# DEPARTMENT OF TAXATION
# 2012 Fiscal Impact Statement

**1. Patron** James M. Scott

**2. Bill Number** HB 1267

**House of Origin:**
X **Introduced**
____ **Substitute**
____ **Engrossed**

**Second House:**
____ **In Committee**
____ **Substitute**
____ **Enrolled**

**3. Committee** House Finance

**4. Title** Income Tax: Unitary Combined Reporting

**5. Summary/Purpose:**

This bill would adopt unitary combined reporting for Virginia corporate income tax purposes. Under this bill, beginning with taxable years beginning on and after January 1, 2013, any taxpayer engaged in a unitary business with one or more other corporations would be required to file a unitary combined report that includes the income and apportionment factors of all the affiliates of the taxpayer that are members of the unitary business, and any other information that the Tax Commissioner requires.

The Tax Commissioner would be allowed to require, by regulation, that the unitary combined report include the income and apportionment factors of any entities that are not included in the unitary return but are members of the unitary business, in order to determine the apportionment of income for the unitary businesses. The Tax Commissioner would also be allowed to require, by regulation, unitary combined reporting for entities that are not subject to the laws of the Commonwealth, even if the entity does not do business in the Commonwealth.

Under this bill, the use of a unitary combined report would not disregard the separate identities of the members of the combined group. Each member of the unitary group would be responsible for the tax based on its taxable income or loss that is allocated and apportioned to Virginia, which would include, in addition to other types of income, the member's apportioned share of business income of the combined group. Business income would be the income of the combined group, calculated as the sum of the individual net business incomes of all members of the combined group.

This bill would allow members of a combined group to annually elect to designate one member of the combined group to file a single return on behalf of the combined group, provided that the designated member consents to act with respect to the tax liability of all members included in the combined group and agrees to act as the agent on behalf of the entire group for the specified amount of time.

Under this bill, a unitary group would determine the apportioned shares of the net business income or loss of the combined group according to a worldwide basis. This bill would allow a unitary group to elect a water's-edge method for determining net business income or loss, provided the election is made on a timely-filed, original return by every member of the unitary group. The Tax Commissioner would be required to develop rules and regulations that provide procedures for making a water's-edge election, including procedures for when a change in the composition of the unitary group, the combined group, the taxpayer members, and any other similar change occurs. The water's-edge election would be binding for 10 years, beginning with the year in which the election is made. The unitary group would be allowed to request in writing to withdraw the water's-edge election provided it can demonstrate that it causes an extraordinary hardship due to unforeseen changes in Virginia law.

This bill would be effective for taxable years beginning January 1, 2013.

**6. Budget amendment necessary:** Yes.
Page 1, Revenue Estimates
ITEM: 273, Department of Taxation

**7. Fiscal Impact Estimates are:** Preliminary. (See Line 8.)

**7a. Expenditure Impact:**

| ***Fiscal Year*** | ***Dollars*** | ***Positions*** | ***Fund*** |
|---|---|---|---|
| 2011-12 | | 0 | GF |
| 2012-13 | $312,620 | 6 | GF |
| 2013-14 | $352,610 | 6 | GF |
| 2014-15 | $607,105 | 6 | GF |
| 2015-16 | $620,386 | 6 | GF |
| 2016-17 | $637,288 | 6 | GF |
| 2017-18 | $654,392 | 6 | GF |

**8. Fiscal implications:**

Administrative Costs

The Department would incur significant administrative costs in the amount of $312,620 in FY 2013, $352,610 in FY 2014, $607,105 in FY 2015, $620,386, in 2016, $637,288 in FY 2017 and $654,392 in FY 2018 to implement unitary combined reporting. These costs include developing new forms for corporations subject to unitary combined reporting as well as the systems to process them, changing audit programs, and making changes to compliance efforts. In addition, the department would need to hire additional full-time employees to conduct audits and handle audit appeals, and provide extensive training to customer service, audit and appeals personnel.

Revenue Impact

This bill would potentially increase General Fund revenue significantly. Developing a reliable revenue impact for adopting unitary combined reporting is limited by insufficient data. Estimating the revenue impact requires information about the income, accumulated net operating losses, and apportionment factors of corporations that are not presently required to file any income tax returns with Virginia. It also requires information about which corporations in an affiliated group are engaged in the same unitary business. Current Virginia data only identifies subsidiaries that corporations elect to include in

Virginia combined or consolidated returns. For corporations that elect to file on a separate basis, Virginia does not collect information that links subsidiaries together or makes determinations as to whether partially owned subsidiaries meet the requirements to be included in the Virginia combined or consolidated returns.

Although federal tax data may be used to identify ownership of corporations in an affiliated group, and their income, the federal returns do not have data on the apportionment factors or the nature of each corporation's business and its functional integration, centralized management and economies of scale that would identify the members of a unitary group. While other states have produced revenue estimates for adopting unitary combined reporting, it is unclear that their methodologies adequately address these concerns.

Based entirely on the estimates produced by other states relating to the enactment or consideration of unitary combined reporting, including Connecticut, Florida, Iowa, Maryland, Massachusetts, New Mexico, Pennsylvania, Rhode Island, Vermont, West Virginia, and Wisconsin, as well as the District of Columbia, the Department estimates that this bill could increase General Fund revenue in an amount up to $93.85 million in FY 2014, $80.23 million in FY 2015, $93.18 million in FY 2016, $106.97 million in FY 2017, and $115.49 in FY 2018. However, this estimate is highly speculative for the reasons stated above. Under this bill, there would be no revenue impact in Fiscal Year 2013 because corporations would be making their estimated payments based on the prior year's tax liability. However, for Taxable Year 2013, tax returns and tax payments would be filed during the Spring of 2014. Beginning in Taxable Year 2014, taxpayers would begin adjusting their estimated payments to conform to the unitary combined reporting requirements that would be created by this bill.

Unitary combined reporting creates winners and losers because there would be some businesses that would see a decrease in tax liability while others would see an increase. This has revenue implications because the winners will comply immediately, while the losers may wait for our auditors to find them.

**9. Specific agency or political subdivisions affected:**

Department of Taxation

**10. Technical amendment necessary:** Yes.

The bill is derived from model legislation developed by the Multistate Tax Commission, but has not been fully adapted to Virginia law (e.g., references to "Director" instead of Tax Commissioner, failure to address special formula for certain industries, and failure to coordinate with the statutory prohibition to worldwide combination. This bill would require that several policy and technical issues are resolved in order to properly implement this bill.

The conflicting policy issues include the following:

- The exclusive use of property, payroll and sales under unitary combined reporting conflicts with the special formulas that Virginia provides for certain industries under *Va. Code* § 58.1-420;

- The broad discretion under unitary combined reporting conflicts with the restrictive allowance of alternative methods of allocation and apportionment under *Va. Code* § 58.1-420;

- The unitary combined reporting worldwide default election conflicts with Virginia's prohibition of the use of worldwide reporting under *Va. Code* § 58.1-443; and

- Virginia has refused to base its allocation and apportionment rules on the distinction between business and non-business income under *Va. Code* § 58.1-407, while non-business income is allocable under unitary combined reporting.

**11. Other comments:**

<u>Background</u>

Currently, forty-four states impose an income tax on corporations. A "corporation" is any entity created as a corporation under the laws of any state or local domestic or foreign jurisdiction, and any association, joint stock company, or any other entity subject to corporate income tax under the Internal Revenue Code. Corporations may also form separate entities (affiliates) for various legal and operational purposes, which may operate in multiple states. The function of these entities can vary, with some engaging in a business that is different from the parent company, while others may perform functions and activities that are related to the business of the parent company.

When assessing tax on corporations, there are several factors that each state must address. The first factor to be addressed is whether the corporation and any affiliates have nexus with the state. Nexus occurs when a non-resident entity, has sufficient contacts with a state to subject it to income tax. Federal law prohibits Virginia from taxing certain corporations that sell tangible personal property to Virginia customers. This law, Public Law 86-272, prohibits states from subjecting the sale of tangible personal property to a net income tax where the taxpayer's only business activities within the state during the taxable year are the solicitation of orders by the taxpayer or his representative for the sale of tangible personal property.

The second factor is to determine how a multistate corporation must allocate and apportion income to a state. For corporate income tax purposes, multistate corporations are generally required to allocate and apportion income among the various states. Most states apportion income by multiplying income by an apportionment factor, which is typically comprised of a payroll factor, a property factor, and a sales factor. The payroll factor is generally the amount of payroll in the state divided by total payroll everywhere. The property factor is generally the amount of property owned in the state divided by total property everywhere. The sales factor is the amount of sales or gross receipts sourced to the state divided by total sales or gross receipts everywhere. Some states (including Virginia) use a double-weighted sales factor, meaning that they multiply the sales factor by two, add it to the property and payroll factors, and divide by four. The allocation method involves a set of rules for determining when to source sales or gross receipts to the state for purposes of determining the sales factor.

The third factor is developing tax reporting and filing procedures to determine which companies are included in a tax return. Generally, there are two different approaches for reporting corporate taxable income. The first is through separate reporting, which allows companies to report the profit of each of its affiliates independently. With separate reporting, the parent company and affiliates are treated as separate companies in determining income. A company that is subject to tax files a tax return that includes only the income and apportionment factors of that company, and there is no merging of income or factors of the related companies. Virginia currently follows the separate reporting model, along with twenty-two other states. The second is through unitary combined reporting, which requires a multi-state corporation to add together the profits and losses of all of its subsidiaries, regardless of their location, into one report. Under unitary combined reporting, however, a parent corporation and its affiliates that are engaged in a unitary business are treated as a single group in determining income. In theory, the resulting tax burden of the combined group of entities is comparable to the tax burden that would result if the entities were merged into a single firm.

For filing purposes, states may require that a corporation file in several ways, but the most common are the following: (1) each entity files its own separate return, (2) the group files a consolidated return, which groups entities together based on ownership requirements, or (3) the group files a combined return, which considers both ownership and business relationships to determine the filing group.

Separate reporting requires each individual company that has nexus in a state to file a separate tax return based on the income of the individual company. This type of reporting follows the separate entity concept, in which a company is treated as distinct and separate from its parent company or affiliates.

Consolidated reporting is based on common ownership to determine a filing group of corporations, each of which has nexus with the state. In a Virginia consolidated return, all companies under common ownership and with Virginia nexus file one tax return that includes all the income of the group, and is apportioned based on the entire group's percentage of in-state factors to total factors. The entire consolidated group pays one tax amount. States define a consolidated group differently, but it usually requires a certain common ownership threshold, such as 80 percent of the voting stock or when at least 80 percent of the voting stock of the corporation is owned by the same interests. Because of these differences, and the nexus requirement, the corporations included in a Virginia consolidated return often differ from those in a federal consolidated return.

Virginia offers a variation of consolidated reporting called a combined return (hereinafter called "Virginia combined return" to distinguish it from the proposed unitary combined return). In a Virginia combined return the ownership and nexus requirements are the same as for a consolidated return, but each corporation computes its income and apportionment factors separately and then the separate incomes are combined.

Unitary combined reporting, unlike consolidated return rules and the existing Virginia combined reporting method, takes into consideration both ownership and the business relationship of related entities, but ignores nexus and the ownership requirements are less than 80 percent. Unitary combined reporting is a tax reporting method in which all of the members of an affiliated group engaged in a unitary business (a "unitary group") are required to determine their net income based on the activities of the unitary group as a whole. The U.S. Supreme Court has held that a unitary business is a single economic enterprise, and that a state may apportion transactions and operations within its borders to determine its taxable income (see Mobil Oil Corp v. Commissioner of Taxes, 445 U.S. 425 (1980)). Under the unitary business model, business could be carried out through one branch of a single legal entity or through several separate affiliated entities operating together.

Purpose of Unitary Combined Reporting

There are several explanations that proponents offer for adopting unitary combined reporting, including providing an accurate measure of income, controlling income shifting, and increasing corporate income tax revenues. In a 2009 report, Wisconsin asserted that the adoption of unitary combined reporting "closes tax loopholes that allow very large multi-state corporations to shift profits from one subsidiary to another, enabling them to move profits out of Wisconsin and thereby minimize or avoid paying state income tax." The report also claims that by closing these loopholes, the state will increase its revenues.

Unitary combined reporting is intended to address the tax planning strategies used by various kinds of entities, including intangible holding companies. An intangible holding company ("IHC") is generally a corporation formed to hold intangible assets such as trademarks, trade names, or patents. The IHC is typically located in states that do not impose a corporate income tax on them. Corporations transfer their intangible assets to their IHC and enter into an agreement to pay for the continued use of its intangible assets. When the corporation computes its state corporate income tax, it deducts the expenses that it paid to the IHC to use these intangible assets. Unitary combined reporting would correct this tax avoidance because the IHC would be included in the unitary combined return.

Another tax planning method creates an affiliate that qualifies as a real estate investment trust ("REIT"). REITs were established in the 1960s by Congress and are exempt from paying taxes on dividends paid to its investors. Some retail stores created a "captive REIT" that owned the land and buildings in which the retail stores were located. The retail chain pays rent, based on a percentage of sales, to the captive REIT, but the rent is paid back to the retail company or an affiliate as untaxed dividends. Unitary combined reporting would include the REIT dividends in apportionable "business income" as well as the affiliates that received them.

Some states have implemented add-back laws to specifically address these types of income shifting, whereby taxable income that is shifted to an entity like an intangible holding company or captive REIT is added back to a taxpayer's income to determine taxable income. Proponents of unitary combined reporting assert that although states can address tax avoidance strategies through add-backs, these types of laws must be specifically tailored to address certain income shifting practices, and are difficult for tax agencies to administer. Unitary combined reporting does not require a tax agency to identify income-shifting transactions through audit and compliance procedures, and instead requires affiliates engaged in a unitary business to combine all income into one report in order to determine the apportionable income.

Virginia Law

If a corporation's income is from activities that are taxable both in Virginia and outside Virginia, the corporation must allocate and apportion income. Dividends must be allocated to the commercial domicile of the corporation and all other income must be apportioned. In 1960, and again in 1981, Virginia chose not to base allocation and apportionment on business and nonbusiness income.

Apportionable income is calculated by multiplying Virginia taxable income by a fraction, the numerator of which is the property factor plus the payroll factor plus twice the sales factor, and the denominator of which is four. If there is no sales factor, the denominator will be the number of existing factors. If there is a sales factor but no property or payroll factor, the denominator will be the number of existing factors plus one.

In general, every corporation that is incorporated under Virginia law, or that has registered with the State Corporation Commission for the privilege of conducting business in Virginia, or that receives income from Virginia sources, must file a Virginia corporation income tax return. Virginia allows corporations that are affiliated to elect to file in one of the following ways: separately, consolidated, or using the Virginia combined return. In order for corporations to be considered affiliated for purposes of filing a Virginia consolidated or Virginia combined return, one of the following conditions must be met: 1) one corporation must own 80% of the voting stock of another or others; or 2) at least 80% of the voting stock of the corporations included in the Virginia affiliated group must be owned by a common interest.

A Virginia separate return reflects only the income, expenses, gains and losses and allocation and apportionment factors of the filing corporation. For purposes of the separate return, any affiliated companies are excluded.

The Virginia consolidated return is a single return filed by a group of affiliated corporations. The return includes the income and apportionment factors of all the affiliated corporations that would have otherwise filed a separate return, and computes taxable income in the aggregate. The Virginia consolidated return would include members of an affiliated group even if they use different apportionment methods.

A Virginia combined return is a single return filed by an affiliated group, in which the corporation's report of income or loss, allocable income, and apportionable income are computed separately for each member of the affiliated group. They are separate returns for each corporation, in which the final tax liability, after apportionment, is combined and included in one return. Similar to Virginia consolidated returns, the affiliated group may be allowed to file a Virginia combined return even if the affiliated members use different apportionment methods. However, whereas, in a Virginia consolidated return the affiliated group computes income as a group, the Virginia combined return allows the affiliated group to file a single return, but still compute income separately.

The election to file on a separate, consolidated or combined basis is made in the first year in which a group of affiliated corporations becomes eligible to file a Virginia consolidated or combined return in Virginia. The filing of the Virginia combined or consolidated income tax return is an election made by the affiliated group. As a general rule, once the election is made, subsequent returns must be filed on the same basis, unless the Tax Commissioner grants permission to the affiliated group to change. The election is also binding for any members that subsequently join the affiliated group.

*Addressing Corporate Loopholes in Virginia*

In 2004, Virginia enacted legislation that specifically addressed tax planning strategies that involve intangible holding companies. Under current Virginia law, a corporation is required to add back any deductible interest expenses and costs and intangible expenses and costs paid, accrued or incurred to one or more related members.

In 2009, Virginia again addressed corporate loopholes by enacting legislation that requires a captive REIT to pay income tax on the business it conducts in Virginia. A captive REIT is now required to add back any federal deduction for dividends paid to its shareholders, and then allocate and apportion income, and pay Virginia income tax, in the same manner as other corporations.

<u>Considerations for Adopting Unitary Combined Reporting</u>

A series of implementation options and decisions determine how unitary combined reporting will work in a state. Any state that is considering adopting unitary combined reporting must, at a minimum, consider the following: (i) how to define a unitary group; (ii) how to treat unitary businesses without nexus; (iii) how to treat international affiliates; and (iv) how to handle certain transitional issues.

*Definition of a Unitary Group*

The U.S. Supreme Court has stated that the hallmarks of a unitary relationship consist of functional integration, centralized management, and economies of scale. The states have developed various definitions of a unitary business to make the application of these hallmarks more certain.

The challenge for tax administrators, as well as taxpayers, is determining if affiliated corporations are engaged in a unitary business, and how to define the trade or business that is unitary. In order to be considered unitary, members of a unitary group must share more than a passive investment relationship, and have developed interdependent economic relationships.

In order to determine a unitary business, tax administrators must be able to identify the activities undertaken by each affiliate and the resulting flow of goods and services. This process is highly complex, and often leads to disagreements over the measures used to determine whether an affiliated group is unitary. Moreover, when a unitary determination is contested, it results in complex audits and appeals, and potentially increased litigation.

The Multistate Tax Commission model statute for unitary combined reporting, on which this bill is modeled, defines a unitary business 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."

For situations in which states share the same statutory definition of a unitary business, there still remains significant variation in how the states and courts have interpreted the statutory definition. Therefore, it is possible that an affiliated group may be treated as unitary in one state, but as nonunitary in other states.

*Treatment of Unitary Members without Nexus*

Under federal law (P.L. 86-272) a state is prohibited from taxing a company whose only activity within a state is the solicitation of sales of tangible personal property and, therefore, lacks nexus. However, the concept of a unitary business allows a state to require unitary combined reporting, which includes the income and apportionment factors of all members of a unitary group, even when a member of a unitary group does not have nexus in the state. This raises concerns over whether unitary combined reporting violates P.L. 86-272. Some states have argued that members of a unitary group should be taxed as one taxpayer and include the apportionment and income from all members of the unitary group. Other states cite P.L. 86-272 and believe that a state is not allowed to tax any individual company that is protected under the statute. The U.S. courts have not issued a decision on this issue, which has left it for state courts to determine.

There are two approaches that states with unitary combined reporting have applied for determining whether to include members of a unitary business who do not have nexus. These rules are called the *Joyce* and the *Finnigan* rules, which are the names for two California Board of Equalization ("BOE") administrative appeals issued in 1996 (Joyce) and 1988 (Finnigan). Those who argue that P.L. 86-272 protects the nonnexus members of a unitary group would follow what is called the *Joyce* rule. Under *Joyce,* the California BOE decided that including the sales factor of a nonnexus entity would essentially result in taxing an entity that should have been protected from in-state taxation. The *Finnigan* rule determined that sales made by members of a unitary group to other states could be included in the unitary group's apportionment and income. The *Finnigan* rule ultimately held that a nonnexus entity may be included in a unitary group's income and apportionment factors. The California SBE returned to the *Joyce* rule in 1999.

*Treatment of Affiliates: Domestic, Water's-edge or Worldwide Reporting*

A difference between separate entity reporting and unitary combined reporting is whether the state places limitations on the inclusion of certain types of unitary entities in the taxpayer's apportionment calculation, in particular foreign entities. The definition of doing business in the United States varies among the states, but typically includes "80/20" corporations (corporations with 80% of their business in foreign countries). Generally, there are three types of unitary combination that are used by the states which address this issue: (i) domestic combination; (ii) water's-edge combination; and (iii) worldwide combination. Domestic combination includes only unitary corporations that are incorporated in the United States. Waters-edge combination includes all unitary affiliates of a business regardless of the location of the affiliates; however, foreign affiliates are included only to the extent that they do business in the United States. Worldwide combination includes all unitary affiliates of an enterprise regardless of the location of the affiliates. While the business community generally opposes any form of unitary combined reporting, worldwide combination is especially disliked, and as a result it has been prohibited in many states.

In 1981, the Virginia General Assembly specifically prohibited worldwide combination, codified at *Va. Code* § 58.1-443.

*Transitional Issues*

There are also transition issues related to moving from separate reporting to unitary combined reporting. A state must determine how to treat prior year overpayments and calculate estimated payments. Other more difficult considerations are how to handle tax incentives, including net operating losses and tax credits that were generated prior to the enactment of unitary combined reporting. The first year of unitary combined reporting would see many corporations included in a state's income tax returns for the first time. On a separate return basis they may have accumulated substantial net operating losses, credits or deductions that could be used to offset income of the combined group. Unrestricted use of tax attributes from prior years could cause revenue loss to the state during the transition to unitary combined filing.

Other States

Currently, twenty-four states and the District of Columbia have mandated unitary combined reporting. A list of those states, along with their water's-edge/worldwide/domestic election requirement and whether they adopted the *Joyce* or *Finnigan* rule is listed below.

| **State** | **Water's-edge/Worldwide/Domestic** | **Joyce or Finnigan** |
|---|---|---|
| Alaska | Water's-edge (Worldwide mandated for oil and gas producers) | Joyce |
| Arizona | Water's-edge unless a consolidated return is elected | Finnigan |
| California | Worldwide, but will allow the taxpayer to elect Water's-edge | Joyce |
| Colorado | Water's-edge | Joyce |

| State | Water's-edge/Worldwide/Domestic | Joyce or Finnigan |
|---|---|---|
| District of Columbia | Water's-edge, but will allow the taxpayer to elect Worldwide | Joyce |
| Hawaii | Domestic | Joyce |
| Idaho | Worldwide, but will allow the taxpayer to elect Water's-edge | Joyce |
| Illinois | Water's-edge | Joyce |
| Kansas | Domestic | Finnigan |
| Maine | Domestic | Joyce |
| Massachusetts | Water's-edge, but will allow the taxpayer to elect Worldwide or a Federal Affiliated Group | Finnigan |
| Michigan | Water's-edge | Finnigan |
| Minnesota | Domestic | Joyce |
| Montana | Worldwide, but will allow the taxpayer to elect Water's-edge | Joyce |
| Nebraska | Domestic | Joyce |
| New Hampshire | Water's-edge | Joyce |
| New York | Domestic | n/a |
| North Carolina | Water's-edge | n/a |
| North Dakota | Worldwide, but will allow the taxpayer to elect Water's-edge | Joyce rule |
| Oregon | Domestic | Joyce |
| Texas | Water's-edge | Joyce |
| Utah | Water's-edge | Finnigan |
| Vermont | Water's-edge | Joyce |
| West Virginia | Worldwide, but will allow the taxpayer to elect Water's-edge | Joyce |
| Wisconsin | Water's-edge | Finnigan |

*Maryland*

In 2007, Maryland enacted legislation to form the Maryland Business Tax Reform Commission to study unitary combined reporting and several other corporate tax policy issues.

In March 2010, the Comptroller's Office issued an analysis of the revenue impact of unitary combined reporting, including an initial analysis of the impact unitary combined reporting would have had on corporate income tax returns filed in tax year 2007 and a revised analysis of tax year 2006 returns. The Comptroller's Office estimated that the *Joyce* method of apportionment would have increased corporate income tax revenues in tax year 2006 by about $144 million (a net change in corporate income tax revenues of 17%), and revenues would have increased by $197 million or 23.5% under *Finnigan*. In tax year 2007, revenue increases would have totaled $92 million under *Joyce* (a net increase of 13%) and $144 million, or 20%, under *Finnegan*.

However, after a rigorous analysis of the effects of unitary combined reporting, the Maryland Business Tax Reform Commission concluded differently. The Commission, in its final report on December 2010, estimated that had unitary combined reporting been in effect for tax year 2008, the State would have collected less revenue than it actually did under existing law. The State would have lost approximately $51 million under the Joyce method and $13 million under the *Finnigan* method of apportionment. The Maryland Business Tax Reform Commission recommended that the General Assembly not implement unitary combined reporting.

*Minnesota*

Minnesota adopted mandatory unitary combined reporting in 1982. At the time, corporate taxpayers filed separate returns, so there was no state tax return data that could be used to determine the revenue impact. Therefore, Minnesota based its revenue estimate on a survey of other states and, as a result, assumed a 15% increase in corporate income tax collections. Because this was a fairly uncertain number, however, lawmakers were told that the actual revenue impact could range from $23 million to $103 million.

In 1984, the Department of Revenue ("DOR") examined the actual revenue impact of this change. In order to do so, the DOR looked at actual combined returns from 1982 – 1983 and recomputed the liabilities as if those corporations had filed separate returns. Based on this analysis, the DOR found that unitary combined reporting had actually reduced tax liabilities by approximately 9%. Therefore, the estimates of the additional revenue raised from unitary combined reporting were lowered to $0 for each fiscal year through 1985.

<u>Bill Proposal</u>

This bill would adopt unitary combined reporting for Virginia corporate income tax purposes. Under this bill, beginning with taxable years beginning on and after January 1, 2013, unitary groups, as defined under this bill, would be required to include the income and apportionment factors for all of its affiliates on a combined basis.

*When Unitary Combined Reporting is Required*

This bill would require any taxpayer engaged in a unitary business with one or more other corporations to file a unitary combined report that includes the income and apportionment factors of all the affiliates of the taxpayer that are members of the unitary business, and any other information that the Tax Commissioner requires.

The Tax Commissioner would be allowed to require, by regulation, that the unitary combined report include the income and apportionment factors of any entities that are not included in the unitary business but are members of the unitary business, in order to determine the apportionment of income for the unitary businesses. The Tax Commissioner would also be allowed to require, by regulation, unitary combined reporting for entities that are not subject to the laws of the Commonwealth, even if the entity does not do business in the Commonwealth.

If the Tax Commissioner determines that the reported income or loss of a taxpayer engaged in a unitary business with an entity that is not included as a unitary business represents tax avoidance, the Tax Commissioner would be allowed, on a case by case basis, to require all or any part of the income and apportionment factors of the excluded entity to be included in the taxpayer's unitary combined report. The Tax Commissioner would be allowed to (i) require the exclusion of one or more apportionment factors, (ii) the inclusion of one or more additional apportionment factors that that represents the taxpayer's business activity in the Commonwealth, or (iii) the use of any other method to determine the proper total income that is subject to apportionment and allocation of the taxpayer's income.

Under existing law, *Va. Code* § 58.1-421 significantly restricts the ability to allow alternative methods of allocation and apportionment for nonunitary corporations.

*Determination of Taxable Income or Loss of Each Member*

The unitary combined report required under this bill would not disregard the separate identities of the members of the unitary combined group. Each member would be responsible for income tax based on its apportioned share of the business income of the combined group, together with that member's own allocated nonbusiness income, and its apportioned share of business income from any other combined group of which it is a member. This bill would provide that restorations of deferred company income resulting from an intercompany transaction between members of a combined group would be apportioned as business income. Unless otherwise provided by regulation, business income from an intercompany transaction between members of the same combined group would be deferred in a manner similar to federal law.

Business income of the unitary combined group would be calculated as the sum of all the unitary members' individually determined net business incomes. The total amount of combined business income apportioned to Virginia would be calculated as a function of each taxpayer's own apportionment factors in Virginia. Under this bill, Virginia would adopt the *Joyce* method of allocating and apportioning income, and determine apportionment factor numerators for each taxpayer member on an individual taxpayer basis.

The property, payroll, and sales of a partnership would be included in the determination of the partner's apportionment percentage 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. Any other commonly-controlled, unitary entities, not otherwise required to be included in a unitary combined report because they do not have income from Virginia sources, would also be required to be included in the combined group by regulation if the Tax Commissioner determines that it would better reflect the proper apportionment of income of the entire unitary business, or on a case-by-case basis.

Any dividends paid by one member of the unitary combined group to another member of the unitary combined group are eliminated from income, and no special treatment is provided for foreign source income included in the combined group. Any deduction or credit may be taken only by the specific taxpayer that earned it, and not against the total combined income or liability of the group. In addition, this bill would restrict net operating loss carryover deductions to the individual members that originally earned them.

Under this bill, a charitable contribution deduction would be allowed to be taken first against the business income of the combined group, and any remaining amount may then be treated as a nonbusiness expense allocable to the member that incurred the expense.

*Designation of a Member to File on Behalf of Unitary Group*

This bill would allow members of a combined group to annually elect to designate one member of the combined group to file a single return on behalf of the combined group, provided that the designated member consents to act with respect to the tax liability of all members included in the combined group and agrees to act as agent on behalf of the entire group for the specified amount of time.

*Water's-edge Election*

Under this bill, a unitary group would determine the apportioned shares of the net business income or loss of the combined group according to a worldwide basis. This bill would allow a unitary group to elect a water's-edge method for determining net business income or loss, provided the election is made on a timely-filed, original return by every member of the unitary group. The Tax Commissioner would be required to develop rules and regulations that provide procedures for making a water's-edge election, including procedures for when a change in the composition of the unitary group, the combined group, the taxpayer members, and any other similar change occurs.

The water's-edge election would be binding for 10 years, beginning with the year in which the election is made. The unitary group would be allowed to request in writing to withdraw the water's-edge election provided it can demonstrate that it causes an extraordinary hardship due to unforeseen changes in Virginia law. If permission is granted to the unitary group to withdraw from the water's-edge election, the Tax Commissioner would be required to impose reasonable conditions that are necessary to prevent tax evasion or to clearly reflect the proper amount of income.

This bill would be effective for taxable years beginning January 1, 2013.

cc : Secretary of Finance

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