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May 17, 2017

Louisiana Tax Institute
Louisiana Department of Revenue
LaSalle Building
617 North Third Street
Baton Rouge, LA 70802

*Via E-Mail*

**Re: May 19, 2017 Louisiana Tax Institute Meeting on Combined Reporting**

Dear Members of the Louisiana Tax Institute:

Thank you for the invitation to address the Louisiana Tax Institute on the issue of mandatory unitary combined reporting (MUCR). On behalf of the Council On State Taxation (COST), I am offering this written statement to supplement my oral remarks to the Institute at its May 19, 2017 meeting. As an addendum to this statement, I am including a study commissioned by the National Conference of State Legislatures ("Combined Reporting With the Corporate Income Tax: Issues for State Legislatures"), and I request that this study be included as a resource under "Materials" on the Institute's website.

While this statement will cover some combined reporting basics and then discuss concerns with MUCR, I wish at the outset to make the following key observations specifically applicable to Louisiana:

- Louisiana already has an "addback" law designed to prevent corporate tax base erosion, and the Louisiana Department of Revenue (LDR) has not yet been able to even provide regulatory guidance regarding its implementation. MUCR would be yet another tax law change imposed on business, unnecessarily creating new uncertainty and burden without giving "addback" a chance to succeed.

- LDR already has discretionary authority to make corporate tax base adjustments similar to those available to the IRS under I.R.C. Section 482, authority that LDR is increasingly asserting. As with the addback law, this obviates the need for further anti-abuse measures.

- No other Southeastern state employs MUCR for corporate income tax purposes today, and in fact Alabama rejected such a measure in committee earlier this year by a 12-2 vote. The geographically closest states to impose MUCR for corporate income taxes are Kansas and Illinois.

- The Louisiana Department of Revenue lacks the resources to audit MUCR. For example, the Wisconsin Department of Revenue in 2015 budgeted for at least 31 auditors to specialize in auditing combined returns because "corporate audits dealing with apportionment among members of a combined group require additional training time as compared to other types of audits."[1] Experiences in other states demonstrate that adopting MUCR would impose increased litigation expense for LDR and increase the burden on the Louisiana Board of Tax Appeals.

- Combined reporting does not demonstrably increase revenue and actually can decrease revenue depending on the rules used and economic conditions, as detailed below. This is especially relevant for Louisiana as it seeks to stabilize its revenues and fund essential state services.

## About COST

COST is a nonprofit trade association consisting of approximately 600 multistate corporations engaged in interstate and international business. COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities. COST's members invest and conduct significant business activity in Louisiana and are pleased to work with the Institute to recommend fair and growth-oriented tax policy in the State.

## COST's Position on Mandatory Unitary Combined Reporting

The COST Board of Directors has adopted a formal policy statement on MUCR. COST's policy position is:

> *Mandatory unitary combined reporting ("MUCR") is not a panacea for the problem of how to accurately determine multistate business income attributable to economic activity in a State. For business taxpayers, there is a significant risk that MUCR will arbitrarily attribute more income to a State than is justified by the level of a corporation's real economic activity in the State. A switch to MUCR may have significant and unintended impacts on both taxpayers and States. Further, MUCR is an unpredictable and burdensome tax system. COST opposes MUCR.*[2]

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[1] Wisconsin Legislative Fiscal Bureau, Paper #560, "Additional Auditor Positions (DOR – Tax Administration)," May 27, 2015, available at https://docs.legis.wisconsin.gov/misc/lfb/budget/2015_17_biennial_budget/102_budget_papers/560_revenue_additional_auditor_positions.pdf.

[2] COST's policy statement is available on the COST website at: http://cost.org/uploadedFiles/About_COST/Policy_Statement/Mandatory%20Unitary%20Combined%20Reporting.pdf.

## 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 return rules, and taxpayers prepare separate state returns with tax computed on a separate company basis. This is the method Louisiana currently uses; it is also used by all other Southeastern states, as well as in the Mid-Atlantic and parts of the Midwest. 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 provide an administrative convenience for "nexus" filers.

Combined reporting generally treats affiliated corporations (parents and subsidiaries) engaged in a "unitary business" as a single group for purposes of determining taxable income. However, 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,[3] 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. This is in part due to 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 multistate businesses. 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.[4] 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, 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

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[3] 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.

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

groups and their members. Nor does it describe all the kinds of combination and consolidation options and requirements in effect across the country.

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.

## Problems with Mandatory Unitary Combined Reporting

- **Reduces Jobs –** Proponents of MUCR focus on perceived benefits of reducing tax planning opportunities, but they fail to acknowledge the evidence that adopting MUCR hinders investment and job creation. Even if MUCR results in a relatively small increase in net corporate tax revenue, there will be both significant increases and decreases in tax liabilities for specific businesses coupled with increases in administrative and litigation costs. Depending on the industry distribution of winners and losers, MUCR may have a negative impact on a state's overall economy. Moreover, economic theory suggests any tax increase resulting from adopting MUCR will ultimately be borne by labor in the state through fewer jobs (or lower wages over time) or by in-state consumers through higher prices for goods and services.

  The evidence shows states using separate entity reporting have experienced higher job growth than states with MUCR. From 1982-2006, job growth was 6% higher in states without MUCR than in states with it (after adjusting for population changes).[5]

- **Uncertain Revenue –** Implementing MUCR would have an unpredictable and uncertain effect on Louisiana's tax revenues. The corporate income tax is the most volatile tax in every state in which it is levied, regardless of whether MUCR is employed. A study conducted by University of Tennessee found no evidence that states with MUCR collect more revenue, and then in a later study found that MUCR may or may not increase revenue.[6] In Maryland, a statutory study found similar uncertainty and volatility,[7] and a legislative commission recommended against even considering MUCR in the future.[8] Further, the Indiana

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[5] Robert Cline, "Combined Reporting: Understanding the Revenue and Competitive Effects of Combined Reporting," Ernst & Young LLP, May 30, 2008, p. 16.
[6] William F. Fox, LeAnn Luna, Rebekah McCarty, Ann Boyd Davis and Zhou Yang, "An Evaluation of Combined Reporting in the Tennessee Corporate Franchise and Excise Taxes," University of Tennessee, Center for Business and Economic Research, October 30, 2009, p. 34. Another study by the two lead authors commissioned by the National Conference of State Legislatures reached similar conclusions (see the attached study to this statement, "Combined Reporting With the Corporate Income Tax: Issues for State Legislatures," Fox and Luna, November 2010).
[7] Andrew Schaufele, Director, MD Bureau of Revenue and Estimates, Report on Combined Reporting to Governor, President and Speaker, March 1, 2013.
[8] Report of the Maryland Economic Development and Business Climate Commission, Phase II: Taxes, published January 19, 2016, p. 39.

Legislative Services Agency conducted a study last year that concluded any potential positive revenue impact would be only short term and would likely decline to zero in the long term.[9]

The idea that MUCR will result in fewer corporations filing "zero returns" is a red herring. A substantial number of companies in *both* separate entity reporting and MUCR states may file minimum or zero tax returns, 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 deductions and capital credits.

It is also important to note, states that have already enacted provisions limiting deductions for related party expenses – like Louisiana's recently enacted "addback" statute – can expect significantly reduced new revenue from combined reporting.[10] Layering on MUCR will create many instances of double taxation due to the application of the addback statute, which already disallows intercompany deductions for payments of royalties and interest.

- **Regional Outlier** – Fewer than half of the states utilize MUCR, and most of the states that do so are west of the Mississippi River. East of the Mississippi River, primarily the Northeastern states have adopted MUCR, beginning with Vermont in 2006 (prior to which no state had adopted MUCR for two decades). Kansas and Illinois are the geographically closest states to Louisiana to apply MUCR for corporate income taxes. It is clear MUCR adoption would make Louisiana a regional outlier.

- **Administrative Complexity –** MUCR is by definition complex, requiring extensive fact-finding 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:

  - *Determining the Unitary Group:* The concept of a "unitary business" is uniquely factual and universally poorly-defined. It is a constitutional (Due Process Clause) concept looking at the business as a whole rather than individual separate entities or separate geographic locations. 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 at a fairly detailed level to determine which affiliates are unitary. Auditors must interact with a corporation's operational and tax staff to gather this operational information. In practice, however, auditors routinely refuse to make a determination regarding a unitary relationship on operational information and instead wait to determine unitary relationships until after they have performed tax computations. In other words, the tax result of a unitary relationship often significantly influences, or in fact controls, the auditor's finding. Determining the scope of the unitary group is a complicated, subjective, and costly process not required in separate filing states and often results in expensive, time-consuming litigation.

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[9] A Study of Practices Relating to and the Potential Impact of Combined Reporting, Office of Fiscal Management Analysis, Indiana Legislative Services Agency, October 1, 2016.
[10] Robert Cline, "Combined Reporting: Understanding the Revenue and Competitive Effects of Combined Reporting," Ernst & Young LLP, May 30, 2008, pp. 2, 11-12.

  - *Calculating Combined Income* – Calculating combined income is considerably more complicated than simply basing the calculations on consolidated federal taxable income. In most MUCR states, the group of corporations included in a federal consolidated return differs from the members of the unitary group. In addition to variations in apportionment formulas among the states that apply to all corporate taxpayers, further compliance costs related to MUCR result from variations across states in the methods used to calculate the apportionment factors. From a financial reporting perspective, adopting MUCR 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.[11]

- **Arbitrary** – Although proponents of MUCR argue that it helps to overcome distortions in the reporting of income among related companies in separate filing systems, the mechanics used under MUCR create new distortions in assigning income to different states. The MUCR 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, MUCR may reduce the link between income tax liabilities and where income is actually earned. Many corporate taxpayers may conclude there is a significant risk MUCR will arbitrarily attribute more income to a state than is justified by the level of a corporation's real economic activity in the state.

## Conclusion

Studies show MUCR is the most costly way for a state to raise tax revenue (if indeed it raises revenue) because of its negative impact on job creation and the uncertainty and litigation it generates. Especially given the measures that have already been undertaken in Louisiana relative to the corporate income tax and the State's continuing fiscal difficulties, COST believes that the Louisiana Tax Institute should not recommend the adoption of MUCR or burden taxpayers with *pro forma* combined reporting requirements.

Respectfully submitted,

Ferdinand Hogroian

cc: COST Board of Directors
Douglas L. Lindholm, COST President & Executive Director

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[11] 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.