] *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977)

apportionment system are, of course, the pool of income subject to apportionment, and the apportionment formula. The apportionment formula is typically some combination of property, payroll, and/or sales factors. As for determining the pool of income, about half the states use the Uniform Division of Income for Tax Purposes Act's (UDITPA's) "business/non-business" rule.[4] The others either categorize income by type or apportion to "the full extent allowed under the U.S. Constitution." The Supreme Court has noted that the UDITPA rule is "compatible" with the Constitution.[5]

So, what is the "full extent allowed under the Constitution?" The Supreme Court has said that that the "linchpin of apportionability" is the unitary business principle.[6] This principle establishes that if income arises from transactions or operations of *a single economic enterprise*, parts of which are carried out in the state, the state can apply formulary apportionment to determine the share of that enterprise's income attributable to the state. The single economic enterprise – that is, the "unitary business" – does not necessarily correspond to a single

---

[4]BNA Tax Management Portfolios, State Series, 1140-1st: Income Taxes: The Distinction Between Business and Nonbusiness Income; Worksheet 2 Adoption of UDITPA, Apportionable Income (September, 2007); The UDITPA rule defines "business income" as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." UDITPA, sect. 1(a).

[5]Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U. S. 768, 786 (1992).

[6]*Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425 (1980).

legal entity. A unitary business could be carried out through one division of a single legal entity or through several separate, but affiliated, legal entities operating together.

All states, separate entity states as well as combined reporting states, must abide by the unitary business principle in applying formulary apportionment. Indeed, when the full scope of the unitary business is contained within all or a part of a single legal entity, the apportionment calculation will be the same under both separate entity and combined reporting apportionment approaches.

The basic difference between the combined reporting and separate entity approaches only arises when the unitary business is conducted by more than one separate legal entity. The difference is simply a matter of how narrowly a state limits the types of unitary entities whose income and factors will be included in the taxpayer's apportionment calculation. A state may not constitutionally require the taxpayer to include in its apportionment calculation the income and factors of any entities that are not engaged in the unitary business. But states routinely limit the calculation to exclude income and factors of some entities that are engaged in the unitary business.[7] Indeed, no state requires taxpayers to determine their apportioned share of unitary business income based on the income and factors of

[7]For example, many states exclude foreign affiliates. This exclusion is discussed in more detail below.

the entire unitary business. Even states that use combined reporting either limit, or allow taxpayers the option to limit, application of the formula to a combined group of unitary affiliates that will usually fall short of the entire unitary group.[8] Separate entity apportionment is essentially the narrowest limitation. Under separate entity apportionment, the apportionment calculation includes only the income and factors of the separate legal entity that is the taxpayer itself.

Thus, a combined report is an apportionment schedule the taxpayer uses to calculate its share of the income arising from a particular unitary business that is attributable to the taxing state. More specifically, a combined report is used when the state requires the taxpayer to include the income and factors of other affiliates engaged in the same unitary business in determining its own apportioned share of the unitary business's income. Separate entity states limit the apportionment computation to only the income and factors of the taxpayer itself, a single legal entity, and have no need for a multi-entity based apportionment schedule.

III. BRIEF HISTORY OF COMBINED REPORTING

[8] For example, most states exclude, or allow an exclusion for, foreign corporations.

A. *Late 1800's: Genesis of the Unitary Business Principle in Context of Property Tax*

Combined reporting developed as a natural corollary to the unitary business principle. A history of combined reporting, therefore, starts with the development of the unity concept in the late 1800's. At that time, property tax was the dominant form of taxation, and the railroads were one of the few types of businesses that typically operated in more than one state. Railroad property, tracks and traveling cars, literally spanned state lines. States and County governments felt that the value of the railroad property which formed their tax base was not simply the stand-alone value of rail and cars in the state. They argued, essentially, that the value of the whole was greater than the sum of the parts. In *In Re State Railroad Tax Cases,* 92 U.S. 575 (1875), the U.S. Supreme Court agreed and explained:

> [A] Railroad must be regarded for many, indeed for most, purposes as a <u>*unit*</u>. The track of the road is but one track from one end of it to the other and except in its use as one track is of little value. In this track as a whole each county through which it passes has an interest much more important than it has in the limited part of it lying within its boundary. Destroy by any means a few miles of this track within an interior county … its effect upon the value of the remainder of the road is out of all proportion to the mere local value of the part of it destroyed … <u>*It may well be doubted whether any better mode of determining the value of that portion of the track within any one county has been devised than to ascertain the value of the whole road and apportion the value within the county by its relative length to the whole*</u>.

In re State Railroad Tax Cases, 92 U.S. 575, 608 (1875) (emphasis added)

In a similar, 1897 decision, the Court reasoned that the taxing state "contributes to that aggregate value not merely the separate value of such tangible property as is within its limits, but its proportionate share of the value of the entire property [or unit]."[9]

B. *1910 - 1920's: Application of the Unitary Business Principle to Corporate Income Tax*

In 1909, the Federal government enacted a corporate excise tax measured by income, and States soon followed. The Act was eventually amended to create a direct tax on corporate income, after ratification of the 16th amendment in 1913 removed the constitutional requirements that would have made a direct tax on income inadministrable.[10] The same sort of multistate apportionment issues then naturally arose in the context of an income tax. In *Underwood Typewriter Co. v. Chamberlain,* 254 U.S. 113 (1920), the U.S. Supreme Court considered a case where the taxpayer earned its income through "a series of transactions beginning with manufacture in Connecticut and ending with sale in other states. The legislature, in attempting to put upon this business its

[9] *Adam's Express v. Ohio State Auditor,* 165 U.S. 194 (1897)

[10] See *Pollock v. Farmers' Loan & Trust Company*, 157 U.S. 429, *aff'd on rh'g*, 158 U.S. 601 (1895), holding the federal Income Tax Act of 1894 violated the constitutional requirement of Article 1. 9.4 that "direct" taxes be apportioned among the states on the basis of population.

fair share of the burden of taxation, was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders. It, therefore, adopted a method of apportionment." The Court upheld the State's logic of applying the unitary concept of formulary apportionment, developed under property tax, to the income tax.[11]

A few years later, in *Bass, Ratcliff & Gretton v. State Tax Commission,* 266 U.S. 271 (1924), the Court was faced with the same issue but in a case where the taxpayer was a foreign corporation, with all of its manufacture and a large part of its sales in England. It imported a portion of its product into the United States which it sold through branch offices in New York and Chicago. The Court relied on *Underwood Typewriter,* and found the state was justified in attributing to itself a portion of the income earned by this multinational corporation from the conduct of its unitary business partly within and partly outside the state. Thus, the Court confirmed that the unitary business and formulary apportionment concepts could apply in the context of an income tax on a world-wide, as well as domestic, basis.

C. *1930's – 1940's: California Combined Reporting*

[11] *Underwood Typewriter Co. v. Chamberlain,* 254 U.S. 113, 120-121 (1920); See also, *Bass, Ratcliff & Gretton v. State Tax Commission,* 266 U.S. 271 (1924)

By the 1930's, more corporations were choosing to separately incorporate segments of their business that might have once been distinguished only as divisions of a single corporation. Because most states treat each separate corporation as a separate taxpayer, this raised the question of whether, and if so how, to apportion the income of a unitary business when the business is carried out through separate affiliated taxpayers, rather than through divisions of a single taxpayer.

California faced the issue with the movie industry during the 1930's. Movies were produced in California, and then sold to out-of-state affiliate distributors. As a result of the pricing, virtually all of the income from filmmaking was reflected by the out-of-state affiliates, and essentially none of it by "Hollywood."

California took the position that the income attributable to the State should not vary depending on the corporate structure in which a business chose to operate and that prices charged between commonly owned affiliates should not drive the apportionment result. Rather, production and distribution of film were two parts of a single unitary business. Thus, some share of the income from that entire single business should be attributed to the in-state taxpayer and apportioned to the state. So in 1937, without explicit statutory authority, California determined the taxpayer should apportion based on a "combined report" that includes the income and factors of all separately incorporated unitary affiliates in order to properly reflect that taxpayer's share of the entire unitary business income attributable to the state. The State argued combined reporting was implicit in the apportionment statutes, based on the unitary business principle.

The movie industry did not challenge the California position. It wasn't until 1947, in *Edison Ca. Stores v. McColgan*, 30 Cal.2d 472 (1947), that the California Court of Appeals upheld the application of formulary apportionment to a unitary business conducted through separate affiliated entities – i.e., combined reporting. And it was another sixteen years before the same California Court held in *Honolulu Oil Corp. v. Franchise Tax Board,* 60 Cal2d. 414 (1963) that the use of a combined report was not something to be imposed at the direction of the tax administrator, but was mandatory in all unitary situations in order to properly apportion income under the unitary business principle.

D. *1950's – 1960's: Widespread Adoption of Uniform Formulary Apportionment*

The 1950's and 1960's are characterized by widespread adoption of uniform formulary apportionment across the states. The National Conference of Commissioners on Uniform State Laws (NCCUSL) promulgated the Uniform Division of Income for Tax Purposes Act (UDITPA) in 1957. It took the States some time to warm up to it, but by the mid-1960's, as

Congress seriously considered preemptive legislation[12], the states rallied. Many adopted UDITPA directly into their statutes. Some adopted it by enacting the Multistate Tax Compact, Article IV of which incorporates UDITPA nearly word for word.[13] The Compact became effective in 1967 when the required minimum of seven states had enacted it.[14] The Compact also created the Multistate Tax Commission as its administrative agency[15], and charged the Commission with several responsibilities. One of these responsibilities is interpretation of Article IV, UDITPA, through promulgation of proposed model uniform laws.[16]

E. *1970's – 1980's: Other States Consider Combined Reporting*

With UDITPA now widely in place, the 1970's and 1980's saw other states pick up on California's lead from the 1930's and consider whether combined reporting is inherent

[12] H.R. Rep. No. 952, 89th Cong., 1st Sess., Pt. VI, at 1139*ff* (1965).

[13] Some states have enacted both UDITPA and the Compact.

[14] The U.S. Supreme Court upheld the validity of the Compact in *United States Steel Corp.* v. *Multistate Tax Comm'n* (1978) 434 U.S. 452. Today, twenty states are members of the Compact: Alabama, Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Michigan, Minnesota, Missouri, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah and Washington. Another twenty-eight states have joined the Commission as either sovereignty or associate members. Sovereignty members are Georgia, Kentucky, Louisiana, Maryland, New Jersey, West Virginia and Wyoming. Associate members are Arizona, Connecticut, Florida, Illinois, Iowa, Indiana, Maine, Massachusetts, Mississippi, Nebraska, New Hampshire, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Vermont and Wisconsin.

[15] Compact, Art. VI

[16] Compact, Art.VII.1.

in UDITPA and unitary apportionment. Courts in Idaho, Illinois, Kansas, Montana, Nebraska, and Oregon found that it is.[17] But the tide seemed to turn a bit in the later 1980's, as state courts in Maine and Massachusetts held there must be either explicit statutory authority or distortion in order for the state to require combination.[18]

By the end of this period, implicitly or explicitly, sixteen states had adopted combined reporting, and the litigation slowed. It was 2007 before another state, North Carolina, took the position that combination was inherent in formulary apportionment. The State was upheld and the matter is on appeal[19]

F. *1980's – 1990's: World-Wide Combined Reporting*

In 1983, California was once again on the forefront. This time, the State was before the U.S. Supreme Court, in *Container Corporation of America v. Franchise Tax Board,* 463 U.S. 159 (1983), on the question of whether formulary

---

[17] *Coca Cola Co. v. Oregon Department of Revenue*, 533 P.2d 788 (Ore., 1975); *Montana Department of Revenue v. American Smelting &Refining Co.,* 567 P.2d 901 (Mont., 1977); *American Smelting & Refining Co.v. Idaho State Tax Com.,* 592 P.2d 39 (Id., 1979); *PMD Investment Co. v. State Dep't of Revenue, 216 Neb*. 553, 345 N.W.2d 815 (1984); *Caterpillar Tractor Co. v. Lenckos*, 417 N.E.2d 1343 (Ill., 1981); *Pioneer Container Corp. v. Beshears*, 684 P.2d 396 (Kan., 1984)

[18] *Polaroid Corp. v. Comm. of Rev.,* 472 N.E.2d 259 (Mass., 1984); *Sears Roebuck & Co. v. State Tax Assessor,* 561 A.2d 172 (Maine, 1989)

[19] *Wal-Mart Stores East, Inc. a/k/a Wal-Mart Stores East I, Inc. v. Hinton*, No. 06-CV-3928, 12/31/07, on appeal to the North Carolina Ct. App. No.: COA08-450

apportionment could be applied to an international unitary business even if the foreign aspects of the business were separately incorporated. Recall that one of the Court's earliest precedents upholding formulary apportionment, *Bass, Ratcliff & Gretton v. State Tax Commission,* 266 U.S. 271 (1924), involved a business operating in both England and the United States. The question now was whether a state could include the income and factors of unitary foreign operations that were separately incorporated. The Court agreed that it could.

Then, in 1994, California was once again before the Court in *Barclays Bank PLC v. Franchise Tax Board*, 512 US 298 (1994). There the Court upheld combined apportionment even though the parent was a foreign corporation.

After the *Container* and *Barclays* cases, a number of states began to show interest in worldwide combined reporting. The international business community and foreign governments became concerned, in part because unitary apportionment was not the standard for United States' or foreign governments' taxation of international income at the national level. The U.S. Treasury formed a Working Group, with state, federal, and business community representatives. The 20 members of this Working Group included chairs of large corporations (Ford, Exxon, IBM, and others) State legislators (such as the house speakers from Florida and New Hampshire), Governors (from Utah, Illinois, and California) and high level federal staff (including the U.S. Secretary of the Treasury and an Under Secretary of State). Although no agreement was reached, The Working Group Chairman's Report ultimately recommended States adopt water's-edge combination that includes only those foreign entities doing business in a tax haven.[20] As a result of the report and the extreme unpopularity of the concept, the States stepped away from worldwide combined reporting.

G. *2000's: Second Generation Combined Reporting*

A second wave of interest in combined reporting took hold in 2004 when Vermont became the first state in almost 20 years to enact it. Over the last four years, six additional states have joined the original sixteen. The six states are Massachusetts, Michigan, New York, Texas, Vermont, and West Virginia. Today, twenty-two states require combined reporting:

• Alaska	• Minnesota
• Arizona	• Montana
• California	• Nebraska
• Colorado	• New Hampshire
• Hawaii	• New York
• Idaho	• North Dakota
• Illinois	• Oregon
• Kansas	• Texas
• Maine	• Utah
• Massachusetts	• Vermont
• Michigan	• West Virginia

[20] Worldwide Unitary Taxation Working Group – Chairman's Report and Supplemental Views (August 1984)

In 2007 and 2008 alone, the governors of Iowa, Maryland, Massachusetts (adopted), Michigan (adopted), New York (adopted), North Carolina and Pennsylvania proposed adoption of mandatory combined reporting.[21] And in August of 2006, the Multistate Tax Commission adopted its model combined reporting statute.

IV. WHY ARE STATES ONCE AGAIN MOVING TO COMBINED REPORTING?

Some of the benefits States expect from combined reporting are (1) a more accurate measure of income, (2) control over income shifting to out-of-state affiliates, (3) an apportionment method that has been approved by the U.S. Supreme Court, (4) a more uniform tax structure, and (5) efficiencies in audit and compliance.

A. *More Accurate Measure of Income*

The premise of combined reporting is that the "synergies, interdependencies, and sharing of knowledge, know-how, and experiences that are typical features of a unitary business often cannot be properly captured by [the alternative,] separate accounting."[22] With combined reporting, the enterprise-wide contributions to income that

[21] Iowa HF 326, SB 1074 (2007); Maryland SB 2 (2008); Massachusetts? (2008); Michigan SB 94 (2007); New York SB 210 (2008); North Carolina SB 244, HB 462 (2007); Pennsylvania HB 1186 (2008)

[22] *Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana*; 61 Louisiana Law Review 699, 700, by Michael J. McIntyre, Paull Mines and Richard D. Pomp (2001), p. 704.

result from these features are not pigeon-holed into a few affiliates. Rather, they are apportioned across the entire enterprise, as they would be for a single corporation operating through divisions.

In this way, the substance of the business activity conducted in the state controls the amount of income subject to apportionment, regardless of the organizational structure of the business entity or entities conducting those activities. Whether a business chooses to operate as one corporation with numerous divisions or to incorporate those divisions into subsidiaries will not impact the amount of income produced by the business as a whole, subject to apportionment, and attributable to the state.

By contrast, attempting separate accounting when a business has incorporated its divisions is very difficult, if not, impossible. Separate accounting "…ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise."[23] It fails to reflect that the value of the whole is greater than the sum of the parts.

B. *Control Income Shifting*

[23] *Container Corporation of America v. Franchise Tax Board,* 463 U.S. 159, 165 (1983).

In principle, combined reporting is a revenue neutral accounting system. Its application to any individual taxpayer could either increase or decrease the amount of tax due, depending on the particular facts of that taxpayer’s unitary business. In some cases, combination will increase the pool of income subject to apportionment. But in other cases, combination will cause an in-state taxpayer’s profits to be off-set with an out-of-state affiliate’s losses, and will reduce the amount of income subject to apportionment. Even where combination brings in only affiliates with net income as opposed to losses, the effect of combination still could be either positive or negative depending on the out-of-state affiliates’ apportionment factors, as those factors will be added to the taxpayer’s apportionment factor denominators and reduce the taxpayer’s apportionment percentage.

Although the tax effect of combined reporting is neutral in principle, in practice combined reporting is likely to have a positive impact on tax revenue because it eliminates the tax benefit from shifting income to out-of-state affiliates. Where profits of a unitary business have been concentrated in an out-of-state affiliate, combination will recognize these profits as part of the income of the unitary business, subject to apportionment.

More recently, states have had to grapple with tax planning that purposely shifts an operating company’s income by transferring trademarks, patents or other intangible property to an affiliated intangible holding company. The affiliate may be located in a state that does not tax income on intangibles, such as Delaware or Nevada, or a foreign tax-haven. The affiliate then charges the operating company for the use of its trademarks or patents. The charge creates a deductible expense for the operating company, which offsets income that otherwise would be taxable by the state in which the company is doing business and earning income. In addition, the royalty or patent income of the affiliated holding company may be loaned back to the operating company, and a second deduction may be allowed for the payment of interest on the loan. Other examples include transactions with an out-of-state affiliate to purchase tangible goods or services that may or may not be undertaken at market prices.

Under combined reporting, affiliated unitary corporations must report income on a combined basis, effectively determining the tax base as though the group were a single business entity, and blocking potential tax benefits from income shifting transactions among the group members. With combined reporting, there is no need for the tax agency to specifically identify these income shifting transactions or defend against them. There is no need to audit and review transfers among affiliates to ensure they were made at arm’s length and reflect market prices. Instead, the incomes of the affiliates are simply combined as a matter of course in determining the apportionable income base.

Some states have used add-backs to address this income shifting. But add-backs are a limited response to income shifting. Usually they only address income shifting from very specific circumstances, such as licensing of intangibles or interest expenses. In addition, add-back statutes have proven difficult to draft and administer, particularly where a state wants to include provision to avoid double taxation or to recognize intangible expenses that aren't primarily a vehicle for tax avoidance.

Compared to the alternatives (for example §482 style arms length pricing audits or add-backs) combined reporting is simpler and less costly for both the tax agency and the taxpayer.

C. *Sanctioned by the U.S. Supreme Court*

The constitutionality of combined reporting has been reviewed by the U.S. Supreme Court. As noted above, the Court's first review was the *Container* case, where combined reporting was sustained as constitutional, even though some of the entities in the group were foreign subsidiaries.[24] Later, in *Barclay's Bank PLC*, the U.S. Supreme Court sustained the application of worldwide combined reporting where the parent of the group was a foreign corporation.[25]

[24] *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983). It should be noted that in *Container* the taxpayer did not challenge combined reporting for domestic affiliates.

[25] *Barclay's Bank PLC v. Franchise Tax Board*, 512 US 298 (1994).

In *Barclays*, the U.S. Supreme Court held California's worldwide combined reporting system was not burdensome and appropriately apportioned the taxpayer's income attributable to California.

By contrast, add-backs are only now beginning to be litigated and the outcomes are uncertain.[26] Many states that currently have add-back provisions are considering adoption of combined reporting[27] which suggests add-backs are not necessarily a complete, or administratively satisfactory, answer to the income shifting problem.

D. *More Uniform Tax Systems*

As noted above, twenty-two states now require combined reporting. Another six states allow its use either at the election of the taxpayer or upon some finding by the tax administrator.[28] To the extent states use, or allow the use of, the same methodology for determining the amount of a business's income subject to tax in the state, the potentials for double taxation and "nowhere" income are reduced and tax preparation is simplified, benefiting both multistate taxpayers and state governments.

---

[26] *See*, *Surtees v. VFJ Ventures, Inc.*, No. 2060478 (Ala. Ct. Civ. App. February 8, 2008), cert. granted (Ala. Sup. Ct. Apr. 8, 2008).

[27] *See,e.g.,* Connecticut HB 5884 (2008), Maryland SB 2 (2007), Massachusetts HB 4499 (2008).

[28] See paper by conference co-panelists, Charolette F. Noel and Carolyn Joy Lee, both of Jones Day.

E. *Efficiencies in Audit and Compliance*

Virtually all states and multistate taxpayers should be familiar with the unitary business principle. All states that use formulary apportionment – and today that means essentially all states with a corporate income or franchise tax - are required by the dormant Commerce Clause of United States Supreme Court jurisprudence to abide by unitary principles. This is true even in the context of separate entity reporting. For example, the determination of whether an item of income may be properly included in the pool to be apportioned requires application of the unitary business principle even in separate entity states where only a single taxpayer's income is at issue.[29] If two divisions of taxpayer are engaged in different unitary businesses, the income from those businesses must be apportioned separately, even in separate entity states. Extending the unitary determinations to all entities included within a combined reporting group presents no greater challenges and should, in fact, simplify the process. Use of combined reporting, and the use of a single return for reporting purposes for all members of the unitary business, can reduce the number of returns filed and will eliminate the need to review intercompany transactions to make sure prices are arms' length and income is fairly reflected.

[29] *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 100 S.Ct. 1223 (1980).

V. CURRENT COMBINED REPORTING STRUCTURES - HOW UNIFORM ARE THEY?

Any combined reporting structure must answer three main questions: (1) When is combined reporting required? (2) Who is required to be combined? (3) How is combination accomplished? While there is clearly diversity in the details across the combined reporting states, there is actually a large degree of uniformity on the fundamental policy choices. In addition, the Multistate Tax Commission has developed a model combined reporting statute that is primarily based on the features of existing structures and should help increase uniformity among the states that are now considering combined reporting.[30]

A. *When is Combination Required?*

Of the 22 states listed above as combined reporting states, all require combination of unitary affiliates, rather than: (a) merely permitting combined reporting upon the request of either the taxpayer or the department; or (b) conditioning combined reporting on some triggering event, such as a showing of distortion or improper transfer

[30] *See* Multistate Tax Commission model combined reporting statute: http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Combined%20Reporting%20-%20FINAL%20version.pdf

pricing. The Commissions model statute follows this approach.[31]

This policy choice reflects a position that combined reporting is the superior method for determining the amount of income properly attributable to a state. Required combination helps ensure the rule will be applied uniformly, regardless of the impact on tax liability in individual cases. A combined reporting rule which applies only upon the request of a taxpayer would do little to address the potential for income shifting to out-of-state affiliates, since a taxpayer that wished to engage in shifting would simply not request combined reporting.

B. *Who is required to be combined?*

1. *Unitary Entities*

As mentioned above, constitutional principles prohibit a state from requiring an entity to be included in the taxpayer's apportionment calculation unless that entity is engaged in a unitary business with the taxpayer. U.S. Supreme Court precedent largely governs the determination of unity, so states are largely consistent with respect to this requirement. Where states have defined unity in statute or regulation, they have by and large defined it using the language from one or more of this handful of landmark U.S.

[31] Multistate Tax Commission model combined reporting statute §2.A.

Supreme Court cases, along with one state case, *Edison California Stores* 183 P.2d 16 (Cal. 1947), which was cited favorably by the U.S. Supreme Court in *Barclays*.[32] (See Table 1.) To enhance state uniformity in applying these judicial standards, the Commission has adopted a model regulation that defines a unitary business in detail.[33]

Because so many states have long-required combined reporting, many taxpayers now have extensive experience determining whether their various affiliates are unitary such that combination is required. And, because the determination of unity is largely governed by U.S. constitutional principles, once a taxpayer has identified its unitary group for one state it has likely determined it for others.

2. *World-Wide vs. Water's-Edge*

Whether or not, and the extent to which, unitary foreign affiliates are included in the apportionment calculation is one of the most significant policy issues addressed in a combined reporting statute. In principle, a combined group should include all affiliates participating in the group's unitary business, domestic and foreign. If

[32] *Barclays Bank PLC v. Franchise Tax Bd. of California*, 512 U.S. 298, 304 (1994)

[33] See MTC General Allocation and Apportionment Regulations; Regulation IV.1(b) Unitary Business (revised January 15, 2004). http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Combined%20Reporting%20-%20FINAL%20version.pdf

combination includes only domestic corporations, then the apportionment of income associated with the foreign activity of a multinational unitary business can be manipulated through changes in the corporate structure. The income (or loss) and apportionment factors associated with the foreign activity could be excluded by conducting the activity as a foreign affiliate, or it could be included by conducting the activity as a foreign division of the domestic corporation. Many tax experts have noted this policy rationale supporting world-wide combined reporting.[34]

But as we've seen, despite its conceptual superiority and U.S. Supreme Court sanction[35], the worldwide approach was extremely unpopular with multinational corporations and much of the international tax community.[36] As a result, few states now require worldwide combined reporting. Those that do, allow taxpayers to *elect* to file on a water's-edge basis. Only Alaska mandates worldwide combined reporting, and only for oil and gas producers and pipeline companies.[37]

[34] *See Use of Combined Reporting by Nation States*, by Michael J. McIntyre, Tax Notes International; p. 945 (Sept. 6, 2004). *See also Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana*; *Supra,* p. 732; citing to *Slicing the Shadow: A Proposal for Updating U.S., International Taxation,* by Reuven S. Avi-Yonah, 58 Tax Notes 1511 (March 15, 1993); *Design of a National Formulary Apportionment Tax System,* by Michael J. McIntyre, 84th Conf. on Tax'n, Nat'l Tax Ass'n 118 (Frederick D. Stocker ed. 1991).

[35] *Container*, 463 U.S. 159, 103 S. Ct. 2983; *Barclays*, 512 U.S. 298, 114 S. Ct. 2268.

[36] *Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana*; *Supra,* p. 732.

[37] Alaska Stat. § 43.20.072

Three states include entities doing business in tax havens - Montana, Alaska and West Virginia.[38]

The Commission's model combined reporting statute follows a similar policy. It requires worldwide combination, with a water's-edge election. The water's-edge election does not exclude unitary foreign affiliates if the affiliate is doing business in a tax haven. The Commission's model defines "tax haven" as a jurisdiction that is either identified by the Organization for Economic Co-operation and Development (OECD) as a tax haven …" , or "exhibits the…characteristics established by the OECD in its 1998 report…as indicative of a tax haven…"[39]

3. *Entities That Are Not Corporate Income Taxpayers*

A unitary business may be carried on by many types of entities acting together, not just corporations and certainly not just corporations that are corporate income taxpayers. It would be theoretically correct and, in many states, legally acceptable to require inclusion of all such entities in the apportionment calculation in order to

---

[38] Alaska Stat. § 43.20.073(a)(5); Mont. Code § 15-31-322(f); W. Va. Code, § 11-24-13f(a)(7).

[39] *See* MTC model combined reporting statute §1.I. http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Combined%20Reporting%20-%20FINAL%20version.pdf. *See also,* Harmful Tax Competition: An Emerging Global Issue (Organization for Economic Cooperation and Development, 1998) http://www.oecd.org/dataoecd/33/1/1904184.pdf

properly apportion the taxpayer's share of unitary business income.

This question has only grown in importance over the last fifteen years as Congress began breaking down barriers between different types of financial services industries.[40] One outcome of the federal changes is that industries such as banking and insurance companies, which are often exempted from the corporate income tax, may now branch out and engage in a unitary business with other financial service industries that are subject to the tax.

Some states have taken the position that non corporate income taxpayers should be excluded from the combined group.[41] Others have either taken the position that they are includable or have not addressed the issue yet. For example, in *State ex rel. Dept. of Revenue v. Penn Independent Corp.* [42], the Oregon Tax Court found the apportionable income of a unitary group should include the income of an insurance corporation even though that corporation was not subject to Oregon's corporate income tax, but instead paid a gross premiums tax. The Tax Court noted "[i]t is important to remember that including the income of a nontaxable member of

---

[40]See *e,g,* Riegle-Neal Act and Gramm-Leach-Bliley Acts of 1994 and 1999.

[41]*See, e.g.,* Vermont and California. The "in lieu of" provisions for insurance premiums tax is a constitutional provision in California, unlike most states where it is statutory.

[42]*State ex rel. Dept. of Revenue v. Penn Independent Corp*. 15 Or. Tax 68 (1999); *See also, Appeal of Wendy's International,* Kansas Board of Tax Appeals Docket No. 2006-3929-DT.

a unitary group does not subject that income to taxation by Oregon. It merely provides the base from which the taxable corporation's share is apportioned."[43] The appropriateness of this holding was noted by Walter Hellerstein: "Although the result in this case is unusual, Judge Byers's thoughtful analysis of the theoretical justification for the result is plainly correct."[44]

Nonetheless, only corporate income taxpayers have are required to be combined under the Commission's model statute. The rationale for this limited requirement is that combination of entities which operate under significantly dissimilar financial and tax regimes can create serious mechanical issues that need to be worked out. Furthermore, the resolution of those mechanical issues is likely to be different depending on the type of business entity or industry at issue. For example, combination of insurance companies may engender questions of how to establish "taxable income" for the insurance company that at the state level is subject only to a tax on gross premiums. Combination of financial institutions in states that exclude these entities from the corporate income tax may raise issues surrounding the treatment of financial instruments in the calculation of the sales or property factors. In addition, different entities subject to different tax

[43] *Penn Independent*, p. 74

[44] Hellerstein, State Taxation: 2001 Cumulative Supplement No. 1, ¶ 8.11[3][e].

regimes in different states, e.g. exempt organizations under IRC section 501(c)(3) may or may not be properly combined in those states. A review of state constitutional, mechanical or policy impediments to combination for each of the different types of entities may be advisable.

For these reasons, the Commission's model statute does not require combination of non corporate income taxpayers. But the model statute does authorize the tax administrator to require combination of such entities by regulation, so that proper inquiry can be made in each situation.[45]

C. *How is Combination Accomplished?*

Of course the method of combination involves a great deal of technical detail and as such states are more likely to deviate in their answers to this question. Nonetheless, there is still a good deal of uniformity with respect to the main policy choices. A threshold policy choice is whether the state treats the members of the combined group as separate taxpayers or treats the group itself as a single taxpayer. This determination can drive the treatment of many other issues, including net operating losses, sharing (or not) of credits, and determination of factor numerators. Most states treat the group members as separate entities.

[45] MTC model combined reporting statute §2.B. The model statute also allows combination on an ad hoc basis in the case of tax avoidance or evasion. http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Combined%20Reporting%20-%20FINAL%20version.pdf

For these states, each entity's share of the combined group's unitary business income attributable to the state is generally determined as shown in Table 2. A handful of states – Arizona, Utah, and New York – view the group as a single taxpayer for some apportionment purposes.[46] In particular, these States include the entire group's sales in the state numerator, regardless of whether some members of the group making those sales would have had nexus or been protected by PL.86-272 if viewed on a stand-alone basis. A few states which treat members as separate taxpayers – Kansas, Michigan and Indiana - employ the reasoning in the California case, *Finnigan*[47], to achieve a similar apportionment result for the group when viewed as a whole.

Under the Commission's model statute, the combined report does not disregard the separate identities of the taxpayer members of the combined group. Each taxpayer member is responsible for tax based on its taxable income or loss apportioned or allocated to the state, which includes, among other items of income, the taxpayer's apportioned share of the unitary income of the combined group. The statute takes into account that taxpayer members may be engaged in more than one unitary business.

Because individual group members are recognized as separate taxpayers, as a general rule, deductions and

[46] *See,* Disney *Enterprises, Inc., et al. v. Tax Appeals Tribunal of the State of New York et al.,* 888 N.E.2d 1029 (N.Y.,2008); *Airborne Navigation Corporation v. Arizona Department of Revenue*, Ariz. Bd. of Tax Appeals, Docket No. 395-85-I (February 5, 1987); Utah R865-6F-24.

[47] *Appeal of Finnigan Corporation*, 88 SBE 022 (1988).

credits are taken only by the taxpayer that earned the deduction or credit, and not against the total combined income or liability of the group. Likewise, the amount of business income apportioned to a state is calculated as a function of each taxpayer's own factors in that state (the *Joyce* method[48]), as opposed to the factors for the entire group as a whole (the *Finnigan* method[49]).

The Commission's model statute does provide some exceptions to this general rule preserving the separate identity of the taxpayer. In particular, a charitable contribution deduction is allowed to be taken first against the business income of the combined group (subject to federal income limitations as applied to the entire business income of the group), and any remaining amount may then be treated as a nonbusiness expense allocable to the member that incurred the expense (subject to the federal income limitations applied to the nonbusiness income of that taxpayer member).

D. *Will States Adopt the Commission's Model Uniform Combined Reporting Statute?*

The Multistate Tax Commission adopted its model uniform combined reporting statute in August of 2006. Since then, West Virginia and Massachusetts have moved to combined

[48] *Appeal of Joyce, Inc.*, 66 SBE 069 (1966)

[49] *Finnigan*, 88 SBE 022 (1988)

reporting and both utilized the Commission model.[50] West Virginia adopted the model nearly verbatim. The Massachusetts legislation is based on the Commission's model with modifications. In 2008, legislation introduced in Florida, Kentucky, and Tennessee also included the model's provisions.[51] It seems the model is given serious consideration by the states that are interested in moving to combined reporting. It should have its intended result of helping to increase uniformity.

[50]Also since August 2006, New York has amended its existing combined reporting statute.

[51]Florida HB 1237 (2008); Kentucky HB 302(2008); Massachusetts HB 4645 (2008); Tennessee SB 3158 (2008).

Table 1

Tests for Unity

- *Mobil* 3 Factors
  445 U.S. 425 (1980)
  - Functional Integration
    - Transfer
    - Pooling
  - Economies of Scale, and
  - Centralized Management
- *Container*
  463 U.S. 159 (1983)
  - Flow of Value, or
  - Substantial mutual interdependence
  - And unity of ownership
- *Butler Bros*. 3 unities
  315 U.S. 501 (1942)
  - Unity of ownership
  - Unity of operation, and
  - Unity of use
- *Edison Ca. Stores*
  183 P.2d 16 (Cal. 1947)
  - Contribution, or
  - Dependency

Table 2

Typical Computation of Tax Liability Using Combined Report

TP's federal taxable income (determined w/o regard to federal consolidated rules)

+ or – state adjustments

– TP's non-apportionable income

– TP's apportionable income from another unitary business (separately apportioned)

= TP's unitary apportionable income

+ Other group members' similarly calculated unitary apportionable income

x TP's apportionment percentage (average of 3 factors where each factor numerator is TP's in state factor, and each factor denominator is the sum of all group members' factors)

= TP's state unitary apportioned income

+ TP's non-apportionable income allocated to the state

+ TP's apportioned income from another unitary business (separately apportioned)

= TP's state taxable income

x tax rate

= TP's gross state tax

– TP's state tax credits

= TP's state tax liability