

DEPARTMENT OF TAXATION

2022 Fiscal Impact Statement

1. **Patron** Vivian E. Watts

3. **Committee** House Finance

4. **Title** Virginia Affiliated Groups; Election to Change
Corporate Filing Status

2. **Bill Number** HB 348

House of Origin:

X **Introduced**

 Substitute

 Engrossed

Second House:

 In Committee

 Substitute

 Enrolled

5. **Summary/Purpose:**

This bill would provide that an affiliated group that has filed on the same basis for at least the preceding 12 years may change the basis of the type of return filed from consolidated to separate or from separate or combined to consolidated if certain conditions are met. Under current law, such group must have filed on the same basis for 20 years.

If enacted during the regular session of the 2022 General Assembly, this bill would become effective July 1, 2022. As a result, this bill would apply to applications filed with the Department of Taxation ("the Department") on or after July 1, 2022.

6. **Budget amendment necessary:** No.

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

8. **Fiscal implications:**

Administrative Costs

The Department of Taxation ("the Department") considers implementation of this bill as routine, and does not require additional funding.

Revenue Impact

This bill would have an unknown negative General Fund revenue impact beginning as early as Fiscal Year 2025. This bill would reduce the time from 20 years to 12 years during which certain corporate groups have the opportunity to change their filing status from consolidated to separate or from separate or combined to consolidated. As under current law, there would continue to be both:

- A two-year transition period, during which they would be required compute their tax liability under their old filing status and their new filing status and pay the higher of the two computations, and
- A requirement that, for the taxable year immediately before the taxable year for which the new election would be applicable, there could be no decrease in tax liability under the new method as compared to the old method.

It is anticipated that only those corporate groups that expect to reduce their overall Virginia income tax liability in the initial years after the two-year transition period would choose to make the filing status change that would be allowed under this bill. However, the extent to which corporate groups would make a filing status change under this bill and the resulting revenue impact is unknown.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

Federal Corporate Tax Filings

For federal income tax purposes, an affiliated group of corporations has the option of filing a consolidated return in lieu of separate returns for each corporation. If a consolidated return is filed, the affiliated group members are treated as one entity and their financial activities are combined for purposes of computing their federal income tax liability. A corporation generally meets the federal requirements for affiliation if it possesses at least 80 percent of the total voting power and at least 80 percent of the total value of a corporation's stock.

Virginia Corporate Tax Filings

Virginia is a separate return state. As a result, Virginia allows each corporation with nexus with the state the ability to elect to file a separate Virginia return, regardless of its federal tax filings. In addition, Virginia allows corporations that are members of an affiliated group of corporations with Virginia nexus the ability to elect to file on a consolidated or Virginia combined basis. All returns for subsequent years are required to be filed on the same basis unless permission to change is granted by the Department. If a new corporation becomes a member of an affiliated group, the new corporation must follow the filing method previously elected by the group.

Virginia Affiliated Group Filing Methods

If an affiliated group of corporations elects to file separately, each corporation in the affiliated group that has nexus in Virginia is required to file its own separate corporate income tax return and report only its income, expenses, gains, losses, and allocation and apportionment factors on such return. This type of reporting follows the separate entity

concept, in which each corporation in an affiliated group is treated as distinct and separate from the other corporations in such group for purposes of determining each corporation's corporate income tax liability.

A consolidated return includes the aggregate income, expenses, gains, and losses, allocation and apportionment factors of all of the corporations in an affiliated group that have nexus with Virginia. The corporate income tax liability of the affiliated group is computed in the aggregate, and the entire affiliated group files one corporate income tax return.

In a Virginia combined return, each corporation in an affiliated group that has nexus with Virginia determines its income, expenses, gains, losses, and allocation and apportionment factors separately. Each corporation then separately computes its individual corporate income tax liability. The final corporate income tax liability, after apportionment, of each corporation is then combined and included on one corporate income tax return.

The table below reflects data regarding corporate tax filing methods for Taxable Year 2019:

Corporate Return Filing Method	Number of Returns	Percentage of Returns	Income Tax Liability (in millions)	Percentage of Total Income Tax Liability
Separate Returns	66,449	96%	\$565	49%
Consolidated Returns	2,130	3%	\$303	26%
Combined Returns	487	1%	\$287	25%
All Returns	69,066	100%	\$1,155	100%

Changing Corporate Filing Status

The Department has the statutory authority to grant or deny requests by corporations to change their Virginia tax filing status. Because switching to or from the consolidated filing status affects the allocation and apportionment formulas and may distort the business done in Virginia and the income arising from activity in Virginia, the Department generally will grant permission to change to or from a consolidated filing status only in extraordinary circumstances. In contrast, separate and Virginia combined returns do not affect the allocation and apportionment formulas for each corporation. Therefore, permission to change from separate to Virginia combined returns or from Virginia combined to separate returns is generally granted.

During the 2003 Session, the General Assembly enacted legislation that effectively provided an exception to the Department's general rule against switching to or from the consolidated filing status. This legislation provided that an affiliated group that has filed on the same basis for at least the preceding 20 years is allowed to change the basis of the

type of return filed from consolidated to separate or from separate or combined to consolidated if:

- The tax computed under the affiliated group's requested return basis would be equal or greater than the tax for the full taxable year immediately preceding the taxable year for which the requested return basis would be applicable ("prior year test"); and
- The affiliated group agrees to compute its tax liability under both the requested return basis and the elected return basis and would be liable for the greater of the two amounts for the taxable year in which the requested basis is effective and the immediately succeeding taxable year ("greater of the two rule").

Other States

Of the jurisdictions that impose a corporate income tax, 27 states and the District of Columbia have enacted mandatory unitary combined reporting. In these states, taxpayers are generally required to file a return with all of their affiliates with which they have a unitary relationship. This differs from Virginia combined reporting, which is based solely on affiliated corporations with Virginia nexus. They are not given the option to file a separate return for each corporation in the affiliated group. However, some of these states provide a consolidated election, giving taxpayers the choice to file on a unitary combined return or consolidated return with varying rules regarding changing such election.

The remaining 15 states are separate return states like Virginia. Seven of these states (Delaware, Louisiana, Maryland, Mississippi, Pennsylvania, South Carolina, and Tennessee) do not offer taxpayers an election with membership and other rules that are substantially similar to the federal consolidated return rules. The remaining eight separate return states (Arkansas, Florida, Georgia, Indiana, Iowa, Missouri, North Carolina, and Oklahoma) offer taxpayers an election, under certain circumstances, with membership and other rules that are substantially similar to the federal consolidated return rules. All of the separate return states that allow consolidated filing require taxpayers to apply for permission from a state tax agency before they can change their filing method. These states impose varying restrictions on granting such permission.

From preliminary research completed by the Department, Virginia's restrictions on switching filing status are generally similar in nature to those imposed by other states.

Work Group to Assess the Feasibility of Transitioning to Unitary Combined Reporting

During the 2021 Special Session I, House Joint Resolution Number 563 was passed, which directed the Division of Legislative Services, in conjunction with the Department, to establish a Work Group to assess the feasibility of transitioning to unitary combined reporting for corporate income tax purposes in Virginia. Such resolution also required the Work Group to submit a summary report with its findings and recommendations to the General Assembly. One of the recommendations of the Work Group was that Virginia should consider providing greater flexibility to taxpayers regarding change their filing elections by reducing the binding election period from 20 to 12 years but retaining the two-year transitional provisions under current law.

Proposed Legislation

This bill would provide that an affiliated group that has filed on the same basis for at least the preceding 12 years may change the basis of the type of return filed from consolidated to separate or from separate or combined to consolidated if certain conditions are met. Under current law, such group must have filed on the same basis for 20 years.

If enacted during the regular session of the 2022 General Assembly, this bill would become effective July 1, 2022. As a result, this bill would apply to applications filed with the Department on or after July 1, 2022.

Similar Legislation

House Bill 224 and **Senate Bill 386** would provide that certain affiliated corporate groups with members related to a state or national bank may elect to change the basis of the type of return filed from combined to consolidated.

cc : Secretary of Finance

Date: 2/4/2022 JJS
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