COST
Council On State Taxation

Testimony to the House of Representatives of Pennsylvania House Finance Committee

Public Hearing on Combined Reporting

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Chairman O'Neill, Chairman Wheatley, and Members of the Committee, thank you for the opportunity to provide testimony today on behalf of the Council On State Taxation (COST) regarding the concept of "combined reporting" for corporate income tax purposes. Combined reporting, which originated in California, is more commonly associated with western U.S. states, but more recently has been adopted in certain eastern states as well. This method is quite different from the federal consolidated method familiar to Pennsylvania corporate tax practitioners. In the brief time available today, I will seek to provide the Committee with an overview of the combined reporting method and COST's and other research on the potential impact – on state revenue, administration, and taxpayers.

About COST

COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of approximately 600 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

Combined Reporting Basics

For state corporate income tax purposes, "separate entity reporting" treats each corporation as a separate taxpayer. Under this method, taxable income is often computed without regard to the federal consolidated rules, and taxpayers prepare separate, *pro forma* state returns with tax computed on a separate company basis. This is the method Pennsylvania currently uses; it is also used by many other "eastern" states. Of Pennsylvania's neighboring states, Delaware, Maryland, and New Jersey employ the separate entity reporting method. The majority of states that use separate entity reporting also allow an *election* for combined or consolidated filing – although sometimes these returns do not so much impact the tax calculation as to provide an administrative convenience for "nexus" filers.

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However, after two decades without any change to the general "east/west" dichotomy of separate versus combined reporting adoption, Vermont in 2004 enacted a combined reporting law. Since that time, a small number of states, mainly in the northeast, have followed suit. The southernmost reach of combined reporting includes two of Pennsylvania's neighbors: West Virginia, which adopted combined reporting in 2007, and New York, which last year adopted full unitary combined reporting after many years of using "distortion" based tests to address certain transactions between affiliates.

Combined reporting generally treats affiliated corporations (parents and subsidiaries) engaged in a "unitary business" as a single group for purposes of determining taxable income. I say "generally" because there are significant variations among combined reporting states in how entities within the combined group are treated vis-à-vis other group members. These variations include application of nexus rules,[1] members of the unitary group, apportionment, loss deductions, credits, and other items. The concept of a "unitary business" is a *constitutional* requirement that limits the states' authority to determine the income of a multistate enterprise taxable in a state. Due to varying state definitions and case law decisions, the entities included in a unitary group are likely to vary significantly from state to state and, in some cases, requires significant analysis by both the taxpayer and taxing authority.

The combined reporting method is significantly different from the federal consolidated method, in part because of the ways in which the combined method has developed independently at the state level, and more fundamentally because of the aforementioned constitutional limitations on state taxation of a multistate business. The purpose of a combined report is to geographically source the income of a unitary business, regardless of the "nexus" or presence of its members, whereas the federal consolidated method is applied on a residence basis.[2] In addition to the unitary requirement – a constitutional requirement that does not apply at the federal level – combined reporting is also generally subject to different ownership requirements (commonly 50%, as opposed to 80% at the federal level).

Combined reporting comes in two general "flavors" – a pre-apportionment combination, or what is commonly called "across and down," and a post-apportionment combination, or "down and across." In the pre-apportionment calculation, the separate companies' income is combined "across" the unitary group, and then is apportioned with a combined factor, yielding base income against which the statutory tax rate is applied. In the post-apportionment calculation, the separate companies determine their own base income "down" the list of combined group members, and then apply their own apportionment factor to yield base income against which the statutory tax rate is applied. This general description lays the groundwork for the calculation, but does not begin to describe the complexities in determining tax attributes and apportionment for unitary groups and their members. Nor does it describe all the kinds of combination and consolidation options and requirements in effect across the country.

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[1] The treatment of the combined group as one taxpayer, or the "*Finnigan*" rule, or the treatment of combined group members as separate taxpayers, or the "*Joyce*" rule, can result in significant differences in tax liability depending on taxpayer facts and state rules such as "throwback" of receipts.

[2] William L. Goldman, Portfolio 1130-2nd: Income Taxes: Consolidated Returns and Combined Reporting, BNA Tax Management, 2015.

The members of a combined group are generally limited to the "water's-edge," that is U.S. incorporated businesses, with certain exceptions for foreign income streams. Historically, there has been a controversy over the expansion of the water's edge filing method to worldwide combined filing (*i.e.*, inclusion of foreign-based entities). As a result, every state (except Alaska, for certain energy companies) limits filing to the water's edge, or provides a water's-edge election.

Having run through the basic concept of unitary combined reporting, let me share with you some of the research on the issue. I am appending to my written testimony COST's 2008 study on the competitiveness and revenue effects of combined reporting, prepared by Ernst & Young,[3] although I will cite other more recent studies as well.

Effect on Jobs

Evidence indicates that adopting combined reporting hinders investment and job creation in adopting states. Where combined reporting results in a relatively small increase in *net* corporate tax revenue, there will be significant increases and decreases in tax liabilities for individual businesses, as well as increases in administrative and litigation costs. Depending on the industry distribution of "winners" and "losers," combined reporting may have a negative impact on a state's overall economy. Moreover, economic theory suggests any tax increase resulting from adopting combined reporting will ultimately be borne by labor in the state through fewer jobs (or lower wages over time) or in-state consumers through higher prices for goods and services.

The COST study shows that states using separate entity reporting experienced higher job growth than states with combined reporting. From 1982 through 2006, job growth was 6% higher in states without combined reporting than in states with it (after adjusting for population changes).[4] Furthermore, during the recent recession, states with combined reporting experienced economic declines 16% greater than states without combined reporting.[5]

Effect on Revenue

Implementing combined reporting can have unpredictable and uncertain effects on state tax revenues. Some of the key uncertainties in implementing combined reporting are the impact of including loss companies in the group and the impact of apportionment dilution from out-of-state affiliates. The corporate income tax is the most volatile tax in every state in which it is levied, regardless of whether combined reporting is employed. In one study, the University of Tennessee found no evidence that states with combined reporting collect more revenue, and later found that combined reporting may or may not increase revenue.[6] In Maryland, a statutory

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[3] Robert Cline, "Combined Reporting: Understanding the Revenue and Competitive Effects of Combined Reporting," Ernst & Young, May 30, 2008
[4] Ibid., p. 16.
[5] Robert Cline, "Comparison of State Economic and Fiscal Performance During the Recession," Ernst & Young, January 12, 2010, p. 2.
[6] Ibid. 3, p. 34.

commission found similar uncertainty and volatility, with combined reporting increasing revenue in some years and reducing it in others.

While the number of corporations filing "zero returns" is often cited as a reason for adopting combined reporting, the COST study reflects that a high percentage of companies in *both* separate entity reporting and combined reporting states filed minimum or zero tax returns. This was generally due to the application of loss carryforwards, a large number of inactive corporations or corporations required to register for regulatory purposes, or the intended effect of exclusions, deductions, and credits.[7]

Another important revenue consideration is that states that have already enacted provisions limiting deductions for related party expenses – like Pennsylvania's existing "addback" statute – can expect significantly reduced anticipated incremental revenue from combined reporting.[8] In addition to mitigating any revenue gains from combined reporting, application of addback may create instances of double taxation, as for example, Pennsylvania's statute already disallows intercompany deductions for payments of certain intangible expenses.

Administrative Considerations

Combined reporting is more complex than separate filing, in particular because of the extensive fact-finding required to determine the composition of the "unitary group" and to calculate combined income. This complexity results in uncertainty and significant compliance costs for both taxpayers and the state. Here are some examples:

- *Determining the Unitary Group Members.* The "unitary business" is a constitutional (Due Process Clause) concept that allows a group of legal entities with common ownership and other specific facts to be treated as a whole "unitary" business enterprise for income tax purposes rather than as individual separate legal entities. In order to evaluate the taxpayer's determination of a unitary relationship, state auditors must look beyond accounting and tax return information. Auditors must annually determine how a taxpayer and its affiliates operate and interact at a fairly detailed level to determine which affiliates are unitary, if any. Auditors must interact with a corporation's operational and tax staff to gather this information. These facts must be analyzed in relation to the applicable unitary law and judicial precedent to come to a conclusion on the composition of a unitary group. In practice, however, the tax result (*i.e.*, revenue effect) of a unitary relationship often significantly influences the auditor's finding, as well as the taxpayer's determination. In short, determining the scope of the unitary group is a complicated and *subjective* process not required in separate filing states, which often results in expensive, time-consuming litigation.

- *Calculating Combined Income.* Calculating combined income is considerably more complicated than simply basing the calculations on consolidated federal taxable income. In most combined reporting states, the group of corporations included in a federal consolidated return differs from the members of the unitary group. In some instances, a

[7] Ibid. 2, pp. 8-9.
[8] Ibid. 2, p. 13.

taxpayer that files a single federal consolidated return may have more than one unitary group and therefore be required to file multiple unitary returns within a state. In addition to the normal variations in apportionment formulas among the states that apply to all corporate taxpayers, further compliance costs related to combined reporting result from variations across states in the methods used to calculate the apportionment factors. These additional complications require additional analysis and data and therefore add to the cost of compliance for both taxpayers and departments of revenue. From a financial reporting perspective, adopting combined is a significant change requiring states to consider ways to mitigate the immediate and negative impact those tax changes have on a company's financial statements, including the impact on deferred tax assets and liabilities.[9]

- *Implementation Concerns*. Both taxpayers and revenue departments have struggled with implementing combined reporting. For example, Texas' "margin tax," implemented on a combined basis, resulted in years of "disqualifications" to conduct business in the State because its computer systems were unable to account for differences between the combined group and separate company filing requirements under the old franchise tax regime. Additionally, the change to combined reporting required significant re-training for the Comptroller's Office compliance and audit staff. The transition has not been smooth in Massachusetts either, resulting in multi-year changes to the State's e-filing requirements for combined groups and the need for multiple rounds of surveys of groups such as COST to determine how to improve the State's filing system. The resulting frustration for taxpayers is substantial, with, for example, 64% of COST member respondents to an internal survey rating Massachusetts combined filing compliance as a "nightmare," 28% called it unnecessarily difficult, and only 8% thought it was of average difficulty. This reflects the steep "learning curve" for both taxpayers and revenue agencies, which translates to substantial investments in compliance and administration.

While some northeastern states have adopted combined reporting in recent years, this does not indicate it would be "simple" for taxpayers to comply with unitary filing if Pennsylvania were to adopt. Each state has its own specific tax regime with regard to apportionment, tax attributes, and nexus, which require separate analysis on a state-by-state basis. In addition, the Pennsylvania Department of Revenue would require extensive staff training on the very technical aspects of administering combined reporting. Based on recent experiences in Massachusetts and elsewhere, this is not a small task.

Concerns with Fairness

Although combined reporting may be designed to help overcome distortions in the reporting of income among related companies in separate filing systems, the mechanics used under combined reporting create a new set of distortions in assigning income to different states. The combined reporting assumption that all corporations in an affiliated unitary group have the same level of profitability is not consistent with either economic theory or business experience. Consequently, combined reporting may reduce the link between income tax liabilities and where

[9] ACS 740 (formerly FAS 109) requires a recordation of tax expense under certain circumstances that can negatively impact a company's stock price and value.

income is actually earned. Many corporate taxpayers may conclude there is a significant risk that combined reporting will arbitrarily attribute more income to a state than is justified by the level of a corporation's real economic activity in the state.

Concerns with the fairness of combined reporting adoption are deepened by restrictions on the use of unitary affiliates' tax credits and losses to offset the group's combined income – a common feature included in the Multistate Tax Commission's model combined reporting statute. A cap on net operating loss deduction utilization – such as that employed in Pennsylvania – further exacerbates the unequal impact of combined reporting adoption. Combined reporting may also result in the unintended disqualification of taxpayers from economic development incentive eligibility – for example, Keystone Opportunity Zone qualification could be negatively impacted by inclusion of combined factors.

Another important consideration is whether combined reporting regimes seek to reach beyond what is commonly recognized as the "water's-edge," as previously described, in a manner that could lead to extraterritorial double taxation of global companies operating in the adopting state. For example, recent water's-edge proposals contain provisions applying tax to income of non-U.S. companies attributable to legitimate cross border transactions, including cross-border payments such as royalties and interest that the federal government does not tax because of bilateral tax treaties. Further, a small number of states have adopted a "tax haven" classification, which includes all income from companies incorporated (or doing business) in certain nations, regardless of the substance of particular transactions or corporate structures. These "tax haven" listing efforts raise significant constitutional issues regarding interference in U.S. foreign affairs. Adoption of such provisions increases concerns over the arbitrary impacts of combined reporting, as well as exacerbating revenue and competiveness concerns as global companies examine locations in which to invest and create jobs.

Conclusion

Although it has been considered and adopted in certain eastern states in recent years, studies show combined reporting is a costly means by which a state may seek to raise relatively small amounts of revenue, because of its negative impact on job creation, the burdens of compliance and administration, and the uncertainty it generates.

Thank you for your invitation to address the Committee this morning, and I welcome any questions.