NAVIGATING STATE TAXATION IN A GLOBAL BUSINESS ENVIRONMENT

Determining What's Unitary: Combined Filing Requirements and Options

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Filing Methods

Worldwide combined reporting

- Held constitutional in *Container* and *Barclays Bank*, but no state requires worldwide combined reporting without providing water's-edge election
  - Ability
  - Elective in certain states – e.g., D.C., Massachusetts, Utah, West Virginia
  - Potential

Water's-edge reporting

- Elective in several states – e.g., California, Idaho, Massachusetts, Utah
- Required in many states – e.g., Illinois, Michigan, Minnesota, Wisconsin
- Some states exclude all foreign corporations from their unitary returns filed on a water's edge basis; however, many states still include foreign corporations under certain circumstances

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Filing Methods

- Water's-edge election generally excludes certain non-US affiliates, except:
  - Non-US members if average of property, payroll, and sales factor within US is 20% or more
  - US source income of non-US members without regard to treaties
  - Certain Subpart F income of non-US members
  - Non-US members that earn more than 20% of income from intangible property or services related activities that are deductible by other members, to extent of income and apportionment factors
  - Entire income of member doing business in tax haven

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Worldwide Reporting

- **Benefits of Worldwide Reporting**:
  - Intergroup eliminations
  - Tax haven issues
  - Foreign entity income / apportionment dilution

- **Add-backs may make water's-edge group detrimental**

- **Issues with Worldwide Reporting**:
  - Functional currency
  - Accounting methods
  - Book v. tax records
  - International tax planning
  - Non-tax issues

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Recent legislation - Elections

- Michigan - Affiliated Group Election
  - Available for tax years beginning after 12/31/2012
  - Binding for 10 years
- New York - Election for “commonly owned groups” with a seven-year election period
- Rhode Island - Election for an affiliated group of corporations regardless of whether the corporations are engaged in a unitary business with a 5-year election period
- Massachusetts and Wisconsin already allow a 10-year election to include all members in the affiliated group (using a greater than 50% ownership threshold)

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Foreign Entity Inclusion

- Some typical rules for inclusion of foreign entities:
  - A foreign corporation may be included in a unitary return if it is subject to federal income tax or required to file a federal income tax return
  - A foreign corporation may also be included in a unitary return to the extent of its ECI
  - A foreign corporation with no ECI may be included in a unitary return to the extent of its U.S. source FDAP income

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Foreign Entity Inclusion

Some typical rules for inclusion of foreign entities (cont'd)

- A CFC may be included in a unitary return to the extent of its subpart F income
  - In California, a CFC is included in the unitary return based on the ratio of its subpart F income to current year E&P
  - In West Virginia, the income of a CFC is included to the extent of its subpart F income, but any income that was subject to an effective rate of tax in a foreign country that is greater than 90% of the maximum federal rate is excluded (i.e., "high tax CFC exception")

New York – A non-US corporation's tax is computed on federal effectively connected income without regard to tax treaty benefits

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Foreign Entity Inclusion

- A foreign corporation may be included in a unitary return to the extent that 20% or more of its activity is within the US
  - Some states will look at the average of the corporation's property and payroll factors
  - Other states look at the average of the corporation's property, payroll, and sales factors
  - Another approach is whether the corporation has less than 80% active foreign business income
  - Data and planning

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Foreign Entity Inclusion

- California
  - Unique rules
- Michigan - foreign corps and foreign operating entities are excluded
  - Foreign Operating Entity: a U.S. corporation with substantial operations outside the U.S., and at least 80% of its income is active foreign business income as defined in IRC Sec. 861(c)(1)(B)

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Foreign Entity Inclusion

- Rhode Island (effective 2015)
  - Non-US corporations are excluded from the combined group if the sales factor of the non-US corporation outside the US is 80% or more
  - If the non-US corporation is includable, income subject to the provisions of a tax treaty and attributable expenses or apportionment factors are not includable in the determination of the combined group's net income
  - Special "tax haven" rules

- Texas
  - If 80% of a taxable entity's property and payroll is outside the U.S., the entity is excluded

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Foreign Entity Inclusion

- Inclusion of a foreign corporation in a unitary return if it earns more than 20% of its income, directly or indirectly, from intangible property or service related activities, the costs of which are deductible against the business income of other members of the unitary group (DC, MA, and WV)
  - Inclusion is limited to the extent of the income and apportionment factors related to such intangible property and service related activities
  - In DC, the provision is limited to foreign corporations that are residents of a country that does not have a comprehensive income tax treaty with the U.S.
  - In WV, the provision does not apply to income that is exempt from federal income tax pursuant to a comprehensive income tax treaty with the U.S.

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Tax Haven Rules

Inclusion of a foreign corporation incorporated or doing business in a "tax haven" jurisdiction (AK, DC, MT, OR, RI and WV)

- In AK, a tax haven jurisdiction is a country that does not impose an income tax, or that imposes an income tax at a rate lower than 90% of the US rate
- In DC, the definition of a tax haven means a jurisdiction that may have one of statutorily enumerated traits
- In MT, the list of tax haven countries is set forth by statute and is updated as necessary
- In WV, the list of tax haven countries is based on the OECD tax haven designations
- Tax Haven Entities may bring in parts of transactions or unexpected income items

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Combined Group Variations – Multiple Groups

Multiple Combined Groups may be Required

- Illinois (General/Financial Corps/Insurance Co's)
- New York / New York City
- Different lines of Business

Issues

- Getting data by entity / group
  - Cost of performance data
- Accounting records may not align with state group requirements
- Splitting entities between groups

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Combined Group Variations – Multiple Groups

Multiple Combined Groups -

- **Intercompany Transactions**
  - Income / expense determination v. apportionment
  - Negative income

- **Audit Considerations**
  - Group changes
  - Fringe entities
  - Ease / benefit of including all companies
  - Get the federal return right

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Combined Groups – Variations from the Usual

Arizona Combined Filing

- Corporations conducting a unitary business are required to file a water's edge combined report
- An Arizona consolidated return may be elected
- Arizona requires operational unity amongst the group members
- Interdependence of basic operations is required
- The same line of business is not determinative

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Combined Groups – Variations (cont'd)

Colorado Combined Report

- A combined report generally includes all C corporations that meet three of six statutory tests for the previous two years and the year of tax filing:
  - Sales or purchases of an affiliated corporation involving another affiliate constitute 50% or more of the gross sales or purchases
  - Five or more specified services are provided to an affiliated corporation at less than an arm's length charge
  - 20% or more of the long-term debt of an affiliated corporation is owed or guaranteed by another affiliate
  - One affiliated corporation substantially uses the intellectual property of another affiliate
  - 50% or more common board of directors with another affiliate
  - 25% or more common officers with another affiliate

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Group Changes

- Instant Unity
- California generally requires some (indeterminate) amount of time to elapse depending on facts and circumstances
- Colorado requires two tax years before becoming unitary
- Pre-existing history
- Multi-factor DC / Mass / WV

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Legislative Update

Michigan – H.B. 5009 (2014)

- Each U.S. person must be treated as a single person
- All transactions between persons in the group must be eliminated from the CIT base, the apportionment formulas, and for purposes of determining exemption, credits, and filing thresholds

Minnesota

- Provisions relating to foreign operating corporations (“FOCs”) are eliminated
- The income of a foreign entity, other than an entity treated as a C corporation for federal income tax purposes, that is included in the federal taxable income of a domestic corporation, domestic entity, or individual must be included in determining the net income of a unitary business
  - a proportionate share of the foreign apportionment factors are also included

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Legislative Update (cont'd)

New York Combined Reporting

- Adopts full water-edge combined reporting
- More than 50% ownership test in place of the 80% test
- Election for "commonly owned groups" with a seven-year lock-in
- Requires combined reporting for certain captive insurance companies
- "One-taxpayer" approach for computing group tax except for credits

Rhode Island

- Adopts mandatory water's edge combined reporting in 2015
  - *Finnigan* approach applies

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Case Law Developments

Vermont

- *AIG Insurance Mgmt. Services, Inc. v. Vermont Dept. of Taxes*, No. 589-9-13 (Vt. Sup. Ct., July 30, 2014).
- The Vermont Superior Court determined that AIG – a parent company that was involved in operating insurance and financial businesses -- was not unitary with its subsidiary which operated a ski resort in Vermont.
- The Court concluded that the ski resort "was a discrete business that did not send taxable value out of state in any appreciable way." Furthermore, there had been no evidence that AIG used the resort for marketing purposes or exerted any significant managerial control over the ski resort.
- Thus, the Superior Court concluded that the ski resort was operated as a discrete business enterprise unrelated to AIG's insurance and financial businesses and the Commissioner's finding of a unitary business was outside the Constitutional boundaries of the unitary business principle.

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Case Law Developments (cont'd)

California

- *Comcon Production Services Inc. v. Franchise Tax Board*, Los Angeles Super. Ct. No. BC489779 (Mar. 6, 2014).
- The California Superior Court determined that Comcast – a parent company that operated a cable network – was not unitary with QVC – a company that operated a retail shopping channel.
- Comcast owned a majority of the interests in QVC, and Comcast's cable network had an agreement under which it broadcast the QVC shopping channel to Comcast's subscribers.
- The court found that none of the indicia of a unitary business set forth by the US Supreme Court in the *Mobil* case were present because the evidence showed there was no centralized management, no functional integration, no economies of scale, and no other non-trivial alleged flows of value.
- The court reiterated the common principle that mere potential to control another commonly owned company is not evidence of a unitary business.

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Fair Apportionment v. Tax Base

Many states have implemented combined reporting:

- The rationale is that combined reporting prevents the distortion that may result from applying the traditional three-factor formula on a separate entity basis.
- By requiring a corporate parent and its subsidiaries to file a combined report, states seek to prevent the perceived loss of state tax revenues.
- In *Media General, Inc. v. SC Dep't of Rev.*, 694 S.E.2d 525 (2010), the taxpayer was the entity seeking combined reporting, even though South Carolina was a separate reporting state. The SC Supreme Court agreed that combined reporting should be allowed to "effectuate an equitable allocation and apportionment of the taxpayer's income."

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