The Lesser of Two Evils? Combined Reporting Versus Addback Provisions

by Cara Griffith

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Although corporate income taxes make up a relatively small amount of states' total revenue, they get a disproportionate amount of attention. That is likely because of the negative connotation toward anything that is perceived as "corporate welfare" or a "corporate tax loophole," particularly given the trend toward more transparency in corporate reporting, and because revenue is tight. Increasing corporate income taxes is more politically palatable than most other potential tax increases. Although states have been concerned for many years about corporate taxpayers' efforts to use related-party charges to manage state tax liabilities, that concern has increased in recent years. As a result, the methods by which states are attempting to capture those charges in a taxpayers' taxable base has continued to evolve. To combat the benefits of related-party transactions, some states have enacted unitary combined reporting, while others have remained separate reporting states but use expense disallowance or addback provisions.

The rationale behind unitary combined reporting is relatively simple. Large, multistate corporations were able to structure their businesses to include passive investment subsidiaries in favorable taxing jurisdictions. Using that structuring, it has been argued, enables them to avoid paying their fair share of the tax burden in higher-taxing jurisdictions. Combined reporting requires all income to be reported to a state, regardless of whether it is attributed to the parent corporation or any subsidiaries or affiliates. Addback provisions, by contrast, are used by separate reporting states but serve as another means of ensuring that related-party transactions are not used to reduce a corporation's taxable income. Those provisions require the addback of some related-party transactions, such as expenses and interest related to the use of intangibles or intercompany interest expenses.

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For corporate taxpayers, the adoption of unitary combined reporting or addback provisions eliminated the benefits of some tax planning opportunities. Also, compliance with either unitary combined reporting or addback provisions brings with it new burdens. However, from a compliance standpoint, combined reporting is arguably simpler than addback provisions because it requires only one return for a group of corporations and is no longer a novel concept. If it is true that unitary combined reporting is less burdensome from a compliance standpoint (which some practitioners might disagree with), that raises the question: Would corporate taxpayers, given the choice, chose combined reporting over addback provisions?

Combined Reporting Versus Addback Provisions

Unitary combined reporting is not a new concept. Most practitioners fully understand the mechanics behind and intricacies of combined reporting. At the most general level, combined reporting requires a group of corporations under common ownership to include the income or loss of each member of the group in arriving at the income subject to a state's modifications and apportionment. Michael Mincieli, a senior accountant with the state and local tax group at Amper, Politziner & Mattia LLP in New York, said that "combined reporting is considered to be a fairly logical approach to state income taxation and apportionment of a unitary group of corporations. Also, combined reporting *may* be one method to eliminate intercorporate transactions between related entities."

Expense disallowance or addback provisions vary widely among states. In general, most states' addback provisions will disallow intangible or interest expenses paid to related parties or related members. Intangibles tend to include trademarks, trade names, patents, and copyrights, and the definition of intangible expenses is likewise relatively broad, encompassing leveraging, royalties, and other transactions. The definition of interest expenses tends to come from Internal Revenue Code section 163. Most addback provisions also contain limited exceptions for some expenses, but to receive those exceptions often requires substantiation of business purpose.

Mincieli said that "states have attempted to limit or eliminate trademark and similar royalty expense deductions paid by taxpayers in separate company reporting states to out-of-state affiliates located in jurisdictions where the payment would have no unfavorable tax consequences. However, provisions to accomplish this typically create considerable uncertainty as to their overall scope. The types of deductions disallowed (and the exceptions to the addbacks) under these statutes differ from state to state. Worse, there is widespread inconsistency in the states' interpretations of their various statutes."

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Addback provisions may also encounter constitutional challenges. While the constitutionality of combined reporting has been upheld, at least in a system in which worldwide combined reporting is applied to a group when the parent of the group is a foreign corporation, the constitutionality of addback provisions is still under question. In particular, if a state enacts an addback provision without a "subject to tax" exception, under which the intangible or interest expense paid to the related party is deductible to the extent it is subject to a net income tax in another state, and the state applies an economic nexus standard, there is the risk of multiple taxation. Good examples are Massachusetts and New Jersey, both of which have enacted addback provisions without subject to tax exceptions. On audit, it has become apparent that multiple taxation is occurring. However, while the Massachusetts Department of Revenue will make adjustments, the New Jersey Division of Taxation has been less willing to do so.

Compliance Burdens

Most practitioners are in general agreement that, from a compliance standpoint, filing a unitary combined return is less burdensome than determining the applicability of states' addback provisions. Donald-Bruce Abrams, a partner and coleader of the tax group at Bingham McCutchen LLP, said that "the mysteries of combined reporting are largely gone. People know how to properly file and so it's doable from a compliance standpoint." Howard Wagner, with the National Tax Office at Crowe Horwath LLP, concurred, saying that "unitary combined reporting requirements are generally less burdensome to comply with than addback provisions because, for example, a royalty company and the company paying the royalty will file one return."

That is not to say, of course, that compliance for combined reporting is simple: It is far from it. There are any number of issues facing taxpayers filing unitary returns, including unitary and ownership determinations and apportionment rules. Jeffrey Saviano, partner and leader of the Indirect, State and Local Tax Services Practice at Ernst & Young LLP, said that one of the most difficult issues facing taxpayers is that when state legislatures enact combined reporting statutes, they do so in a broad manner and leave the more specific rulemaking up to state departments of revenue. That delegation of authority provides corporate accounting departments, at least at the outset, with limited guidance to implement the law change in the company's financial statements.

While addback provisions tend to be written with more specificity, Wagner said, "navigating addback provisions on a state-by-state basis presents a significant burden." For example, when a deduction is permitted if the entity is subject to tax in another state, the entity that wants to use that deduction will be required to make many disclosures and the transaction must have been negotiated on an arm's-length basis. Failing to make those disclosures or file the appropriate forms can result in losing the deduction.

In addition to the simple compliance burdens that addback provisions present, taxpayers may also be required to undertake "potentially expensive transfer pricing studies, such as establishing arm's-length pricing for intercompany royalty expense," said Mincieli. "When a state has both an addback statute and also combined reporting, it may well prove to be beneficial to combine related companies, rather than implement an intercompany agreement that would be subject to addback challenge."

Taxpayer Benefits

If addback provisions are, in general, more burdensome from a compliance standpoint than filing a unitary return, would corporate taxpayers, given the choice, prefer unitary combined reporting over addback provisions? The answer, far from resounding, is probably not. Some taxpayers prefer addback provisions to unitary combined reporting because with unitary combined reporting there is no chance for them to get any state tax benefit. Abrams agreed, explaining that unitary returns largely put an end to the domestic intangible holding company concept, while with addback provisions there is still the hope of a taxpayer-friendly court decision or federal legislation.

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Nonetheless, although addback statutes may provide some opportunity for a state tax benefit, or at least the hope of that opportunity, obtaining such a benefit is difficult in practice. As noted above, compliance with addback provisions can be difficult and taxpayers hoping to receive a deduction must fit squarely into an exception and properly document it. Saviano said that if states decide to extend their addback provisions to the intangible component of goods purchased and sold, that could present additional burdens for taxpayers.

On the unitary front, while combined reporting may have put an end to the intangible holding company concept as it was first conceived, Carl Richie, a tax manager with Kaufman Rossin & Co., said taxpayers "can still receive some benefits of tax planning even if a state has moved to unitary combined reporting." For example, using the familiar intangible holding company example, if the holding company has little economic purpose, the parent company will lose the deduction at the operating level. However, if substance is added to the holding company, perhaps by adding employees, the parent company may reap the benefit of having payroll outside the taxing state, which will dilute its apportionment. "Because unitary combined reporting looks at the entire group as one entity, the benefit of apportionment dilution is still available," Richie suggested. However, that type of planning won't work in unitary states with single-sales-factor apportionment.

Saviano concurred, noting that there continue to be tax planning opportunities in combined filing states, driven from a business's operational changes. That planning is still relevant, for example, if a business is divesting of assets or another line of business, starting a new business venture, or making other changes to its operations. The capital structure of a business will also likely have state tax implications.

Mincieli also said that:

> depending upon the combined apportionment factors of the group with a given state, either a higher or a lower state income tax may result than under separate company state reporting. Combined reporting can facilitate tracking of the state tax attributes (net operating losses and credit carryforwards) of a unitary group. Regarding state NOL usage, combined reporting could be a more effective filing route to utilize group member NOLs that are in danger of expiring on a stand-alone basis.

The Elephant in the Room

Given states' concern about the potential for corporate taxpayers to reduce their taxable income, and even with many states using unitary combined reporting or addback provisions, there is an elephant in the room: economic nexus. "Economic nexus is difficult to get around," said Richie. As a result, states may be eying economic nexus instead of addback provisions. He added: "Economic nexus casts a much wider net than addback provisions in the sense that it will capture e-commerce businesses and transactions beyond the related-party interest and expense transactions that addback provisions capture."

However, any trend toward economic nexus may be limited. Abrams said that once a state is using unitary combined reporting, it doesn't need economic nexus. Also, because of the difficulty for a state in going after taxpayers on a case-by-case basis to assert nexus and the potential for a court decision that strikes down economic nexus or federal legislation that mandates a physical presence standard, a simpler and safer route is for a state to require unitary returns.

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Also, now may not be the time for the enactment of new combined filing statutes in legacy separate filing states. Saviano said, "Because corporate profits are significantly down for many companies, many states will be hesitant to shift to a unitary taxing system for fear that the change will not yield a significant revenue increase."

Of course, reduced corporate profits should not lull corporate taxpayers into the false sense of security that states will do nothing to increase corporate taxes. As an alternative, Saviano suggested that more states might consider turning to alternative broad-based taxes, such as gross receipts taxes, that will apply regardless of whether a company is profitable.

Conclusion

Choosing between unitary combined reporting and addback provisions is a choice between the lesser of two evils for corporate taxpayers. Both present compliance challenges and eliminate some of the tax planning opportunities that previously existed. The ultimate choice by corporate taxpayers would depend largely on taxpayers' individual circumstances (and what produces the best return for them).

That said, it appears taxpayers would chose certainty and uniformity of either system over the often ad hoc systems that are in place today. Saviano agreed, saying "how difficult it is for taxpayers to operate in a system where they don't know the rules." The adoption of unitary combined reporting and addback provisions were wholesale, significant changes in states' taxing systems. In the end, what taxpayers want is "certainty and predictability in the application of the tax rules," Saviano said. Wagner summed it up by saying that unfortunately, "taxpayers and practitioners must do what they can to continue navigating the ever-changing landscape, but rest assured, it is unlikely there will be taxpayer-friendly alternatives in this area." ✰