

District of Columbia's 2012 Budget Support Act of 2011 Implements Combined Unitary Reporting

September 14, 2011

Overview

On June 14, 2011, the D.C. Council adopted the Fiscal Year 2012 Budget Support Act of 2011 (D.C. Bill 19-203, referred to herein as "Act 19-0098" or the "Act"), containing the city's fiscal 2012 budget.¹ On July 8, 2011, the bill was transmitted to D.C. Mayor Gray for his review, and on August 2, 2011, the Act was transmitted to Congress for the 30-day review and approval period. As of the issuance date of this External Tax Alert, the official website of the Council of the District of Columbia indicates that the Act is projected to become permanent law on September 14, 2011.²

The Act requires a taxpayer engaged in a unitary business with one or more corporations to file a unitary combined D.C. Franchise Tax report for tax years beginning after December 31, 2010.

In this External Tax Alert, we summarize the provisions of the Act relating to combined reporting, including composition of the water's-edge filing group, worldwide filing elections, the separate identity of each member, application of tax attributes such as net operating losses and credits, and the impact on corporate partners. We also summarize the deduction allowed for an increase in net deferred tax liabilities. The Act also makes numerous other changes to D.C. income and transaction taxes. We have issued a separate External Tax Alert summarizing these other changes.

Combined Reporting

The Act requires a taxpayer engaged in a unitary business with one or more corporations to file a unitary combined D.C. Franchise Tax report (hereinafter, a "combined report"), which includes the income and the allocation and apportionment factors of all corporations that are part of a water's-edge combined group. The "combined report" appears to be generally limited to corporations.³ This change will apply to tax years beginning after December 31, 2010.⁴

Unitary Business

A unitary business is defined as "a single economic enterprise that is made up either of separate parts of a single business entity or of a commonly controlled group of business entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts."

The Act does not provide a definition of "commonly controlled" or provide ownership criteria for group members.

¹ Please see our June 15, 2011 Multistate Tax Alert summarizing the provisions of the Act, available at: http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/Tax/us_tax_multistate_DC_061611.pdf.

² See <http://www.dccouncil.washington.dc.us/lms/searchbylegislation.aspx>.

³ The definition of a combined group (§ 47-1801.04(7)) and the composition of a water's-edge combined group (§ 47-1810.07(a)(2)) both include entities other than corporations. The broad powers provided the Mayor under the Act would allow the inclusion of other types of entities by regulation or as deemed necessary on a case-by-case basis.

⁴ In new § 47-1805.02a the effective date is "for tax years beginning on and after December 31, 2010." However, Act § 8004 provides that the new combined reporting subtitle (including new § 47-1805.02a) is effective tax years beginning after December 31, 2010.

Water's Edge Filing and Worldwide Election

The Act provides that taxpayer members of a unitary group will file as a water's-edge unitary combined group unless an election is made to report on a worldwide unitary basis. A water's-edge combined group takes into account only the following unitary members:

- a member incorporated in the U.S. or formed under the laws of any state,⁵ D.C., or any U.S. territory or possession;
- a member, regardless of where formed, if the average of its property, payroll, and sales factors within the U.S. is 20% or more;
- a member that is a domestic international sales corporation, a foreign sales corporation, or an export trade corporation;
- a member that is a controlled foreign corporation, to the extent of certain income defined in IRC § 952 of Subpart F;
- a member that is a resident of a country that does not have a comprehensive income tax treaty with the U.S. and earns more than 20% of its income, directly or indirectly, from intangible property or service-related activities that are deductible against the business income of other members of the water's-edge group, to the extent of that income; and
- certain members doing business in a tax haven and engaged in activity sufficient for that tax haven to impose a tax under U.S. constitutional standards.

Note also that a member not otherwise included "shall include its business income that is effectively connected" with the conduct of a U.S. trade or business subject to federal income tax.

An election is available to file as a worldwide unitary combined group that includes all the corporations that are members of the unitary business. The election is generally binding for the tax year made and ten years thereafter.

Separate Identities

Under the Act, a combined report does not disregard the separate identities of the individual taxpayer members of the combined group. This appears to suggest the *Joyce*⁶ approach, but the application of the *Joyce* rule to the sales factor for apportionment purposes has not been specifically addressed by the Act. Each taxpayer member is responsible for tax attributable to its taxable income or loss apportioned or allocated to D.C., based on the taxpayer's apportioned share of business income of the combined group. Business income of the combined group is calculated as a summation of the individual net business incomes of all members of the group.

As a filing convenience, the group may annually elect to designate one member to file a single return.

Net Operating Losses

If the taxable income computed under the Act results in a loss for a member of the combined group, that member has a D.C. net operating loss ("NOL"), subject to the NOL limitations and carryover provisions. The D.C. NOL is applied as a deduction in a subsequent year only against that taxpayer's D.C. source positive net income, whether or not the taxpayer is or was a member of a unitary combined reporting group in the prior or subsequent year.

Tax Credits and Post-Appportionment Deductions

Except where otherwise provided, no tax credit or post-apportionment deduction earned by one member of the group may be used by another member of the group or applied against the total income of the combined group.

⁵ Note – the definition of "state" as contained in amended § 47-1801.04(45) includes "any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory, or possession of the United States *and any foreign country or political subdivision thereof*" (emphasis added). Although this would seem to be an apparent drafting error, the definition of a water's-edge group appears to include foreign corporations.

⁶ *Appeal of Joyce, Inc.*, California State Board of Equalization, SBE-XIV-215, 66-SBE-070 (11/23/66).

Unincorporated Business Tax

If the combined group includes or owns an unincorporated business that would be subject to the D.C. tax on unincorporated businesses, the income or loss of such unincorporated business shall be separately apportioned to D.C. using apportionment factors of the unincorporated business, and the combined group member's distributive share of such post-apportionment income shall be added to the combined group member's D.C. taxable income. The member will otherwise compute its D.C. taxable income without regard to any income, loss, or apportionment factors of such unincorporated business. A combined group member's distributive share of an unincorporated business's pre-apportionment income or loss shall be exempt from the unincorporated business tax.

Corporate Partners

Any business conducted by a partnership is treated as conducted by its partners, whether directly held or indirectly held through a series of partnerships, to the extent of the partner's distributive share of the partnership's income (regardless of the percentage of the partner's ownership interest or its distributive or any other share of partnership income). A business conducted directly or indirectly by one corporation through its direct or indirect interest in a partnership is unitary with that portion of a business conducted by one or more other corporations through their direct or indirect interest in a partnership if there is a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts and the corporations are members of the same commonly controlled group.

The property, payroll, and sales of a partnership shall be included with the partner's factors in proportion to a ratio, the numerator of which is the amount of the partner's distributive share of partnership's unitary income included in the income of the combined group and the denominator of which is the amount of the partnership's total unitary income. (Note – see discussion of Unincorporated Business Tax, above.)

Powers Reserved for the Mayor

The Act specifically reserves certain powers for the Mayor. For example, the Mayor may:

- By regulation, require a unitary combined report to include the income and apportionment factors of any persons that are not included in the standard water's-edge group but that are members of a unitary business in order to reflect proper apportionment of income of the entire unitary business;
- Require the exclusion of any one or more of the factors, the inclusion of one or more additional factors, or the employment of any other method to reflect an equitable allocation and apportionment of the taxpayer's income to D.C.;
- Adopt regulations to ensure that the D.C. tax liability or net income of any taxpayer is properly reported; and
- Disregard a worldwide unitary election if any member of the unitary group fails to comply with D.C. law, or compel a worldwide unitary group.

Deduction for Increase in Net Deferred Tax Liabilities

If the enactment of unitary combined reporting results in an increase to a combined group's net deferred D.C. tax liability, the group may be entitled to a deduction to the extent of the net increase in the taxable temporary differences that caused the increase in the net deferred tax liability. Only publicly traded companies, including affiliates participating in the filing of a publicly traded company's financial statements as of the effective date of the Act, will be eligible for the deduction.

In determining the deduction allowed, "net deferred tax liability" means the net increase, if any, in deferred tax liabilities minus the net increase, if any, in deferred tax assets of the combined group. Computations must be made in accordance with either Generally Accepted Accounting Principles ("GAAP") or International Financial Reporting Standards ("IFRS").

The deduction is allowed over seven years, beginning in the fifth year of combined filing. The annual deduction is equal to 1/7th of the net increase in the taxable temporary differences resulting from the imposition of unitary combined reporting computed at the time of enactment that caused the increase in the net deferred tax liability. To the extent the deduction would produce a net operating loss in any tax year, the unused deduction is carried forward to each succeeding tax year indefinitely by the combined group and deducted without regard to any limitation. The cumulative deduction is limited to the amount necessary to offset any increase in the net deferred tax liability that results from the imposition of unitary combined reporting but for this deduction.

Status of the Act

As of the issuance date of this External Tax Alert, the official website of the Council of the District of Columbia indicates that the Act is projected to become permanent law on September 14, 2011, when the 30-day Congressional review period expires.

Contacts

If you have questions regarding the D.C. combined reporting law or other D.C. tax matters, please contact any of the following Deloitte Tax LLP professionals or your Lead Multistate Professional.

David Vistica
Director
Deloitte Tax LLP, Washington D.C.
dvistica@deloitte.com
(202) 370-2268

Joe Carr
Director
Deloitte Tax LLP, McLean
josecarr@deloitte.com
(703) 251-1532

Scott Frishman
Principal
Deloitte Tax LLP, McLean
sfrishman@deloitte.com
(703) 251-3471

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