Louisiana Law Review

Volume 61 | Number 4
Louisiana Tax Reform: A Symposium
Summer 2001

Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana

Michael J. McIntyre

Paull Mines

Richard D. Pomp

Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana†

*Michael J. McIntyre**

*Paull Mines***

*Richard D. Pomp****

TABLE OF CONTENTS

---

† The authors thank members of the California and Louisiana tax departments, particularly Mike Brownell, Ben Miller, and Mike Pearson, for helpful comments on portions of this article.

The views expressed by the authors in this Article do not necessarily represent the views of the organizations with which they are associated. Indeed, in some instances, the views do not necessarily represent the unanimous views of the individual authors, notwithstanding their common commitment to the major reform goals advocated here. In some instances, they fashioned mutually acceptable compromises to reach a consensus position.

* Professor of Law, Wayne State University; A.B., Providence, 1964; J.D. Harvard Law School, 1969.

** General Counsel, Multistate Tax Commission; B.A., University of Washington, 1964; L.L.B., Harvard Law School, 1967; L.L.M., New York University, 1985.

*** Alva P. Loiselle Professor of Law, University of Connecticut Law School; B.S. University of Michigan, 1967; J.D. Harvard Law School, 1972.

I. INTRODUCTION

This article presents a plan for revitalizing the Louisiana corporate income tax through the adoption of a combined reporting regime. Our plan would require affiliated companies engaged in a unitary business in the State to pay their Louisiana income tax based on an apportioned share of their combined income. Combined reporting is the only effective way for any state to impose a fair and uniform corporation income tax on multistate and multinational enterprises and to gain or maintain control over its own tax base. The current Louisiana corporate income tax is subject to abuse through tax planning techniques that are very familiar to members of the tax-avoidance community. California and other states that have adopted combined reporting have demonstrated that combined reporting fairly and effectively responds to most of these common tax avoidance techniques.

Part II, below, discusses the potential benefits inuring to Louisiana from adopting a combined reporting regime. Those benefits are not mere speculation. California has been operating a combined reporting system successfully for nearly seven decades. In brief, the benefits are a uniform treatment of corporate groups without regard for differences in their organizational structure, a strong bulwark against the use of tax-haven jurisdictions to avoid state taxation, a significant reduction in administrative burdens on the tax department and on complying taxpayers, and the removal of the competitive disadvantage currently imposed on local firms that are unable to engage in cross-border tax-avoidance.

In Part III, we address some basic issues in the design of an effective combined reporting regime. One of the important features of combined reporting is the use of a formula to apportion the unitary business income of a unitary enterprise between Louisiana and the rest of the relevant universe. Louisiana already uses formulary apportionment in its current corporate tax system. To operate a combined reporting regime, however, Louisiana must apply that formula not to the separate income of each corporation but to the combined income of a corporate group engaged in a unitary business in Louisiana. Yielding to political realities, we recommend that Louisiana offer companies a water's edge election that would allow them to exclude from their combined report the income derived by certain foreign affiliates that do not have an obvious close tie to the unitary business conducted in Louisiana.

Part IV addresses a variety of technical issues that Louisiana should address when adopting a combined reporting regime. We offer our views on how those issues should be resolved, drawing, when appropriate, on the experience of other combined-reporting states. Some of these issues relate to potential transition problems. Other issues relate to practical problems of assessing and collecting a tax from corporations operating in Louisiana on income that is computed by reference to the combined income of a unitary group. A brief conclusion is presented in Part V.

In adopting a combined reporting regime, we recommend that Louisiana follow the well-marked trail forged by California and other combined-reporting states. Those states have solved many technical difficulties and have won many important victories in the courts.[1] We see no good reason why Louisiana should fight those battles anew by introducing untested provisions into its combined reporting regime. We also strongly favor uniform state taxing rules, and uniformity is obviously enhanced when states borrow from the successful experiments of sister states. We do not suggest, however, that Louisiana should avoid innovation when the experience of the combined-reporting states has been unhappy. The combined-reporting regime we recommend, if adopted by Louisiana, would have a definite Cajun flavor.

1. The two leading combined-reporting cases decided by the U.S. Supreme Court are *Container Corp. of America v. Franchise Tax Bd. of California*, 463 U.S. 159, 103 S. Ct. 2983 (1983), and *Barclays Bank PLC v. Franchise Tax Bd. of California*, 512 U.S. 298, 114 S. Ct. 2268 (1994). In *Container*, California successfully defended its combined-reporting regime, as applied to a U.S.-based multinational enterprise, against attacks based on the Commerce Clause and the Due Process Clause. *Barclays Bank* upheld the California system as applied to a foreign-based multinational enterprise against attacks based on the Foreign Commerce Clause.

II. BENEFITS OF COMBINED REPORTING

Louisiana has long employed a system of formulary apportionment for determining the Louisiana taxable income of a corporation that is operating within and without Louisiana through multiple divisions or branches. In adopting formulary apportionment, the Louisiana Legislature has implicitly concluded that apportioning income by payroll, property, and receipts (sales) is superior, as a system of tax accounting, to a system based on the separate transactions of the taxpayer, as reflected on its books of account. The case for combined reporting is a logical extension of the case for apportioning by formula the business income of an individual corporation. The rationale of both cases is that the substance of the business activities in the state should control, not the organizational structure of the business entity or entities conducting those activities. That is, whether a business enterprise chooses to have numerous divisions or whether it chooses to incorporate those divisions and operate them as subsidiaries should have as little impact as feasible on the amount of Louisiana income tax paid by that enterprise.

The U.S. Supreme Court has acknowledged that combined reporting is both a better method for measuring the income of a unitary business and a safeguard against taxpayer manipulation:

> The problem with [formal geographical or transactional accounting, including separate accounting] is that formal accounting is subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise. The unitary business/formula apportionment method is a very different approach to the problem of taxing businesses operating in more than one jurisdiction. It rejects geographical or transactional accounting, and instead calculates the local tax base by first defining the scope of the "unitary business" of which the taxed enterprise's activities in the taxing jurisdiction form one part, and then apportioning the total income of that "unitary business" between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction.[2]

Section II.A., below, presents support for the U.S. Supreme Court's assertion that combined reporting is a superior method for determining the in-state income of a member of a unitary group of corporations. In Section II.B., we explain how a combined reporting regime protects a state against various tax-avoidance techniques that multistate companies routinely use to lower their tax bills in separate reporting states. Section II.C., examines the potential of combined reporting for simplifying the Louisiana corporate income tax.

2. *Container*, 463 U.S. at 164-65, 103 S. Ct. at 2940 (citations omitted). These sentiments were repeated in part in *Barclays Bank*, 512 U.S. at 303-04, 114 S. Ct. at 2272.

Our recommendation that Louisiana adopt combined reporting does not mean that we would eliminate the use of the separate accounting method entirely. Louisiana law currently permits taxpayers to apply to the tax department for permission to use separate accounting under certain conditions "if the taxpayer shows that the apportionment method produces a manifestly unfair result."[3] We would continue that rule as a useful safeguard against unfair results and as a protection against constitutional attacks on Louisiana's use of formulary apportionment.[4]

A. Better Measurement of In-State Income

Under Louisiana's separate reporting regime, the amount of corporate income taxes that a unitary group of corporations pays to Louisiana depends on the structure of the corporate group. A corporation is likely to pay a different amount of tax, for example, if it incorporates a branch or division or if it liquidates a subsidiary. Under combined reporting, unitary groups that are similarly situated generally would pay the same aggregate amount of Louisiana tax regardless of their corporate structure. There are some exceptions to the general goal, due to factors outside the control of the Louisiana Legislature. The exceptions, however, are just that; they do not undermine the general goal.[5]

Combined reporting also helps create a level playing field for intrastate corporate groups, whether large or small, and multistate corporate groups. A unitary group that is engaged in business only in Louisiana is taxable on all of its income under Louisiana's current system of separate reporting. The adoption of combined reporting would not change that result. A multistate corporate group, however, is currently able to reduce its Louisiana apportionable income, and hence its Louisiana income taxes, by isolating highly profitable parts of its

---

3. La. R.S. 47:287.94(C)(2001). Some administrative flexibility may be required to prevent an unconstitutional tax on extraterritorial values. *See* Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell, 283 U.S. 123, 51 S. Ct. 2933 (1931) (allowing the taxpayer to introduce evidence to challenge the apportionment resulting under a one-factor (property) apportionment formula based on an offer of proof that the formula produced an unreasonable and arbitrary result, out of all appropriate relationship to the business activities in the state).

4. *See* Unif. Div. of Income For Tax Purposes Act § 18, 7A U.L.A. 331 (1985) [hereinafter UDITPA] (providing similar escape hatch). The Louisiana corporate tax statute is not based on UDITPA, although UDITPA and the Louisiana statute have many common elements. We do not discuss in this Article whether Louisiana should adopt UDITPA.

5. One significant exception to the equal treatment of similarly situated unitary groups is the result of the protection against state income taxation provided in Act of Sept. 14, 1959, Pub. L. No. 86-272, 1986 U.S.C.C.A.N. (73 Stat. 555) 613 (codified as 15 U.S.C. § 381 *et seq.*). That Federal law limits the ability of a state to tax a corporation when thecorporation's only connection with the state is through the solicitation of sales within the state. That protection extends, however, only to the corporation itself—not to the unitary group of which it is a member. As a result, a corporate group that is organized as a single corporation might be ineligible for protection under Pub. L. No. 86-272, whereas a corporate group that placed its purely solicitation activities inone corporation and its disqualifying activities in another corporation might obtain at least some protection.

unitary business in a corporation that is not taxable in Louisiana. Under combined reporting, this advantage for the multistate enterprise is eliminated.[6]

The improved equity under combined reporting is due to its superiority over separate reporting as a method of tax accounting. The premise of combined reporting is that the synergies, interdependencies, and sharing of knowledge, know-how, and experiences that are typical features of a unitary business often cannot be properly captured by separate entity accounting. By taking into account only the income and factors of the corporation having nexus with the taxing state, separate-entity accounting often cannot provide an accurate measurement of the income of the unitary business that is properly attributable to that state. A combined reporting regime, in contrast, avoids this failing by automatically apportioning all of the unitary business income of a unitary group among the states where it is engaging in meaningful business activities.

To illustrate, consider a unitary oil enterprise that explores, refines, and markets oil products. The parent company is PCo. PCo is assured by its geologists that an oil field that straddles Texas and Louisiana is rich in oil. The geologists estimate that if ten wells are drilled, one is likely to be a gusher and the other nine wells will be dry holes. PCo directs LCo, its Louisiana subsidiary, to drill for oil on the Louisiana side of the oil field. It directs its Texas subsidiary, TCo, to drill on the Texas side. LCo drills five holes and finds no oil. TCo also drills five holes and discovers oil. The crude oil is transferred to RCo, another subsidiary of PCo, and RCo refines it into gasoline at a Texas refinery. The gasoline is sold in California by CCo, another PCo subsidiary. The profits for the year from the combined activities of the related companies are $100. Under separate accounting, none of that income would be apportioned to Louisiana. Yet the Louisiana activities were integral to finding oil in Texas and to the other operations of the unitary business.

Adding additional facts to the scenario above would further complicate the problem of assigning income under a separate reporting system. Assume, for example, that RCo, the Texas refinery, used oil produced in a prior year by LCo, the Louisiana subsidiary, in producing gasoline for the California market. Under separate reporting, LCo would have no income in the current year, notwithstanding its substantial contribution to the profits of the unitary business. It would have income in the prior year, however, calculated by assigning a sales price to its transfer of crude oil to RCo. Under a combined reporting regime, LCo would be taxable on its apportioned share of the income of the unitary business in the year the income was actually earned.

The more facts that are added to the above example, the more difficult it becomes to determine the income of each affiliated company under a separate reporting regime. Assume that PCo's geologists, based in Oklahoma, were extraordinarily talented in predicting where the unitary business should drill. Should the activities of the geologists be taken into account in computing the

6. Examples of the tax-planning advantages available to the multistate enterprise under the separate reporting system are addressed *infra* in Section II.B.

income apportioned to Louisiana? In what way? Assume also that the Texas refinery, RCo, was inefficient because it used obsolete equipment. Should no profits be attributed to it? What if RCo used that equipment temporarily in order to allow the unitary group to hold its market while a new refinery was under construction? What if the $100 of profits were attributable entirely to a spike in the world price of oil resulting from a decision of the OPEC cartel?

All of the above questions must be answered in a satisfactory and consistent way for separate accounting to operate successfully. In addition, they must be answered consistently in the states where the unitary business operates. They will be answered initially by the taxpayer when it prepares its tax books. The taxpayer is likely to resolve doubtful issues in its favor. The tax department may have difficulty challenging the taxpayer's reported income absent some clear showing of abuse.

The example above dealt with affiliated companies engaged in transactions between related entities for which the market provides at least some evidence of arm's length prices.[7] In many cases of related-person transactions, however, market prices cannot be determined with reasonable accuracy. Market prices are particularly difficult to obtain for the value contributed through use of intangible property, such as a trademark, patent, trade secret, franchise, customer list, copyright, unique management system, and know-how.

Market prices are also difficult to estimate when one related company transfers value to another under conditions that would not be duplicated in transactions between unrelated persons. Consider, for example, the transfer of value that occurs when the vice president of LCo, an affiliated company that manufactures telephones, calls the vice president of TCo, the affiliated company engaged in research and design. The LCo vice president resolves a problem facing TCo in a way that will increase corporate profitability significantly. LCo operates only in Louisiana and TCo operates only in Texas. No comparable prices will be available to allow LCo and TCo to determine in an objective manner the value of that telephone call.

As a further example, consider a unitary business that operates two stores. One store is operated by LCo in Louisiana and the other store is operated by MCo in Mississippi. LCo, the parent corporation, buys inventory centrally for itself and MCo, getting a volume discount. On a separate accounting basis, MCo reports a high profit to Mississippi and LCo breaks even in Louisiana. If LCo closed its store in Louisiana, the profits of MCo would decline because its unit costs for inventory would increase. Under these facts, it is clear that LCo contributes to the profitability of MCo. The result reached under separate accounting, which does not take LCo's contribution into account, is misleading.[8]

In a combined reporting regime, none of the difficult questions posed above needs to be answered. The goal of combined reporting is to apportion the entire

---

7. In *Exxon Corp. v. Dept. of Revenue of Wisconsin*, 447 U.S. 207, 100 S. Ct. 2109 (1980), the Court held that combined reporting and formulary apportionment is preferred to the arm's length method of apportionment even in the face of good price data.

8. *See* Butler Bros. v. McColgan, 315 U.S. 501, 62 S. Ct. 701 (1942).

unitary income of a business enterprise among the states where it operates. By using a fixed formula, the combined report largely eliminates opportunities for a state to manipulate the rules to maximize its revenues. Similarly, it eliminates opportunities for unitary businesses to manipulate the rules to minimize their tax obligations. Minor imperfections in the operation of combined reporting are likely to average out over time because of the absence of any systemic bias in favor of increasing or reducing a state's entitlement to tax revenue.

B. Protection Against Tax-Minimization Strategies

The many techniques that tax planners have developed to exploit the weaknesses of a separate reporting system are too numerous to catalog in this Article. One popular strategy for a corporate group is to isolate nexus-creating activities and property of its unitary business in one corporation. That corporation is taxable by the state on an apportioned share of its taxable income. Other members of that group, however, have no nexus-creating activities or property in the state and are thereby insulated from tax by that state on any part of their unitary income. As a result, the state only gets to tax that portion of the income of the unitary group that appears on the books of account of the corporation having nexus with the state, even though all of the members of the corporate group are engaged in the same unitary business.

Another technique used by multistate and multinational corporate groups to minimize state income taxes is to create an intra-group expense on the books of a corporation having nexus with the state that is payable to another member of the unitary group located outside the state, typically in a tax haven. Yet another technique is for the members of a unitary group to set the prices charged for the transfer or provision of goods and services to related persons in a way that allows them to shift income from high-tax states to low-tax states. Tax planners may use some or all of these techniques simultaneously.

A separate reporting state is not defenseless against these tax-planning techniques. To combat them, however, its tax department must take aggressive action to detect their use and to find some way under the separate reporting rules to subject the deflected income to tax. Sometimes the tax department will enjoy some measure of success. In some cases, however, the unitary group is successful in having its tax-planing techniques upheld.[9]

The combined report directly blocks these techniques and other similar tax-minimization strategies. The isolation of nexus-creating activities in a single corporation is impossible because the state imposes its income tax on an apportioned share of the aggregate income of the members of the unitary group. Deflecting income by manipulating transfer prices or by setting up inter-company

9. In *SYL, Inc. v. Comptroller of the Treasury*, Circuit Court for Baltimore City, No. 24-C-99-002389AA (Mar. 17, 2000), *aff'g* Maryland Tax Court, No. C-96-0154-01 (Apr. 26, 1999), the court indicated that it would not stretch the letter of the law to prevent tax avoidance when the state could have prevented that avoidance by adopting a combined reporting regime.

payables is unsuccessful because transactions between members of a unitary group are washed out in preparing the combined report.[10]

The advantages of combined reporting in combating tax avoidance are nicely illustrated by examining the treatment of tax-haven holding companies under separate reporting and combined reporting. The use of a holding company is a common tax-minimization technique in Louisiana and other separate reporting states.[11] In the typical approach, the holding company is domiciled in a state that has no income tax or has favorable rules on the taxation of passive income. One state with these favorable rules is Delaware. Under Delaware law, a corporation is not subject to Delaware tax if its activities in that State are limited to maintaining and managing intangible assets that generate income such as capital gains, dividends, interest, and royalties.[12]

As an example of the potential advantages of using a holding company, assume that PCo is a corporation that is domiciled in Texas and is engaged in business in Louisiana. PCo establishes HCo, a holding company domiciled in Delaware.[13] PCo transfers valuable trademarks and trade names that it is using in its business to HCo. HCo executes a license agreement allowing PCo to use the transferred property in exchange for a royalty equal to five percent of its sales receipts. PCo deducts the royalty payment to HCo in calculating its pre-apportionment income. The royalty income is not taxed by Delaware.

The licensing of a trademark is only one way of using a Delaware holding company to generate a deduction for the payer without any tax being paid by the payee. Another way involves loans made by the Delaware corporation to the related payer corporations. Assume, for example, that PCo in the example above needs additional capital for its business. HCo has accumulated a large cash pool from its royalty income. HCo loans PCo $500 at a market interest rate of 8 percent. The annual interest payment of $40 ($500 × .08) is deducted by PCo in computing its pre-apportionment income. The interest income of that same amount is not taxable to HCo because of the exemption provided by Delaware.

As noted above, a separate reporting state like Louisiana can assert a variety of arguments to defeat the tax-minimization strategies described above. The tax

10. For discussion of the wash rule, *see infra* Part IV.C.1.

11. There are many types of holding companies. Here we are concerned primarily with companies organized in a tax-haven jurisdiction that hold intellectual property or other intangible property made available for a fee to affiliated companies engaged in business in the taxing state.

12. Del. Code Ann. tit. 30, § 1902(b)(8) (1997). As an alternative to Delaware, a holding company could be based in a state without an income tax, such as Nevada. An even better strategy, because it is less of a red flag to auditors, may be to create a holding company in a state in which the taxpayer is already filing a combined report.

13. The creation and operation of Delaware holding companies has become a specialty of certain Wilmington-based banks. A pamphlet of one of these banks promises to arrange for the rental of office space, telephone answering services, secretarial help, and accounting and legal services through Delaware's top accounting and legal firms. "By developing relationships with these Delaware professionals, the substance of your Delaware holding company will be further reinforced." *See* Richard D. Pomp and Oliver Oldman, State & Local Taxation 10-34 n.204 (4th ed. 2001) [hereinafter Pomp & Oldman, State & Local].

department may argue that the holding company lacks substance and should be ignored for tax purposes. The transfer of intangible assets to the holding company might be challenged as lacking a business purpose or lacking substance. Louisiana might assert nexus over the holding company on account of the company's exploitation of the Louisiana market[14] or the business situs of the intangible property generating the income. It might try to impose a withholding tax on the income paid to the holding company.[15] It might deny the in-state company a deduction for amounts paid to the holding company on the ground that they are not legitimate business expenses.[16] It might recharacterize the payments to the holding company as capital expenditures. It might recharacterize the holding company's debt instrument as an equity investment, so that payments on that instrument would become non-deductible dividends.

Whether some or all of the various arguments suggested above will prevail in court is likely to depend on the facts and circumstances of each case. There can be legitimate reasons for creating a holding company, and special-purpose subsidiaries are a common feature of corporate America. The case law is full of illustrations of the good, the bad, and the ugly.[17]

The advantage of combined reporting is that it makes arguments of the type suggested above unnecessary. The tax advantage of the holding company is nullified without the state having to prevail on one or more of these arguments as

---

14. *See, e.g.*, Geoffrey, Inc. v. South Carolina Tax Commission, 437 S.E.2d 13 (1993).

15. Under the Internal Revenue Code, a foreign corporation licensing a trademark for use in the United States would be subject to federal tax on the amount of the royalties, typically at a rate of 30 percent. *See* I.R.C. §§ 861(a)(4); 881(a)(1)(2001); Treas. Reg. § 1.861-5 (as amended in 1975). Many U.S. tax treaties provide an exemption or reduced withholding rate for residents of the Contracting States on a reciprocal basis. *See, e.g.* Convention with Respect to Taxes on Income and Capital, Sept. 26, 1980, U.S.-Canada, T.I.A.S. No. 11087 at 15 (enforceable Aug. 16, 1984) (reducing withholding rate in both countries to 10 percent); Convention on Taxes on Income and Capital Gains, Dec. 31, 1975, U.S.-U.K., 31 U.S.T. 5681 (enforceable Apr. 25, 1980) (reducing withholding rate to zero). Unlike the states, the Federal government is free to tax royalties without the constraints imposed by the dormant Commerce Clause.

16. Some states have recently adopted anti-holding company legislation disallowing deductions for payments made to certain related entities. *See* Ohio Rev. Code Ann. § 5733.052 (West Supp. 2001); Iowa Code Ann. § 422.61 (West 1998); Conn. Gen. Stat Ann. § 12-218c (West 2000).

17. For a sampling of cases in which a state challenged a holding company arrangement, see *In the Matter of the Petition of Sherwin-Williams*, No. 816712 (N.Y. Tax App. June 7, 2001), *SYL, Inc. v. Comptroller of the Treasury*, No. C-96-0154-01, 1999 WL 322666 (Md. Tax Ct. Apr. 26, 1999); *Crown Cork & Seal v. Comptroller of the Treasury*, No. C-97-0028-01, 1999 WL 322699 (Md. Tax Ct. Apr. 26, 1999); *In re Burnham Corp.*, DTA No. 814531, 1997 N.Y. Tax Lexis 304 (N.Y. Tax App. July 10, 1997); *In the Matter of the Petition of Express, Inc. et al.*, DTA Nos. 812330, 812331, 812332, 812334, 1995 N.Y. Tax Lexis 493 (N.Y. Tax. App. Sept. 14, 1995); *Kmart Properties, Inc. (KPI), Decision of Hearing Officer, New Mexico Taxation and Revenue Department*, No. 00-04, NM ID. No. 01-287446-006 (Feb. 1, 2000), available at <http://www.state.nm.us/tax/d&o/dno2000_04.htm> (citing memorandum from Detroit office of Price Waterhouse that concluded that "if structured properly, a company formed to hold and license Kmart's intellectual property could generate significant state and local income tax savings for Kmart in states which allow separate entity filing for corporate income taxes as well as other non-tax benefits"). *See generally* Peter L. Faber, *Planning for the Use of Intangible Holding Companies*, 14 State Tax Notes 1931 (1998). For a recent case interpreting the meaning of business purpose, see *Ex parte Sonat*, 752 So. 2d 1211 (Ala. 1999).

long as the holding company is an includable member of the unitary group conducting business in the state. In a combined reporting state, the income of the holding company (often substantial) is added to the pre-apportionment tax base of the unitary group, and the factors of the holding company would be taken into account in applying the apportionment formula.

In some cases, a unitary group may argue that its holding company is not part of its unitary business. If that argument succeeds, then the income of the holding company would not be included in the combined report.[18] That argument, however, is often difficult for the taxpayer to win, due to the general presumption that the activities of the members of a commonly controlled group are part of that group's unitary business.[19] In addition, a unitary group attempting to keep the income of a holding company out of the combined report by claiming that the holding company's activities are unrelated to the unitary business may have difficulty convincing a court that it had a legitimate business reason for engaging in a license or other transaction with that holding company.[20]

C. Simplification

The transition from one tax regime to another typically involves some complexity, even if the new system, once up and running, is significantly less complex than the system it replaces. In some respects, a combined reporting system would be more complicated to administer than Louisiana's current separate reporting system. Overall, however, it would be simpler. In addition, both systems have so many points of commonality that a transition to the new regime should not present substantial problems for the tax department. Both systems, for example, use formulary apportionment, both require a definition of a unitary business, and both require an identification of "allocable" or "nonbusiness income"—that is, income that a non-domiciliary state may not apportion by formula under U.S. Supreme Court decisions.

The one major increase in administrative burden under combined reporting arises from the need to audit members of a unitary group that were not taxable in

---

18. For discussion of whether a holding company is part of a unitary business, see Eric J. Coffill & Clare M. Rathbone, *"Unitary" Holding Companies: Uncertainty and Pitfalls Under Current California Law*, 6 State Tax Notes 757 (1994).

19. *See e.g.*, Container Corp. of America v. Franchise Tax Bd. of California, 463 U.S. 159, 103 S. Ct. 2983 (1983) (clear and cogent evidence required). For recent cases involving holding companies, see *Shaklee Corp. v. Dept. of Revenue*, 738 N.E.2d 236 (Ill. App. 1st Dist. 1998) (Japanese holding company unitary with Shaklee); *Extrusion Dies, Inc. v. Wisconsin Dept. of Revenue*, Nos.94-I-1463, 94-I-1464 (Wis. Tax App. Comm'n Aug. 21, 1996) (corporation acting as a holding company and owning stock in a subsidiary unable to deduct net losses because it lacked nexus with Wisconsin and was not subject to the Wisconsin franchise tax).

20. As discussed *infra* in Part III.E., we recommend that Louisiana permit a water's edge election, under which an enterprise conducting a unitary business partly in Louisiana could exclude certain foreign corporations from the unitary group. In this situation, special anti-avoidance rules are necessary to prevent use of foreign holding companies for tax avoidance purposes. *See* Part III.E. and especially text at *infra* note 137.

Louisiana. Assume, for example, that PCo operates a store exclusively in Louisiana and its subsidiary, SCo, operates a store exclusively in Mississippi and that the two operations are part of a unitary business. Under current law, SCo would not be taxable in Louisiana and Louisiana would not need to audit SCo. Under combined reporting, the unitary income of both companies must be reported to the Louisiana tax department and apportioned by formula among the states where the unitary business operates. The department must do whatever is appropriate in a voluntary compliance system to make sure that the information provided to it is accurate.

The additional burden created by the increased audit coverage of corporations that do not have nexus with Louisiana is offset, however, by eliminating the need to pursue costly and complex investigations to monitor the type of tax-planning opportunities discussed in Section II.B., above. Obviously the magnitude of the administrative benefits derived, for example, from ending the tax benefits of holding company tactics and improper transfer prices depends on the vigor with which the department has pursued those schemes in the past. If the department has not been diligent, the administrative benefits may be modest. In that event, however, the revenue gains to the Louisiana treasury from adopting the combined reporting regime are likely to be very substantial.

The biggest potential gain in simplicity from adopting combined reporting comes from eliminating the need to police most intra-group transfer pricing practices.[21] Determining the proper price on a transfer of property is often difficult, for the taxpayer and the tax department.[22] In the case of transfers of valuable intangible property, the problem is particularly acute. In a separate reporting state like Louisiana, a unitary group may use intercorporate transactions to shift profits from Louisiana to a state with a lower effective tax rate.[23] Because those gambits do not work under combined reporting, the tax department is spared the expense of monitoring them for abuse.

---

21. Taxpayers would also enjoy some gains from simplification. One commentator, writing during a period when separate accounting was commonly used, described it as so expensive to implement that the bookkeeping costs could far exceed the tax due under formulary apportionment. Charles W. Gerstenberg, Allocation of Business Income, 1931 Nat'l Tax Assoc. Proc. 301, 306.

22. Nearly every state allows its tax administration to adjust transfer prices to reallocate income among companies in order to reflect income accurately. In some states, this power is more constrained than that possessed by the IRS under I.R.C. § 482 (2001). The states seem to be getting more aggressive in adjusting intercorporate pricing and related expenses. The courts have not always supported these efforts. For recent cases, see *SLI Int'l. Corp. v. Crystal*, 671 A.2d 813 (Md. 1996); *New York Times Sales, Inc. v. Comm'r of Rev.*, 667 N.E.2d 302 (Mass. 1996); *Petition of Express, Inc.*, Nos. 812330, 812331, 812332, 812334, 1995 N.Y. Tax Lexis 493 (N.Y. Tax App. Sept. 14, 1995); *Aaron Rents, Inc. v. Collins*, No. D-96025 (Super. Ct., Fulton County, Ga., 1994); *Comm'r of Revenue v. AMI Woodbroke Inc.*, 634 N.E.2d 114 (Mass. 1994); *Trans-Lux Corp. v. Meehan*, 652 A.2d 539 (Conn. 1993); *Petition of Bausch & Lomb, Inc.*, No. TSB-D-90(11)C, 1990 N.Y. Tax Lexis 325 (N.Y. Tax App. July 19, 1990); *Petition of Hilton Hotels Corp.*, 1989 N.Y. Tax Lexis 63 (Feb. 24, 1989); *Commonwealth v. General Electric Co.*, 372 S.E.2d 599 (Mass. 1988). For a survey of these issues, see Mary Jane Egr, *State Section-482 Type Authority*, 11 State Tax Notes 1547 (1996).

23. In planning a transaction at the state level, advisers cannot focus solely on the nominal tax rates in the relevant states. The focus should be on the corporation's effective tax rate in each state.

Consider for example, PCo, a parent corporation that manufactures widgets in Louisiana. It sells the widgets to SCo, its subsidiary. SCo sells the widgets in Washington, a state that does not have an income tax. PCo is taxable only in Louisiana, and SCo is not taxed under Washington law, although Washington has jurisdiction to impose an income tax. In a separate filing regime, PCo's income depends on the price at which the widgets are sold to SCo. Because Louisiana has a higher effective tax rate than Washington, the corporate group is tempted to sell the widgets at the lowest defensible price. Indeed, if the taxpayer doubts the ability of the Louisiana tax department to pursue transfer pricing abuses effectively, it may arrange the sale to be made at what objectively may be an indefensible price.[24]

In combating transfer pricing abuses, a separate filing state cannot expect effective assistance from the Internal Revenue Service. Except in some very special cases, a shift of income from one domestic corporation to another has no impact on Federal tax liability. As a result, the Federal tax authorities have no institutional obligation or incentive to police such shifting. The Internal Revenue Service is properly concerned in some cases about the use of transfer prices to shift income outside the United States to foreign entities. Its track record in preventing transfer pricing abuses, however, is at best mixed, notwithstanding its allocation of extensive resources to the issue.[25]

III. MAJOR DESIGN FEATURES OF A COMBINED REPORTING REGIME

In this part, we discuss the main building blocks of a combined reporting system. Section III.A., below, describes the rules applicable in preparing a combined report. In general, a combined report is an accounting of the total income derived by a corporate group from the operation of its unitary business. The corporations that participate in a unitary business, part of which is conducted in the taxing state, must include their unitary income in the combined report of that state.

Section III.B. describes the concept of a unitary business and discusses its constitutional parameters. In general, a unitary business is a common enterprise engaged in by one or more members of a group of affiliated entities. Louisiana employs a unitary business concept, at least implicitly, under current law. We suspect, however, that Louisiana has left the meaning of a unitary business fairly

24. Although the example in the text involved the sale of tangible personal property, the same shifting of profits can occur using management fees, consulting fees, royalty payments, or interest charges.

25. For a full discussion of the IRS efforts at preventingtransfer pricing abuses, see Michael J. McIntyre, The International Income Tax Rules of the United States ch. 6 (2d ed. 2000) [hereinafter McIntyre, Int'l Treatise]. For a comparison of the Federal rules on separate accounting and the state rules on formulary apportionment, see Michael J. McIntyre, Contrasting Methodologies: A Systematic Presentation of the Differences Between An Arm's-Length/Source-Rule System and a Combined-Reporting/Formulary-Apportionment System, Proceedings of the 86th Annual Conference, National Tax Association 226 (1994) (excerpted in Pomp & Oldman, State and Local, *supra* note 13, at 11-142).

undeveloped. To operate a combined reporting regime successfully, the State will have to give greater attention to the concept. We offer some recommendations at the end of this section on how Louisiana might define a unitary business.

Section III.C. addresses issues that arise in distinguishing apportionable business income from allocable income. In many states, allocable income is referred to as nonbusiness income.[26] Louisiana does not use that latter term in its tax statute. The name is not of any great importance. The substance of the Louisiana definition of allocable income, however, differs in some significant respects from the definition of nonbusiness income used by states that have incorporated UDITPA into their tax code.

In a combined reporting regime, the portion of the apportionable income of a unitary business that is taxable by a state is determined through application of an apportionment formula. Louisiana currently employs an apportionment formula in operating its separate reporting regime. That formula, in effect, apportions half of the income of a manufacturing or merchandizing business to the place of production and the other half to the place of sale. In Section III.D. we defend the constitutional right of Louisiana to use that apportionment formula in a combined reporting regime.

Section III.E. addresses so-called "water's edge" rules. In principle, a combined reporting regime should not recognize any geographical boundaries. That is, the unitary income apportioned to Louisiana should be computed by reference to the entire worldwide income of all members of the unitary combined group. For practical and political reasons, however, we recommend that Louisiana allow taxpayers to elect to exclude from their unitary group certain foreign corporations that are not engaged directly in nexus-creating activities in the State.

A. The Combined Report

A combined report is an accounting document prepared on behalf of a group of corporations engaged in a unitary business. It contains a tabulation of the aggregate taxable income derived by the members of the group from that unitary business. The initial step in preparing a combined report is to determine the scope of the group's unitary business.[27] In computing the aggregate taxable income of group members from that unitary business, transactions between members of the group generally are eliminated.[28] The combined report also includes a tabulation of each group member's apportionment factors used in the apportionment formula. In most states, including Louisiana, the factors are property, payroll, and receipts

26. *See* UDIPTA, *supra* note 4, at § 1(e).

27. It is possible that some or all of the members of a group of entities would be engaged in more than one unitary business. In that event, a combined report typically would be prepared for each unitary business. For simplicity, our discussion in this part assumes that the combined group is engaged in only one unitary business. For discussion of issues arising when members of a combined group are engaging in more than one unitary business, *see infra* Section III.B.3.

28. For discussion of this wash rule, *see infra* Part IV.C.1.

(sales). The corporations that are included in a combined report are sometimes referred to as a combined group or a unitary group. We use these terms interchangeably in this Article. Although the combined report would be appended to the tax return of each group member that has a tax-filing obligation in Louisiana, it is not itself a tax return.

A combined reporting state requires the unitary group to use the combined report to determine the amount of the group's taxable unitary income apportioned to the state. That amount equals the aggregate taxable income of the group multiplied by the group's apportionment percentage. The apportionment percentage is determined by applying the apportionment formula. The application of the formula is described in detail in Section III.D., below. If the apportionment percentage is, for example, twenty-five percent, then twenty-five percent of the aggregate taxable unitary income of the combined group would be taxable in the state. The tax is not imposed, however, on the unitary group itself. Rather, each member of the group having nexus with the state is made taxable on its assigned share of the unitary income apportioned to the state under the apportionment formula. Issues that arise in determining the amount taxable to particular members of a unitary group are addressed in Part IV.A.1., below.

To be included in the combined group, a corporation must be engaged in a unitary business with the other members of that group. In addition, the corporation must be controlled, directly or indirectly, by a common parent corporation or by some consortium of related owners.[29] States using combined reporting generally determine control by reference to a minimum ownership of voting stock.[30]

Some states using combined reporting define "control," for purposes of a combined report, as common ownership of more than fifty percent of a corporation's voting stock.[31] For example, if PCo owns fifty-one percent of the voting stock of SCo and the two corporations are engaged in a unitary business, they would form a combined group.

29. Louisiana should specifically provide that a combined group may exist if the members are owned by one or more individuals acting in concert. *See* Rain Bird Sprinkler Mfg. Corp., California State Board of Equalization, June 27, 1984, 84-SBE-094 (upholding the tax department's position that unity of ownership exists if a group of corporations is owned by members of a family); *but see* True v. Hietkamp, State Tax Comm'r, 470 N.W.2d 582 (N.D. 1991) (upholding the tax department's position that a unitary combined group must be controlled by a single entity that is a member of that group). As a matter of tax policy, we agree with the result in *Rain Bird* and disagree with the result in *True*.

30. *See, e.g.*, Cal. Rev. & Tax. Code § 25105(b) (West Supp. 2001). The Federal government has given considerable attention to the issue of defining control for purposes of its controlled foreign corporation rules. *See* I.R.C. § 958 (2001) (defining indirect and constructive ownership for purposes of defining a controlled foreign corporation). Similar rules should be adopted by Louisiana in determining ownership for purposes of a control test.

31. *See, e.g.*, Cal. Rev. & Tax. Code § 25105(b)(1) and (2) (West Supp. 2001); Idaho Code § 63-3027B(b)(1) and (2) (Michie 2000). *But see* Utah Code Ann. § 59-7-101(28)(a) (2000) (defining a unitary group as a group of corporations that are related through common ownership and are economically interdependent). For a comparable definition of control under Federal tax law, see I.R.C. § 957(a) (2001) (defining a controlled foreign corporation).

An issue that sometimes arises in defining a combined group is the proper treatment of a company that is not itself engaged in an active business but simply is holding stock in affiliated companies that are actively engaged in a unitary business. Assume, for example, that PCo owns all of the stock of SCo and TCo and that SCo and TCo are actively engaged in the same unitary business. PCo is acting merely as a holding company and is not actively engaged in that unitary business. Consistent with the goals of combined reporting, PCo should be treated as a member of the combined group. California would treat PCo as a member of the combined group under these circumstances.[32]

Having a strong control test that is not easily avoided is an important aspect of a combined reporting regime. The more-than-fifty-percent stock-ownership rule used by most states is a rule of statutory convenience, not a rule mandated by the U.S. Constitution. We endorse that rule for Louisiana because of its familiarity and wide acceptance. We would buttress the rule, however, by giving the Tax Department the authority to include a corporation in a unitary combined group when there is control in fact and a failure to include it would result in a distortion of the income of the combined group.[33] We also would endorse regulations that would treat ownership of more than fifty percent of the value of stock[34] as establishing control and that would treat restrictions on transferability of stock as indicia of control in appropriate cases.[35]

A combined report is not a consolidated tax return.[36] In a combined reporting regime, each group member files its own tax return and pays tax on its determined share of the unitary income of the combined group. In a consolidated return, a single tax return is filed on behalf of all the members of the consolidated group. A major difference between a state combined report and a Federal consolidated return is that the consolidated return may be elected regardless of whether the

32. Cal. FTB Legal Ruling 95-7 (Nov. 29, 1995); Cal. FTB Legal Ruling 95-8 (Nov. 29, 1995).

33. *See* Treas. Reg. 1.957-1(b)(2) (as amended in 1997) ("Any arrangement to shift formal voting power . . . will not be given effect if in reality voting power is retained"). The Federal government defines control for purposes of adjusting intra-group prices without reference to any ownership percentage. Treas. Reg. § 1.482-1(i)(5) (1994). Two entities are presumed to be controlled if income or deductions are artificially shifted between them. Treas. Reg. § 1.482-1(i)(4) (1994). *See also* Idaho Tax Regulation 63-3027C(b) (giving the tax commissioner authority to include or exclude a corporation from a combined group).

34. In defining a controlled foreign corporation, ownership of over 50 percent of the stock by vote or value is sufficient to constitute control. I.R.C. § 957(a)(1) and (2) (2001).

35. California has a "stapled stock" rule that treats two or more corporations as members of a control group if over 50 percent of the shares of stock are "stapled" together as a result of restrictions on their transfer.. The stock of two companies is stapled if a person acquiring a share of stock in one corporation must also acquire a share of stock in the other corporation. Cal. Rev. & Tax. Code § 25105(b)(3) (West Supp. 2001). We endorse the California rule. For a related Federal stapled-stock rule, see I.R.C. § 269B (2001) (treating a foreign corporation stapled to a U.S. corporation as a U.S. corporation).

36. Under Federal rules, certain eligible corporations that are related to one another through common ownership under an 80 percent-control test may elect to file a consolidated return rather than separate returns. *See* I.R.C. §§ 1501-1505 (2001).

included corporations conduct a unitary business.[37] The state concept of a unitary business, developed in part to deal with issues under the Commerce Clause and Due Process Clause of the U.S. Constitution, has no federal counterpart in this context.[38]

Combined reporting is a neutral accounting system that neither favors nor penalizes the taxpayer or state. In some cases, a group of corporations may want to include a particular corporation in their control group; in other cases, they may want to exclude it from the group. Everything depends on the facts and circumstances of the particular case.

In general, a group of corporations would prefer combined reporting if one member of their unitary combined group has suffered a loss and the loss otherwise would not be useful to them. Consider, for example, PCo, a parent corporation with nexus in Louisiana. PCo has a unitary subsidiary, SCo, that operates at a loss in another state. PCo has income of $200 and SCo has a loss of $100. Under these facts, PCo would pay tax to Louisiana on $200 in a separate reporting regime. In a combined reporting regime, the pre-apportionment income of the unitary business would be only $100, so PCo's apportioned income taxable in Louisiana would be no more than $100.

Of course, a combined reporting regime may cause some combined groups to pay higher aggregate taxes. For example, if PCo in the above example had the loss of $100 and SCo had income of $200, PCo would not pay any tax in Louisiana in a separate reporting regime. In a combined reporting regime, however, the combined group of PCo and SCo would have pre-apportionment income of $100, some portion of which would be apportioned to Louisiana under the apportionment formula.

If multistate corporations were not engaging in tax planning to exploit defects in Louisiana's separating reporting regime, the overall revenue impact of adopting combined reporting probably would not be substantial. Some corporate groups would pay more and some would pay less, with the overall revenue impact uncertain. The major effect of the reform would be a better measure of in-state income and some simplification.[39] In the world we live in, however, the adoption of combined reporting would increase Louisiana tax revenues by reducing tax planning opportunities.[40] Although we do not have data necessary to make a revenue estimate, we expect that the revenue gains would be significant.[41] Of course the Louisiana legislature could adopt offsetting tax reductions if it wanted to make its overall reform package revenue neutral.

---

37. *See generally*, William L. Goldman et al., 1130 T. M. Income Taxes: Consolidated Returns and Combined Reporting (revised 2001).

38. Some states permit corporations that file—or could have filed—a federal consolidated return to file a similar state return. The taxpayer is not required to file a consolidated return; indeed, a mandatory rule probably would be unconstitutional in some situations because the unitary business principle both empowers and limits the tax jurisdiction of states.

39. *See supra* Parts II.A. and II.C.

40. *See supra* Part II.B.

41. *See* Richard D. Pomp, *The Future of the State Corporate Income Tax: Reflections (and Confessions) of a Tax Lawyer*, *in* The Future of State Taxation 49, 64-65 (David Brunori ed. 1998) [hereinafter Pomp, Future of State Taxation].

The Uniform Division of Income for Tax Purposes Act (UDITPA), promulgated in 1957 by the National Conference of Commissioners on Uniform State Laws and the American Bar Association, contains no express statement on the use of combined reporting.[42] This silence is unfortunate, for UDITPA is the basic document used by the states to promote uniform corporate tax rules.

Section 18 of UDITPA does provide, inter alia, for "the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income," if its rules on apportionment and allocation "do not fairly represent the extent of the taxpayer's business activity in [the taxing] state." Some courts have relied on Section 18 to uphold state regulations that require the use of combined reports.[43] That street, however, is one way. Taxpayers generally have been unsuccessful in invoking Section 18 to secure the right to file a combined return in the absence of legislative authorization.[44]

It makes no sense for Louisiana to adopt combined reporting unless the combined reporting regime is mandatory. Indeed, Louisiana taxpayers already can achieve the results of combined reporting by merging certain of their separate entities into other members. This self-help approach typically involves some transaction costs and other business obstacles that might outweigh the tax savings in some circumstances. If combined reporting were elective rather than mandatory, these costs and obstacles would be eliminated and the cost in revenue forgone by the Louisiana treasury would increase. Moreover, elective combined reporting would do nothing to reduce tax planning opportunities because taxpayers that are reducing their taxes by gaming the current system would simply decline to make the election.

B. Defining a Unitary Business

In Section III.B.1. below, we discuss the ways in which the unitary business concept both empowers and limits state taxing power. In Section III.B.2., we discuss the major pronouncements of the United States Supreme Court on the unitary business concept. In Section III.B.3., we address issues arising when affiliated entities engage in more than one unitary business. Section III.B.4. provides our practical advice to Louisiana on how to define a unitary business.

---

42. *See* UDITPA, *supra* note 4.

43. *See, e.g.*, Caterpillar Tractor Co. v. Lenckos, 395 N.E.2d 1167 (Ill. 1979); Pioneer Container Corp. v. Beshears, 684 P.2d 396 (Kan. 1984). For discussion, see Laura L. Farrell, *The State of Combined Reporting Today*, 11 State Tax Notes 635 (1996); 2000 Multistate Corporate Tax Guide at I-533 to I-550; I-613 to I-623 (J. Healy ed.).

44. The Supreme Court has not addressed the issue of whether a constitutional right exists to file a combined report. The taxpayer raised this issue in *Mobil*, but the Court did not address it on the grounds that it was not presented in a timely manner. Mobil Oil Corp. v. Comm'r of Taxes of Vermont, 445 U.S. 425, 441 n.15, 100 S. Ct. 1223, 1233 (1980). The state courts have uniformly rejected taxpayer arguments that they have a constitutional right to file a combined report. *See, e.g.*, Ashland Pipe Line Co. v. Marx, 623 So. 2d 995 (Miss. 1993). Some courts have rejected attempts by the tax administration to impose a combined report if a statute did not explicitly authorize it. Polaroid Corp. v. Comm'r of Revenue, 472 N.E.2d 259 (Mass. 1984); Sears Roebuck & Co. v. State Tax Assessor, 561 A.2d 172 (Me. 1989).

1. Jurisdictional Issues

Under well-established constitutional doctrine, a state cannot tax a corporation's income unless there is "some definite link, some minimum connection"[45] between the state and the corporation's income that the state seeks to tax. This necessary connection or relationship is referred to as "nexus." Nexus is present when the income of the corporation is attributable in a meaningful way to the unitary business, part of which is conducted in the taxing state.

To tax the income of corporations in a combined reporting regime, therefore, Louisiana must limit the reach of its tax to income having a nexus with the State. According to the United States Supreme Court, the "linchpin of apportionability in the field of state income taxation is the unitary-business principle."[46] In the Court's authoritative view, the income derived by a group of corporations from the operation of a unitary business has nexus with all of the states in which that unitary business is conducted. In sum, if a unitary business is being conducted in Louisiana, the State may apportion all the income of that unitary business regardless of where, why, how, or from what specific activities that income is realized.

To illustrate the implications of the Court's doctrine, consider a corporation, PCo, that conducts activities both within and without Louisiana. Louisiana obviously would have nexus over the in-state activities and could tax PCo on some portion of the income generated by those activities. Louisiana also would have nexus to tax PCo on an apportioned share of the income generated by the out-of-state activities if those activities had a sufficient relationship to the in-state business.[47] That relationship is established if the activities of PCo within and without Louisiana are integrated, interdependent, or synergistic—that is, if the activities of the enterprise constitute a unitary business.[48] The simple rule is that

45. Miller Bros. Co. v. Maryland, 347 U.S. 340, 344-45, 74 S. Ct. 535, 539 (1954).

46. *Mobil*, 445 U.S. at 439, 100 S. Ct. at 1232.

47. Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 112 S. Ct. 2251 (1992).

48. For state cases interpreting and applying the concept of a unitary business, see *Earth Resources Co. v. Alaska, Dept. of Revenue*, 665 P.2d 960 (Alaska 1983); *Appeal of the Leland Corp., California State Board of Equalization*, No. 94A-0916 (Feb. 5, 1997); *Dental Ins. Consultants, Inc. v. Franchise Tax Bd.*, 1 Cal. Rptr. 2d 757 (Cal. Ct. App. 1991); *Arizona Dept. of Revenue v. Talley Indus.*, 893 P.2d 17 (Ariz. Ct. App. 1994); *Pledger v. Ill. Tool Works, Inc.*, 812 S.W.2d 101 (Ark. 1991); AMAX, Inc. v. Groppo, 550 A.2d 13 (Conn. App. Ct. 1988); *McLean Gardens Corp. v. District of Columbia*, No. 3158-82 (D.C. Sup. Ct. Jan. 31, 1983); *Albertson's Inc. v. Idaho Dept. of Revenue*, 683 P.2d 846 (Idaho 1984); *Citizens Utils. Co. v. Dept. of Revenue*, 488 N.E.2d 984 (Ill. 1986); *Super Value Stores, Inc. v. Iowa Dept. of Revenue*, 479 N.W.2d 255 (Iowa 1991); *Texas Co. v. Cooper*, 107 So. 2d 676 (La. 1958); *Md. Comptroller of Treasury v. Diebold*, 369 A.2d 77 (Md. 1977); *Russell Stover Candies, Inc. v. Dept. of Revenue*, 665 P.2d 198 (Mont. 1983); *Cox Cablevision Corp. v. Dept. of Revenue*, No. 3003, 1992 Ore. Tax Lexis 17 (Ore. Tax Ct. June 10, 1992); *Homart Dev. Co. v. Norberg*, 529 A.2d 115 (R.I. 1987); *Exxon Corp. v. S.C. Tax Comm'n.*, 258 S.E.2d 93 (S.C. 1979), *appeal dismissed*, 447 U.S. 917, 100 S. Ct. 3005 (1980); *Corning Glass Works, Inc. v. Va. Dept. of Taxation*, 402 S.E.2d 35 (Va. 1991), *cert. denied*, 502 U.S. 900, 112 S. Ct. 277 (1991); *Interstate Finance Corp. v. Wis. Dept. of Taxation*, 137 N.W.2d 38 (Wis. 1965); *see generally* Franklin C. Latcham, 1110 T.M.,

a taxing state may tax an apportioned share of the separately stated income attributable to activities that otherwise may be viewed as occurring outside the taxing state when those activities are a part of the unitary business conducted, in whole or in part, within the taxing state.

The example above illustrates the application of the unitary-business principle to a single corporation. The same principle applies, however, when two or more corporations are preparing a combined report. Assume that PCo, in the example above, organized a subsidiary, SCo, to conduct its out-of-state business activities. That change in legal organization would not affect Louisiana's jurisdiction to tax the income of SCo. SCo could be included in the combined report and its income subject to Louisiana tax if its activities are integrated, interdependent, or synergistic with the business of PCo.

A state is not permitted under the U.S. Constitution to tax all of the unitary income of a member of the combined group with which it has nexus. A state is only permitted to tax its apportioned share of that income.[49] The issue of fair apportionment is addressed in Section III.D.

2. *Definitional Guidance from the U.S. Supreme Court*

The U.S. Supreme Court has never attempted a rigorous, systematic definition of a unitary business.[50] The Court has acknowledged that "the unitary business concept is . . . not, so to speak, unitary: there are variations on the theme, and any number of them are logically consistent with the underlying principles motivating the approach."[51] Instead, it has identified some of the indicia of a unitary business. Those indicia include the following:

(1) Unity of use and management;[52]

Income Taxes: Definition of a Unitary Business (revised 2001) [hereinafter Latcham, Unitary Business].

49. Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 460, 79 S. Ct. 357, 363 (1959) ("[T]he entire net income of a corporation, generated by interstate as well as intrastate activities, may be fairly apportioned among the States for tax purposes by formulas utilizing in-state aspects of interstate affairs.").

50. The unitary business principle grew out of the "unit rule" of the late 19th century, which was used for apportioning the property tax of railroads, telegraph and express companies. Under the unit rule, the value of the entire enterprise was first determined and then apportioned to a taxing jurisdiction through the use of a formula. *Allied-Signal*, 504 U.S. at 778-79, 112 S. Ct. at 2258-59. *See* Elcanon Isaacs, *The Unit Rule*, 35 Yale L.J. 838 (1926). The unit rule respected the self-evident reality that the value of an assembled whole may be greater than the value of the individual elements that constituted the interconnected system being taxed. The Supreme Court at one point made the observation in defense of the unit rule that "[c]onsidered as distinct subjects of taxation, a horse is, indeed, a horse; a wagon, a wagon; a safe, a safe; a pouch, a pouch; but how is it that $23,430 worth of horses, wagons, safes and pouches produces $275,446 in a single year? . . . The answer is obvious." Adams Express Company v. Ohio State Auditor, 165 U.S. 194, 222-23, 17 S. Ct. 305, 310 (1897).

51. Container Corp. of America v. Franchise Tax Bd. of California, 463 U.S. 159, 167, 103 S. Ct. 2983, 2941 (1983).

52. Butler Bros. v. McColgan, 315 U.S. 501, 508, 62 S. Ct. 701, 704 (1942).

(2) A concrete relationship between the out-of-state and the in-state activities that is established by the existence of a unitary business;[53]

(3) Functional integration, centralization of management, economies of scale;[54]

(4) Substantial mutual interdependence;[55] and

(5) Some sharing or exchange of value not capable of precise identification or measurement—beyond the mere flow of funds arising out of a passive investment or a distinct business operation.[56]

Whether the activities of one member of a corporate group are related to the business of another member of that group can depend on how that latter corporation's business is described. A corporation's business can be described in many ways, from the most specific to the most general. For example, assume that PCo manufactures widgets for use in the aerospace industry and that SCo, its subsidiary, manufactures widgets for the automotive industry. If PCo's business is described very specifically as conducting a unitary business of manufacturing widgets for the aerospace industry, then the activities of SCo might not appear to be related to that business.[57]

Moving to a slightly higher level of generality, PCo's unitary business might be described as manufacturing widgets. Under that definition, SCo's activities would more likely be considered to be unitary with PCo's business. Even more generally, PCo's unitary business might be described as a manufacturer. In that event, the activities of all of PCo's manufacturing subsidiaries might be unitary with PCo's business. On the highest level of generality, PCo could be described as in the business of allocating its resources to maximize its internal rate-of-return. At that level of generality, any activities of a subsidiary of PCo might be unitary with PCo's business. The United States Supreme Court, in *Allied-Signal*,[58] rejected the highest level of generality.[59] It almost certainly would

53. *Container*, 463 U.S. at 166, 103 S. Ct. at 2940.

54. Mobil Oil Corp. v. Comm'r of Taxes of Vermont, 445 U.S. 425, 438, 100 S. Ct. 1223, 1232 (1980).

55. F.W. Woolworth Co. v. Taxation and Revenue Dept. of New Mexico, 458 U.S. 354, 371, 102 S. Ct. 3128, 3139 (1982).

56. *Container*, 463 U.S. at 166, 103 S. Ct. at 2940. For a detailed treatment of the definition of a unitary business, see Latcham, Unitary Business, *supra* note 48.

57. We certainly are not suggesting by this example and those that follow that similarity of the actual products being sold determines whether two separate entities are in a unitary relationship. California has recognized that businesses diverse in what they sell can be in a unitary relationship. *See* Mole Richardson Co. v. Franchise Tax Bd., 269 Cal. Rptr. 662 (1990) (rental of lighting for Hollywood and Colorado ranching held to be unitary).

58. Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 112 S. Ct. 2251 (1992).

59. In defending its broad characterization of the business of *Allied Signal*, New Jersey did little to help the Court see that selecting the appropriate level of generality in defining a unitary business is

reject the most limiting extreme as well. In the middle is the grey area where law suits are won and lost.

The Court has asserted that it "will, if reasonably possible, defer to the judgment of state courts in deciding whether a particular set of activities constitutes a 'unitary business.'"[60] The Court has declared that "our task must be to determine whether the state court applied the correct standards to the case; and if it did, whether its judgment 'was within the realm of permissible judgment.'"[61] Some decisions suggest, however, that the Court will not actually apply its professed standard.[62]

Whether income is part of the unitary business cannot be determined by the label attached to it. For example, dividends, interest, or capital gains cannot automatically be assumed to be nonbusiness income. Similarly, rental income may not necessarily constitute business income. Whether an item of income should be included in the apportionable unitary business income of a corporation depends on the relationship of that item to the business being conducted in the taxing state. For example, if a corporation holds its working capital in a bank account, interest paid on this account would be part of the corporation's unitary business income because of its integral relationship to the corporation's business operations.[63]

3. *Multiple Unitary Businesses*

A corporate group, or even a single company, may simultaneously conduct more than one unitary business. In some cases, only one of these unitary businesses would have activities in the taxing state. In such a case, Louisiana should tax an apportioned share of the income from the unitary business that is conducted in part within the State. The corporate group would determine the taxable income of that unitary business and would apply the apportionment formula using only the property, payroll and receipts (sales) factors relating to that unitary business.

As an illustration, assume that a corporate group owns a chain of gas stations in Louisiana and Missouri and a chain of pharmacies in Arkansas and Mississippi.[64]

---

an application of a more pervasive problem in the law. *See, e.g.*, Bruce Ackerman, *Levels of Generality in Constitutional Interpretation: Liberating Abstractions*, 59 U. Chi. L. Rev. 317 (1992); Laurence H. Tribe & Michael C. Dorf, *Levels of Generality in the Definition of Rights*, 57 U. Chi. L. Rev. 1057 (1990); Richard D. Pomp, *Issues in the Design of Formulary Apportionment in the Context of NAFTA*, 49 Tax L. Rev. 795, 802-03 (1995) [hereinafter Pomp, NAFTA]; Pomp & Oldman, State and Local, *supra* note 13, at10-21.

60. *Container*, 463 U.S. at 175, 103 S. Ct. at 2945.

61. *Id.* at 176, 103 S. Ct. at 2946.

62. *See Allied-Signal*, 504 U.S. 768, 112 S. Ct. 2251 (1992). For discussion, *see* Benjamin Miller, *Allied-Signal—A Cursory Examination*, 2 State Tax Notes 888 (1992).

63. *See* Richard D. Pomp & Rebecca S. Rudnick, *Federal Tax Concepts as a Guide for State Apportionment of Dividends: Life After ASARCO*, 18 Tax Notes 411 (1982) (excerpted in Pomp & Oldman, State and Local, *supra* note 13, at 11-67); *Allied-Signal*, 504 U.S. at 787, 789, 112 S. Ct. at 2263, 2264. Louisiana currently deviates from the general principle that the label attached to a corporation's business income should not control the way it is taxed. Louisiana does not treat dividends and interest as apportionable income even if the income is related to a unitary business. For discussion of the treatment of allocable income under Louisiana law, see Section III.C.

64. *See* Pomp, NAFTA, *supra* note 59, at 802-03.

Assume the corporate group is considered to be conducting two separate and independent unitary businesses. Louisiana and Missouri would apply formulary apportionment to determine their share of the income of the gas stations, and Arkansas and Mississippi would apply formulary apportionment to determine their respective shares of the income of the pharmacies. Louisiana and Missouri would not include the income from the pharmacies in the corporate group's combined report, and the factors attributable to that operation would not enter into the apportionment formula.[65] Similarly, Arkansas and Mississippi would not include the income from the gas stations in the corporate group's combined report, and the factors attributable to the gas station business would not enter into the apportionment formula. Some method akin to separate accounting should be used to determine the separate incomes of the pharmacy business and the gas station business.

A corporation might conduct two unitary businesses, each of which was conducted in Louisiana. In this case, Louisiana should calculate the taxable income of each unitary business separately. It would then apply a separate apportionment formula for each of the businesses.

4. Some Specific Recommendations

In adopting a combined reporting system, we recommend that Louisiana adopt as broad a definition of a unitary business as the Court's Due Process and Commerce clause jurisprudence allows. In our view, it is consistent with that jurisprudence to define a unitary business as a common enterprise undertaken by one or more commonly controlled entities in pursuit of business profits. Evidence that a commonly controlled entity is engaged in a common enterprise would include:

(1) that the participants in the enterprise contribute or are expected to contribute in a nontrivial way to each other's profitability;

(2) that it is sharing or exchanging value with other participants in the enterprise;

---

65. The appropriate function of an apportionment factor is to measure the business activities in a taxing state relative to the business activities in the other states where the unitary business is conducted. When an apportionment factor is being used in two unitary businesses, the question arises as to how much of the value of that factor should be included in the apportionment formula of each business. One possibility would be to bifurcate the factor and allocate it between the two businesses. For example, if an employee spends forty percent of his time on one unitary business and sixty percent of his time on the other unitary business, it would seem appropriate to include forty percent of his salary in the payroll factor of the first business and sixty percent in the payroll factor of the other business. In other circumstances, bifurcating the factor may be inappropriate. For example, if an asset provides full benefits to both businesses without any diminution in the value to either business from the dual use, then it may be appropriate to include the full value of the factor in the apportionment formula of each business.

(3) that the prices it charges or is charged on transfers of assets or services to other participants in the enterprise are inconsistent with the arm's length principle;[66]

(4) that it is dependent on other participants in the enterprise or one or more of those participants is dependent on it for achieving some nontrivial business objectives;

(5) that its functions are integrated with the functions of one or more participants in the enterprise;

(6) that its activities are managed by some central authority of the enterprise; or

(7) that it offers some economies of scale or economies of scope that benefit the enterprise.

To avoid becoming enmeshed in disputes over the interpretation of particular court decisions, we have formulated our list of the evidentiary determinants of a unitary business without invoking the "magic" phrases that courts sometimes use to summarize their views on the unitary business concept. The court-approved phrases are intended to serve as a summary of the holdings of their prior decisions. Our listing is more suggestive of the legal and economic analysis required to determine the existence and scope of a unitary business.

By employing a definition of a unitary business that is co-extensive with its taxing power under the United States Constitution, Louisiana improves its chances of making substance rather than form control the treatment of unitary businesses. A broad definition provides less opportunities for manipulation by taxpayers and by the tax department and results in lower compliance costs for everyone.

In particular, we strongly recommend that Louisiana explicitly provide, by statute or authorized regulations, that holding companies may be included in a combined report even if their activities are primarily passive. We are concerned with two types of holding companies. The first, and most important, is a company that holds assets, such as trademarks and patents, that are used by the unitary business. As discussed in Part II.B., the courts are unlikely to allow a group of affiliated companies to exclude such a holding company from its combined report. To avoid litigating risks, nevertheless, we recommend that this important point be clarified in the statute or regulations. A rule requiring that holding companies be included in a combined report is consistent with constitutional standards.

The second type of holding company is a parent company that owns a controlling interest in two or more affiliated companies engaged in the same unitary business. As indicated in Section III.A., we believe that such a holding

66. The fact that affiliates set their transfer prices in accord with the arm's length principle does not negate in any way the existence of a unitary business. *See* Exxon Corp. v. Dept. of Revenue of Wisconsin, 447 U.S. 207, 100 S. Ct. 2109 (1980).

company should be included in the unitary group with its affiliated companies, even if its activities are essentially passive.[67] This rule is often helpful to the taxpayer, although the overall revenue implications of the rule are not likely to be large. In large measure, the rule simply removes a trap for unwary taxpayers that have not received good tax planning advice.

Although we favor a broad definition of a unitary business, we obviously recommend against a definition that would go beyond constitutional bounds. Some states have adopted taxing statutes that subject corporations to tax on an apportioned share of all of their income, regardless of the relationship of that income to the state.[68] These states, known as full apportionment states, would violate the Court's nexus holdings if they tax income generated by activities having no relationship to the state.[69] Not only do these states make their tax statutes subject to constitutional attack, they also lose whatever presumption the Court is willing to indulge that the state's determination of nexus is "within the realm of permissible judgment."[70]

We recommend that Louisiana adopt several rebuttable presumptions that would apply in establishing the existence of a unitary business. The goal of these presumptions is to treat income as part of a unitary business whenever that treatment is consistent with constitutional standards. Our proposed presumptions make clear that in the absence of any proof that a unitary relationship is lacking, a challenge, whether by the taxpayer or the state, against the presumption will fail.[71] We prefer that the presumptions be included in authorized regulations rather than in the tax statute so that they may be fine tuned by the tax department in light of its experience in administering a combined reporting regime.

In some cases, a presumption favoring the existence of a unitary business may be helpful to the taxpayer. In other cases, the presumption is likely to encourage taxpayers to volunteer information that will help the state determine whether a unitary business exists. Experience teaches that a non-cooperative taxpayer can make things difficult when a state engages in discovery. The use of presumptions may help overcome taxpayer recalcitrance and obstinacy.

We recommend that Louisiana consider adopting the following four presumptions:

(1) A taxpayer or corporate group is presumed to be engaged in a unitary business when all of its activities are in the same general line;

---

67. *See* text at *supra* note 32.

68. *See, e.g.*, Conn. Gen. Stat. Ann. §§ 12-218 (West 2000); Md. Tax-Gen. §§ 10-401, 402 (1997); N.J. Stat. Ann. §§ 54:10E-6, 54:10A-6 (West Supp. 2001); R.I. Gen. Laws § 44-11-14 (1999).

69. *See* Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 112 S. Ct. 2251 (1992).

70. Container Corp. of America v. Franchise Tax Bd. of California, 463 U.S. 159, 176, 103 S. Ct. 2983, 2946 (1983).

71. A presumption against the taxpayer has long been recognized by the Supreme Court. *See id.* at 164, 103 S. Ct. at 2939-40. "[T]he taxpayer has the distinct burden of showing by clear and cogent evidence that [the state tax] results in extraterritorial values being taxed." *Id.* at 175, 103 S. Ct. at 2945 (internal quotation marks and citations omitted). *See* Adams Express Co. v. Ohio State Auditor, 165 U.S. 194, 227, 17 S. Ct. 305, 311 (1897) ("Presumptively all the property of the corporation or company is held and used for the purposes of its business . . . .").

(2) A taxpayer or corporate group is presumed to be engaged in a unitary business when its various divisions, segments, branches, or affiliates are engaged in different steps in a vertically structured enterprise;

(3) A taxpayer or corporate group that might otherwise be considered as engaged in more than one unitary business is presumed to be engaged in one unitary business when there is a strong central management, coupled with the existence of centralized departments or affiliates for such functions as financing, advertising, research, or purchasing; and

(4) A taxpayer operating different business segments within the organizational structure of the single business entity is generally presumed to be engaged in a single unitary business with respect to the business segments.

Another set of presumptions should address when a newly-formed or acquired business would be considered as part of the unitary business of the corporation that formed or acquired it.[72] Based on our involvement with the Multistate Tax Commission's Public Participation Working Group on the Definition of a Unitary Business,[73] we believe that the following presumptions are desirable and are likely to meet the legitimate expectations of state tax administrators and corporate taxpayers:

(1) Newly-acquired corporations. When a corporation acquires another corporation, a presumption should exist against a finding of unity between the two corporations during the first year. Any party may rebut such presumption by proving that the corporations were unitary.[74] If the presumption is rebutted, the corporations shall be considered unitary as of the date of acquisition, unless the evidence shows that unity was established as of another date.

(2) Newly-formed corporations. When a corporation forms another corporation, a presumption should exist in favor of finding unity between the two corporations as of the date of formation. Any party may rebut such presumption by proving that the corporations were not unitary or that unity was established as of a later date.[75]

In addition to the presumptions noted above, Louisiana should adopt a presumption that the tax department's determination of whether a taxpayer is

72. These presumptions are not suitable for statutoryenactment but instead should be included in authorized regulations.

73. Information on the PPWG and on the Definition of a Unitary Business is available on line at <http://www.mtc.gov/PPWGs/ppwglist.html> (last visited May 14, 2001).

74. An instant unitary relationship might be established, for example, when the acquired company was previously an unaffiliated supplier to, or buyer from, the acquiring unitary business.

75. A newly formed affiliate might lack instant unity when the new affiliate was a separate business that had no ties to the existing business of the unitary business.

engaged in a unitary business is correct if the taxpayer unreasonably refuses to provide information pertinent to the determination of a unitary business. The taxpayer should not be allowed to use any of the unfurnished information that was covered by the request of the tax department to rebut that presumption at a later date.[76]

C. Apportionable and Allocable Income

A combined reporting regime applies only to income derived from a unitary business. That income is apportioned among the various states where the unitary business is conducted. Unitary business income subject to apportionment is referred to as "business income" or "apportionable income." The Louisiana tax statute uses the term apportionable income.[77] Income that does not constitute apportionable income is referred to as "nonbusiness income" or "allocable income." Allocable income is the term of choice in the Louisiana statute.[78] Allocable income is allocated to a single state without apportionment.

The states have not developed uniform practices on the treatment of allocable income. One very common approach, however, is to treat allocable income as the residual category and to apply allocation rules to income that does not constitute the unitary business income of the taxpayer.[79] This approach has been adopted by UDITPA.[80] Interest, dividends, rents, royalties, and certain capital gains are examples of income that sometimes can qualify as allocable income under this approach. All of these types of income, nevertheless, could constitute business income in many circumstances.

A less common approach, followed by Louisiana, designates certain categories of income as allocable income, regardless of whether the income in those categories arose from business activities. Typical examples of income subject to this rule include interest, dividends, rents, royalties, and certain capital gains.[81] In Louisiana, allocable income is limited to most interest and dividend income,[82]

76. For an analogous Federal rule, see I.R.C. § 982 (2001) (prohibiting a taxpayer that fails to comply with a formal document request without reasonable cause from later using the requested document in a court of law to resist a tax assessment).

77. La. R.S. 47:287.92(A) (2001) ("items of gross income, not otherwise exempt, shall be segregated into two general classes designated as allocable income and apportionable income").

78. *Id.*

79. The definition of unitary-business income is addressed in *supra* Section III,B.

80. UDITPA, *supra* note 4, at § 1(e) ("'Non-business income' means all income other than business income.").

81. The rules allocating these categories of allocable income will vary, depending on the income at issue. *See, e.g.*, Del. Code Ann. tit. 30, § 1903 (1995); La. R.S. 47:287.91-.93 (2001); Ohio Rev. Code Ann. § 5733.051 (West 1995). States that define allocable income in terms of income categories typically adopted their statutes in the distant past, when the constitutional landscape was quite different. In those earlier times, allocation was thought to be appropriate for interest, dividends, rents, and royalties because they formed "no part of the trading profit and do not need to be apportioned by formula, since they can readily be specifically allocated to their proper sources." Report of the Committee of the NTA on Allocation of Income, 1939 NTA Annual Conference 190, 207.

82. La. R.S. 47:287.93(A)(4) (2001). In 1993, Louisiana adopted a special apportionment rule

certain rents and royalties from tangible real and personal property,[83] royalties from intangible property, income from construction and repair services, and income from estates, trusts, and partnerships.[84]

We recommend in Section III.B.4., that a unitary business be defined as broadly as the Court's current constitutional jurisprudence allows. Consistent with this recommendation, corporate income should be subject to apportionment unless that income has no nexus with the states in which the corporation is engaging in a unitary business. Because a corporation's income is either apportionable income or allocable income, our broad definition of apportionable income results in a narrow definition of allocable income. By defining apportionable income as broadly as the United States Supreme Court allows, a state simplifies the administration of its tax and substantially reduces opportunities for tax avoidance.

The approach that we recommend is consistent with UDITPA but is not compelled by UDITPA. By defining nonbusiness income as income other than business income, however, UDITPA certainly suggests that business income is the primary category and nonbusiness income is the subordinate category.[85]

Our recommendation, however, goes beyond UDITPA. Under UDITPA, business income is defined as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."[86] This language has been interpreted by some state courts as requiring a positive showing that an income item arose from normal business activities to be categorized as business income.[87] Under our view, any income having a nexus with a taxpayer's business would constitute business income subject to apportionment. An item of income would be classified as nonbusiness income only if the taxpayer established that the income did not have a nexus with its business or if there were a compelling reason why apportionment would not reach an appropriate result.

for certain dividend and interest income received by a corporation from a controlled subsidiary. La. R.S. 47:287.94(I)(1) and (2) (2001). Under the 1993 amendment, interest paid by a subsidiary on indebtedness having a situs in Louisiana generally would be apportioned pro rata to the payer's real and tangible personal property within and without Louisiana. A dividend from a subsidiary would be apportioned pro rata to the place where the profits out of which the dividend was paid had arisen. The Louisiana Supreme Court held that the 1993 amendment violated Article III, Section 2 of the Louisiana Constitution, which prohibits the legislature from levying a new tax in an odd-numbered year. *See* Dow Hydrocarbons & Resources v. John Neely Kennedy, et al., 694 So. 2d 215 (La. 1997). With the demise of the 1993 amendment, the pre-1993 allocation rule applies.

83. The statutory phrase is "corporeal movable property."

84. La. R.S. 47: 287.92(B) (2001).

85. For development of the concept of nonbusiness income as residual and subordinate to the concept of unitary-business income, see Michael J. McIntyre, *Constitutional Limitations on State Power to Combat Tax Arbitrage: An Evaluation of the Hunt-Wesson Case*, 18/1 State Tax Notes 51, 63-64 (Jan. 3, 2000) (reprinted 86/14 Tax Notes 1907-1922 (Mar. 27, 2000)).

86. UDITPA, *supra* note 4, § 1(a); Multistate Tax Commission Allocation and Apportionment Regulations, Reg. IV.1 (adopted February 21, 1973, as revised through July 30, 1993) [hereinafter MTC].

87. *See* Pomp & Oldman, State & Local, *supra* note 13, at 10-28.

Our recommendation also goes beyond the definition of business income contained in a regulation that was under study in the mid-1990s by the Multistate Tax Commission.[88] That draft regulation attempted to modernize UDITPA's definition of business and nonbusiness income without the necessity of amending UDITPA. The draft regulation interprets the UDITPA definition of business income as containing a transactional test and a functional test.

Under the transactional test, business income includes only income arising from transactions and activity in the regular course of business. Under the functional test, business income also includes income arising from the acquisition, management, and disposition of property that constitutes an integral part of the taxpayer's regular trade or business. Some critics of the MTC regulation assert that the MTC has read the UDITPA definition of business income too broadly.[89] No one can fairly argue, however, that a state employing those two tests would be taxing extraterritorial values in violation of the United States Constitution.

Louisiana has not adopted UDITPA and is not constrained by its language in fashioning its definitions of apportionable income and allocable income. On most issues, we recommend that Louisiana follow UDITPA in order to contribute to more uniform state corporate taxing statutes. Tax professionals fully understand, however, that the UDITPA definition of business income is not an exemplar of clarity and therefore has failed as an instrument of uniformity. It currently is an instrument of complexity, confusion, and wasteful litigation.

To understand the logic of our recommendation, it is useful to review UDITPA's treatment of allocable income. Under UDITPA, allocable dividend and interest income is allocated to the taxpayer's state of commercial domicile.[90] The same rule applies to allocable gains derived from the sale of stock, bonds, and other intangible property, such as patents, copyrights, and knowhow.[91] It also applies in some cases to allocable rental and royalty income derived from tangible personal property and intangible property and to allocable capital gains from the sale of tangible personal property.[92]

When UDITPA was drafted, a domiciliary state was expected to tax—and generally did tax—all income allocated to it. The drafters of UDITPA did not invent novel rules but simply codified and standardized existing state practices, to avoid duplicative taxation, among other things.[93] In the world we live in, however,

---

88. Multistate Tax Commission Allocation and Apportionment Regulations (Integrating Amendment regarding Classification of Income as Business or Nonbusiness—April 1995 Proposal), available at <http://www.mtc.gov/uniform/Busnonbs.pdf> (visited May 5, 2001).

89. The Supreme Court of California disagrees. *See* Hoechst Celanese Corp. v. Franchise Tax Board, 22 P.3d 324 (Cal. 2001) (holding that the California statutory definition of business income, which "mirrors" the UDITPA definition, establishes separate transactional and functional tests and that the reversion to the taxpayer of surplus pension plan assets satisfies only the latter test).

90. UDITPA, *supra* note 4, at § 7. A common definition of "commercial domicile" is the place from which the business is directed or managed. UDITPA, *supra* note 4, at § 1(b).

91. *Id.* at § 6(c).

92. UDITPA, *supra* note 4, at §§ 5(b), 6(b), 8.

93. George N. Carlson et. al., *Perspectives on the Reform of UDITPA, in* State Taxation of Business: Issues and Policy Options (Thomas F. Pogue ed. 1992).

income allocated to a domiciliary state has become untaxed income much of the time. Connecticut and New York, for example, which serve as the commercial domiciles for many of the Fortune 500 companies, have very generous rules on the taxation of dividends, capital gains, and interest.[94] In this environment, the UDITPA rule on allocable income fosters manipulative tax avoidance and harmful tax competition—lessons not lost on America's largest companies.

In principle, the problem created by the disinclination of domiciliary states to tax income allocated to them might be mitigated by allocating that income to a jurisdiction more inclined to tax it.[95] Given the constitutional requirements of nexus, however, states may not always be able to allocate nonbusiness income to a state with the power and inclination to tax many important categories of income.[96] For that reason, we recommend that Louisiana address the problem by defining allocable income as narrowly as the United States Supreme Court will allow.

To adopt the strategy we recommend, Louisiana would not need to make radical changes in its treatment of allocable income. The current definition is already narrower in most respects than the UDITPA definition, and all income not fitting that definition is classified as apportionable income. Some income treated as allocable income, moreover, is allocated under current law to a state that would have the power and inclination to tax it. The one necessary change—constitutionally required whether or not Louisiana adopts combined reporting— is a broadening of the current definition of allocable income to include income of whatever type if the taxpayer demonstrates that it has no nexus with the state.

D. Formulary Apportionment of Income

Almost all states that have a corporate income tax apportion income to their state by using an apportionment formula.[97] States following the UDITPA rule apportion business income using an evenly-weighted three-factor formula. Those three factors are property, payroll, and sales.[98] Louisiana includes in the "sales"

94. Conn. Gen. Stat. § 12-217(a)(1) (2000); N.Y. Tax Law § 209(9) (1998).

95. Allocation rules are a type of source rule. One hallmark of a good source rule is that it locates income in a jurisdiction that is willing and able to tax it. *See* McIntyre, Int'l Treatise,*supra* note 25, at § 3/C.4. Under this standard, the UDITPA allocation rules are defective.

96. Intangible assets and income from such assets are not easily located in a specific state except through legal fictions. One old doctrine, known as ***mobilia sequuntur personam***, treats intangibles as being attached to the person that owns the intangible. *See* Pullman's Palace Car Co. v. Com. of Penn., 141 U.S. 18, 11 S. Ct. 876 (1891); St. Louis v. Ferry, 78 U.S. 423 (1870). That doctrine may be the source of the domiciliary rule of UDITPA that we have criticized. The Supreme Court has described that doctrine as falling into desuetude. Japan Line, 441 U.S. 434, 442, 99 S. Ct. 1813, 1818 (1979). *See also* Mobil Oil Corp. v. Comm'r of Taxes of Vermont, 445 U.S. 425, 445, 100 S. Ct. 1223, 1235 (1980) ("the maxim ***mobilia sequuntur personam***, upon which these fictions ofsitus are based, 'states a rule without disclosing the reasons for it'").

97. Mississippi uses separate accounting more than most states. Miss. Code Ann. § 27-7-23(c)(2)(B)(iii) (1999).

98. UDITPA, *supra* note 4, at §§ 10-17. The evenly weighted, three-factor formula is known as the Massachusetts formula, presumably because the drafters of UDITPA used that State's law as its model. Massachusetts has abandoned an evenly-weighted three-factor formula, moving first to a double-

factor other receipts not generally considered to be sales receipts.[99] To avoid confusion, this Article sometimes refers to what UDITPA labels the "sales" factor as the "receipts (sales)" factor. In some states, this factor is referred to as the "revenue" factor.[100]

Probably the most common deviation from the UDITPA apportionment formula is the use of a formula that double-weights the receipts (sales) factor.[101] The effect of the double-weighted receipts formula for manufacturing and merchandising businesses is to apportion roughly half of the apportionable income to the market state[102] and the remaining half to the production state. For manufacturing and merchandising businesses, Louisiana uses the double-weighted receipts formula.[103] It uses a two-factor formula for certain transportation businesses,[104] service businesses,[105] and loan businesses.[106] It uses the UDITPA three-factor formula as the default rule for the remaining businesses.[107]

Contrary to popular belief, income apportionment does not involve an inquiry into the geographical location of income. The reason is that income, by its very nature, has no geographical place. It is a number, calculated by adding and subtracting other numbers. A number is a quantity that has shed its accidental properties of time, place, color, and so forth. This abstraction from all accidental properties other than quantity is a prerequisite to mathematical manipulation. As the U.S. Supreme Court has noted in one of its more pellucid pronouncements on income apportionment, dividing up income according to its geographical attributes is like "slicing a shadow."[108]

A virtue of apportionment by formula is that it can associate income with factors that can be located geographically. The locations of the three items in the typical apportionment formula—property, payroll, and sales—are not always unambiguous. Reasonable rules can be devised, nevertheless, for resolving or sidestepping those ambiguities. For example, many states exclude intangible assets, such as stock, bonds, copyrights, and goodwill, from the property factor due to the obvious difficulty of determining the physical location of an asset that has no physical attributes. In addition, many intangible assets benefit all aspects of a unitary business, and it would be folly in such circumstances to locate these

---

weighted receipts factor and most recently to a one-factor receipts formula for certain industries.

99. La. R.S. 47:287.95(F)(1)(c) (2001).

100. Colo. Rev. Stat. § 39-22-303(4)(a) (2000).

101. *See, e.g.*, 1993 Cal. Stat. 946; Cal. Rev. & Tax. Code § 25128 (West 2001).

102. This statement assumes the nearly uniform practice of the states in assigning sales of tangible personal property to the state where the goods are delivered. *See* UDITPA, *supra* note 4, at § 16. We do not address in this Article the issue of how the place of sale should be determined on the sale of intangible property or services.

103. La. R.S. 47:287.95(F)(2) (2001).

104. La. R.S. 47:287.95(A)(C) (2001).

105. La. R.S. 47:287.95(D) (2001).

106. La. R.S. 47:287.95(E) (2001).

107. La. R.S. 47:287.95(F)(1) (2001).

108. Container Corp. of America v. Franchise Tax Bd. of California, 463 U.S. 159, 192, 103 S. Ct. 2983, 2954 (1983).

intangibles for apportionment purposes on the basis of legal fictions. Based upon similar considerations, some states exclude receipts from the sale of intangible property from the sales factor.[109]

In applying an apportionment formula to calculate its tax obligations under current Louisiana law, a non-domiciliary corporation performs the following steps:[110]

> First, it calculates its apportionable worldwide taxable income under Louisiana law. This amount represents a corporation's pre-apportionment income.
>
> Second, the corporation calculates its apportionment percentage by applying the appropriate apportionment formula. Only factors that helped generate the pre-apportionment income enter into the formula.
>
> Third, the corporation multiplies its pre-apportionment income, calculated in the first step, by the apportionment percentage calculated in the second step. The resulting amount is the corporation's taxable income apportioned to Louisiana.
>
> Fourth, the corporation applies the Louisiana rate schedule to determine its tentative tax due. The Louisiana tax rates are graduated, with income in the first bracket taxed at four percent and income in the top bracket taxed at eight percent.[111]
>
> Fifth, it reduces its tentative tax by any allowable tax credits.

In a combined reporting regime, the first three steps outlined above would be modified in two respects. First, the computation of pre-apportionment income would be made for the entire combined group, not separately for each member of that group. Second, the apportionment formula would be applied using the aggregate factors of the combined group and the aggregate taxable income of the combined group.

Louisiana's apportionment formula applicable to manufacturing and merchandising business uses three fractions—the property fraction, the payroll fraction, and the receipts (sales) fraction. In each of those fractions, the numerator would be the relevant aggregate Louisiana factors for the combined group and the denominator would be the relevant aggregate worldwide factors for that group.

For example, assume that PCo and its subsidiary, SCo, are engaged in a unitary business in Louisiana. PCo manufactures 100 widgets in Louisiana at a unit cost

---

109. MTC, *supra* note 86, Reg. IV.18.(c).(3).

110. This list is provided for illustrative purposes and is not intended to be exhaustive. In addition, the text does not address the treatment of allocable income.

111. La. R.S. 47: 287.12 (2001). The use of progressive corporate rates, like those used by Louisiana, is criticized in Richard D. Pomp, *Reforming a State Corporate Income Tax*, 51 Alb. L. Rev. 375, 484-508 (1987).

of \$40 and sells the widgets to SCo for \$50 each. SCo sells thirty widgets to unrelated customers in Louisiana and sells the remaining seventy widgets to unrelated customers in Texas. SCo has a distribution cost for each sale of \$30. All of SCo's sales are made at a unit price of \$100. In step one, PCo and SCo would compute the pre-apportionment income for their combined group. In making that computation, the intra-group sales from PCo to SCo would be ignored. The gross receipts of the combined group would be \$10,000 (100 unit sales × \$100 unit sales price). From that amount, the combined group would deduct PCo's costs of \$4,000 (100 units × \$40 unit production costs) and SCo's sales costs of \$3,000 (100 unit sales × \$30 unit sales costs). Thus the pre-apportionment income of the combined group would be \$3,000 (\$10,000 – \$4,000 – \$3,000).

To do the calculations required in step two, some assumptions must be made about the property and payroll of PCo and SCo.[112] Assume that PCo has property of \$900, located entirely in Louisiana. It has payroll of \$2,000, all paid to employees located in Louisiana. SCo has property of \$300 located in Louisiana and property of that same amount located in Texas. It has payroll of \$1,000 in Louisiana and payroll of \$2,000 in Texas. Under these facts, the combined group's Louisiana property relating to the unitary business would be \$1,200 (\$900 + \$300) and the relevant worldwide property would be \$1,500 (\$900 + \$300 +\$300). The property fraction, therefore, would be 0.8 (\$1,200/\$1,500). The combined group's Louisiana payroll is \$3,000 (\$2,000 + \$1,000) and its relevant worldwide payroll is \$5000 (\$2,000 + \$1,000 + \$2,000). The combined payroll fraction is 0.6 (\$3,000/\$5,000).

PCo has no relevant sales of widgets because its intra-group sales to SCo are eliminated in the combined report. SCo has Louisiana sales of \$3,000 (30 unit sales × \$100 unit price) and worldwide sales of \$10,000 (\$3,000 + (70 unit sales × \$100)). Thus the sales fraction is 0.3 (\$3,000/\$10,000). Under these facts, the apportionment percentage, calculated under the double-weighted sales formula,[113] would be fifty percent (1/4 × (0.8 + 0.6 + (2 × 0.3)). As a result, \$1,500, or fifty percent of the combined income of \$3,000, would be apportioned to Louisiana.

Each member of a combined group would compute its separate tax liability by applying steps four and five outlined above. Before those steps can be applied, however, each member of the combined group must determine its share of the combined group's Louisiana taxable income. The process of making that calculation is referred to as intra-group apportionment. Our recommendations on

112. The example ignores the possibility that the State might include the value of inventory in the property factor. In principle, a formula that seeks to allocate half of the profits to the production states and the other half to the market states should exclude inventory and assets related to the sale of inventory from the property factor because inventory property relates to marketing profits and not to production profits. Only "production assets" should be included in the formula. *See* McIntyre, Int'l Treatise, *supra* note 25, at § 3/A.2.3.3. The Federal government included inventory and related assets in its apportionment formula for over 70 years but finally got the correct theoretical answer in 1998. *See* Treas. Reg. § 1.863-3(c)(1)(i)(B) (as amended by T.D. 8786 (1998)).

113. In the UDITPA three-factor apportionment formula, the sum of the three fractions is multiplied by 1/3. That sum is multiplied by 1/4 in the example because of the double weighting of sales.

how that apportionment should be accomplished are discussed in Part IV.A.1, below.

E. Water's Edge Rules

Even states that have not adopted a combined reporting regime often include what the Federal government characterizes as foreign source income in the pre-apportionment income of their corporate taxpayers. Under current law, Louisiana does not provide an exclusion for foreign source income. Corporations that participate in a unitary business similarly should be required to include in their combined report their aggregate worldwide unitary income. Excluding income that is classified as foreign source income under Federal tax concepts from the combined report would be inconsistent with formulary apportionment, which ignores federal concepts of source.[114] Including foreign source income in a combined report is correct in theory and is constitutionally valid. In addition, it should not present any serious practical difficulties in Louisiana.

In principle, a combined reporting regime should require foreign corporations to be included in the combined unitary group if they are participating in the group's unitary business. As discussed in Part II.A. above, the income of a unitary enterprise should be taxed without regard to its organizational structure. Substance should prevail over form. Form is elevated over substance when the income from the foreign activities of a unitary business are excluded from the combined report if they are conducted through a foreign corporation but are included in the combined report if they are conducted through a foreign branch of a domestic company. Obviously the operation of a unitary business is not confined by the borders of the United States.

The Multistate Tax Commission has supported worldwide combined reporting from its formation.[115] That method of taxation also has been supported by many academics.[116] Two major United States Supreme Court cases have upheld its constitutionality.[117] Its leading supporter among the states has been California. Notwithstanding its many supporters, worldwide combined reporting has been

114. As long ago as 1924, the United States Supreme Court upheld the inclusion of foreign source income in the pre-apportionment income of a corporation operating within the United States through a branch. *See* Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission, 266 U.S. 271, 45 S. Ct. 82 (1924). *See also* Container Corp. of America v. Franchise Tax Bd. of California, 463 U.S. 159, 103 S. Ct. 2983 (1983), and Barclays Bank PLC v. Franchise Tax Bd. of California, 512 U.S. 298, 114 S. Ct. 2268 (1994).

115. Pomp and Oldman, State & Local, *supra* note 13, at 10-36.

116. *See, e.g.*, Reuven S. Avi-Yonah, *Slicing the Shadow: A Proposal for Updating U.S. International Taxation*, 58 Tax Notes 1511 (Mar. 15, 1993); Richard Bird & Donald Brean, *The Interjurisdictional Allocation of Income and the Unitary Taxation Debate*, 34 Canadian Tax Journal 1377 (1986); Paul R. McDaniel, *Formulary Taxation in the North American Free Trade Zone*, 49 Tax Law Review 691 (1994); Michael J. McIntyre, *Design of a National Formulary Apportionment Tax System*, 84th Conf. on Tax'n, Nat'l Tax Ass'n 118 (Frederick D. Stocker ed. 1991); Pomp, Future of State Taxation, *supra* note 41, at 63-64.

117. *Container*, 463 U.S. 159, 103 S. Ct. 2983; *Barclays*, 512 U.S. 298, 114 S. Ct. 2268.

under relentless attack from the multinational corporations and much of the international tax community. During the Reagan Administration, the Treasury Department joined the attack.[118]

In 1986, California adopted legislation that allowed a corporate group under some conditions to avoid including certain foreign corporations in their combined report.[119] The legislation is referred to as the water's edge election, and a combined group making that election computes its income according to a water's edge combined report. The water's edge election was liberalized in 1993.[120] Subject to certain restrictions, a unitary group making a water's edge election could eliminate many foreign corporations from its combined report. Both the income and the factors of those foreign corporations would not be taken into account in preparing the combined report.

A water's edge election has no necessary effect on the treatment of the foreign source income of domestic corporations that are included in the combined group. In California, for example, the foreign source income of included corporations remains includible in the unitary group's income.[121] Some other states that have provided a water's edge election, however, have also limited their taxation of foreign source income.[122] We recommend against any such limitation.

States that had followed California's lead in adopting worldwide combined reporting joined or preceded California in retreat from that position.[123] Without engaging in a comprehensive review of all state tax codes, we note that Alaska, California, Idaho, Montana, New Hampshire, North Dakota, and Utah employ worldwide combination,[124] and all of those States provide some form of water's

---

118. The Treasury Department convened a working group on formulary apportionment that recommended that the states not include foreign corporations in their combined report. *See* The Final Report of the Worldwide Unitary Taxation Working Group: Chairman's Report and Supplemental Views (1984) (reprinted in Charles E. McLure, Jr., Economic Perspectives on State Taxation of Multijurisdictional Corporations 235 (1986)).

119. 1986 Cal. Stat. 660.

120. 1993 Cal. Stat. 881. For discussion of the 1993 legislation and the combination of pressures that led to its enactment, see Eric J. Coffill, *A Kinder, Gentler 'Water's Edge' Election: California Wards off Threats of U.K. Retaliation as Part of Comprehensive Business Incentive Tax Package*, 61 Tax Notes 477 (Oct. 25, 1993) (also published in 7 Tax Notes Int'l 1049 (Oct. 25, 1993)). Jerome R. Hellerstein, *Federal Income Taxation of Multinationals: Replacement of Separate Accounting With Formulary Apportionment*, 60 Tax Notes 1131, 1139 (Aug. 23, 1993) (referring to the water's edge legislation as "a 'shotgun' marriage arrangement" because of the Federal and other pressures brought to bear on California).

121. Cal. Rev. & Tax. Code § 25110(a)(2) and (3) (West Supp. 2001) (including domestic corporations in the water's edge election without limitation as their income).

122. *See, e.g.*, Ariz. Rev. Stat. § 43-1122(7) (1998) (exempting foreign dividends).

123. For example, the Colorado Legislature overrode the governor's veto to adopt a water's edge election. 1985 Colo. Sess. Laws 309. Florida, which had adopted worldwide combined reporting in 1983, abandoned it in 1984. 1983 Fla. Laws ch. 83-349; 1984Fla. Laws ch. 84-549. Oregon limited its combined group to corporations filing federal consolidated returns, from which foreign corporations are generally excluded. OR. VAB. 3029, 1984 Or. Spec. Sess. 1, ORS section 317.715.

124. Alaska Stat. § 43.20.072 (Michie 2000); Cal. Rev. & Tax Code §§ 25104-25137 (West Supp. 2001); Idaho Code 63-3027B (Michie 2000); Mont. Code Ann. §§ 15-31-301, 15-31-305 (1999); N.H. Rev. Stat. Ann. § 77-A:1,I (Supp. 2000); N.D. Cent. Code § 57-38-14.3 (2000); Utah Code Ann. § 59-7-

edge election.[125] Many other states have adopted a combined reporting regime but do not include foreign corporations in the combined unitary group.[126]

Notwithstanding the merits of the case for mandatory worldwide combined reporting, we do not recommend that Louisiana adopt it. In the current political climate, the potential benefits simply are not worth the inevitable conflicts. We also do not recommend a mandatory water's edge regime, due to our concerns about potential constitutional challenges to it on Foreign Commerce Clause grounds.[127] Our recommended strategy is to adopt worldwide combined reporting as the general rule and to allow taxpayers to make a water's edge election.

With some important exceptions, a unitary group making the water's edge election would be permitted to omit the income and apportionment factors of foreign affiliates from the combined report unless the foreign affiliates are engaged in business in the United States under Federal tax concepts.[128] All unitary domestic corporations, however, would be included in the water's-edge combined report. By permitting this election, Louisiana would avoid the need to audit the books of many foreign affiliates and would reduce compliance costs for many multinational corporations.[129]

In general, we suggest that Louisiana follow California's lead in specifying the details of the water's edge election.[130] Although we obviously do not recommend

---

403 (2000).

125. Alaska Stat. § 43.20.073 (Michie 2000); Cal. Rev. & Tax.Code 25110 (West Supp. 2001); Idaho Code 63-3027(t) (Michie 2000); Mont. Code Ann. § 15-31-322 (1999); N.H. Rev. Stat. Ann. 77-A:2-b (1991); N.D. Cent. Code § 57-38.4-02 (2000); Utah Code 59-7-402 (2000).

126. States that generally require unitary business groups to file a combined report only for their domestic members include Arizona, Hawaii, Illinois, Kansas, Maine, Minnesota, and Nebraska.

127. Under a purely domestic combination regime, a foreign incorporated enterprise would not have the same right to combine its affiliates as would a domestic enterprise. A foreign corporation that would have been better off under a combined report arguably would have a foreign commerce clause complaint. We note, however, that state statutes limiting combined reports to U.S.corporations have been upheld against foreign commerce clause attacks. *See* Caterpillar, Inc. v. C.I.R. of Minnesota, 568 N.W.2d 695 (Minn.), *cert. denied*, 522 U.S. 1112, 118 S. Ct. 1043 (1998); Appeal of Morton Thiokol, Inc., 864 P.2d 1175 (Kan. 1993); E.I. DuPont De Nemours & Co. v. State Tax Assessor, 675 A.2d82 (Me. 1996).

128. Under Federal concepts, a foreign corporation is taxable on its business income that is effectively connected with a U.S. trade or business. *See* I.R.C. § 871(b)(1). For discussion of the Federal engaged-in-businessconcept, see McIntyre, Int'l Treatise, *supra* note 25, at § 2/B.3. California requires that a unitary foreign corporation be included in the water's edge combined report to the extent of its U.S. source business income. Cal. Rev. & Tax. Code § 25110(a)(5) (West Supp. 2001); 18 Cal. Code of Regs. § 25110(d)(2)(G)(i)(I).

129. Taxpayers have asserted that California's worldwide combined reporting system imposed unreasonable burdens on them. No doubt there are some special burdens, but the extent of those burdens is unclear. In the *Barclays Bank* case, Barclays estimated, and the trial court found, that it would have to pay $5 million to set up an appropriate accounting system and an additional $2 million annually to maintain that system. In contrast, the California Court of Appeal found that Barclays' actual annual compliance costs ranged from $900 to $1,250. *See* Barclays Bank PLC v. Franchise Tax Bd. of California, 512 U.S. 298, 313-14, 114 S. Ct. 2268, 2277-78 (1994).

130. California provides a useful summary of its water's edge rules, including copies of required forms, in California Franchise Tax Board, "FTB 100W Booklet—2000 Water's-Edge Booklet (2000) [hereinafter FTB Water's-Edge Booklet], available on-line at <http://www.ftb.ca.gov/forms/

a slavish adoption of all of the California rules, we do recommend that Louisiana use the various anti-abuse provisions built into the California water's edge rules as a check list in fashioning its own system.

We also recommend that Louisiana adopt the California system of requiring an electing water's edge group to sign an agreement consenting to taxation under the water's edge regime. The California consent agreement is binding on current members of the water's edge group and on any subsequent members that would have qualified for inclusion in the group at the time of the agreement.[131] As part of the agreement, the water's edge group obligates itself to provide the tax department, on request, with extensive documentation of its activities, including copies of relevant Federal tax forms.[132]

One important anti-abuse rule in the California system requires electing taxpayers to make a binding election for an initial period of seven years.[133] Seven years seems long enough to keep companies from moving into and out of the system based on the relative profitability of their U.S. and foreign activities.[134] We recommend, however, that Louisiana fine tune this election period by providing that the election is automatically extended for an additional five years unless the taxpayer gives notice of its intention not to renew before the beginning of the last two years of its election period.[135] We also recommend that a control group, after it has terminated a prior water's edge election, not be permitted to make a new election until the end of a three-year waiting period.[136] The tax department should have the authority to waive these restrictions in appropriate cases. The objective of these election restrictions is to reduce the administrative burdens associated with changes in the membership of a unitary group and to minimize tax planning opportunities.

00_forms/00_100Wbk.pdf> (last visited Mar. 11, 2001).

131. 18 Cal. Code of Regs. § 25111-1(d)(2) (1998).

132. Cal. Rev. & Tax. Code § 25112(b) (West Supp. 2001). The members of the water's-edge combined group should also be required to provide the tax department with copies of any combined report filed with any other state. North Dakota requires an electing group to provide a spreadsheet showing its tax position in every state. N.D. Cent. Code 57-38.4-02.1.d (2000).

133. *See* Cal. Rev. & Tax. Code § 25111(a) (West Supp. 2001). As adopted in 1986, the election period was ten years. 1986 Cal. Stat. 660. It was reduced to five years bya 1988 amendment. 1988 Cal. Stat. 989 and increased to seven years in 1993. The election period is five years under North Dakota's water's edge regime. N.D. Cent. Code § 57-38.4-02.1.c (2000).

134. Idaho makes the water's edge election irrevocable, unless the intervening consent of the tax administrator is obtained. Idaho Code § 63-3027C(a) (Michie 2000). Utah follows the same rule. Utah Code § 59-7-402(2)(c) (2000). We do not favor this rule because we see some advantage in the tax department making periodical reviews of an electing group's status and modifying, when appropriate, certain terms of a water's edge renewal agreement.

135. California automatically renews an election for an additional year if the taxpayer has not given notice of an intent to terminate within 90 days of the anniversary date. Cal.Rev. & Tax. Code § 25111(a) and (d) (West. Supp. 2001).

136. The Federal rule on entity classification under the so-called check-the-box regulations is that a change in classification can only be made every five years. Treas. Reg. § 301.7701-3(g)(1)(ii). In the California water's-edge system, the fact that a taxpayer has terminated its election does not affect its ability to make a later election. 18 Cal. Code of Regs. § 25111-1(a)(4) (1998).

To control certain tax-avoidance strategies, Louisiana should follow the California lead and require the inclusion of some unitary foreign affiliates in the water's edge combined report. For example, Louisiana should require that a foreign holding company be included in the water's edge group if it is being used to park profits offshore that arose from the operation of the unitary group's business. California achieves this result for U.S.-based unitary enterprises by mandating that a controlled foreign corporation (CFC), as defined under Federal tax-haven legislation, be included in the water's edge group to the extent of its tax-haven income.[137] The Federal anti-haven rules, popularly referred to as the Subpart F provisions,[138] impose a current tax on various categories of passive income and certain active business income deflected to a tax haven.[139] By piggy-backing on the Federal legislation, Louisiana would block the most important types of foreign holding company abuses by U.S.-based multinational companies without adding substantially to their compliance burdens.

A different approach must be used to deal with foreign holding companies controlled by foreign-based multinational companies and other foreign interests because those holding companies are not subject to the Federal rules under Subpart F. California has not developed a mechanism for dealing with that issue under its water's edge regime.[140] Our recommendation is that Louisiana adopt an earnings-stripping rule that would deny members of the water's edge group a deduction against its pre-apportionment income for payments made to a foreign corporation controlled by foreign interests if two conditions are met. First, the foreign corporation receiving the payment must be part of a control group that includes members of the water's edge combined group. Second, the income received by the foreign corporation must be of a type that would be taxable by the Federal government under the Subpart F provisions if received by a CFC.[141] Because denial of a deduction for a payment is economically equivalent to a tax on the

137. Cal. Rev. & Tax. Code § 25110(a)(7) (West Supp. 2001). The CFC includes in the water's edge combined report its tainted income and the apportionment factors that relate to earning that income.

138. I.R.C. §§ 951-964 (2001). These sections are contained in subpart F of Part III of subchapter N of chapter 1 of the Internal Revenue Code. The anti-avoidance rules applicable to certain foreign funds, contained in I.R.C. §§ 1291-1297 (2001), are usually treated as part of the subpart F regime.

139. For a detailed discussion of Subpart F and related rules, see McIntyre, Int'l Treatise, *supra* note 25, at ch. 7.

140. In *Barclays Bank*, 512 U.S. 298, 114 S. Ct. 2268 (1994), California successfully imposed worldwide combined reporting on a foreign corporation that had affiliates in many tax-haven countries, including Bahamas, Barbados, Bermuda, Cayman Islands, Channel Islands, Gibraltar, Hong Kong, Isle of Man, Nauru, Netherlands Antilles, New Hebrides, Singapore, Turks and Caicos, and the Virgin Islands. *See* Barclays International, A World of Banking—List of Offices (Nov. 1977). California's water's edge regime generally would not reach income deflected to affiliates organized in such countries.

141. The main category of income subject to the earnings-stripping rule would be income of the type classified as foreign personal holding company income, as defined in I.R.C. § 954(c)(1) (2001) and Treas. Reg. § 1.954-2(a)(1) (as amended in 1997). Absent special relief provisions, the Federal government typically would treat such income as periodical income subject to withholding under I.R.C. § 881 when received by a foreign corporation from U.S. sources.

income out of which the payment was made, this anti-avoidance rule would result in functionally equivalent treatment of foreign tax-haven companies whether they are controlled by U.S. interests or by foreign interests.[142]

The water's edge election should not allow foreign corporations having substantial business activities in the United States to avoid being included in a unitary group's combined report. California addresses this issue by requiring a unitary corporation, whether domestic or foreign, to be included in the water's edge combined group if twenty percent or more of its business activities, as measured by its apportionment factors, is conducted within the United States.[143] Corporations included in a water's edge combined report under this rule are popularly referred to as "80-20 companies."[144] Under the California system, foreign banks are not included in the water's-edge election under the 80-20 rule.[145] Thus a foreign bank is included in the water's edge combined report only to the extent of its U.S. source business income and the related apportionment factors.[146] Other states using the 80-20 rule do not have a special rule for foreign banks.[147] We endorse the 80-20 rule without the exception for banks.

A foreign corporation that is treated as a domestic corporation for purposes of the Federal consolidated return rules should be treated as a domestic corporation for purposes of determining the members of water's edge combined group.[148] In addition, the income and related apportionment factors of a unitary foreign corporation engaged in exporting goods from the United States should be included in the water's edge combined group to the extent that the income qualifies for favorable treatment under Federal tax laws. For example, a provision adopted by the Federal government in 2000 provides an exemption for so-called "extraterritorial income" that constitutes qualifying foreign trade income.[149] That income should be included in the water's edge combined report.[150]

---

142. The Federal government denies a deduction to foreign controlled domestic corporations with respect to certain interest payments made to foreign related persons in order to prevent earnings stripping. *See* I.R.C. § 163(j) (2001).

143. Cal. Rev. & Tax. Code section 25110(a)(3). Sales are not double weighted for purposes of calculating the 20 percent figure. *See* FTB Water's Edge Booklet, *supra* note 130, at 8. Utah has a similar rule except that only payroll and property are taken into account. Utah Code Ann. §§ 59-7-101(26) and (33), 59-7-401(2)(a).

144. The term "80-20 company" probably was borrowed from the Federal tax lexicon. Under I.R.C. § 861(a)(1)(A) (2001), interest paid by a domestic company is foreign source income if 80 percent or more of its gross income for a three-year testing period is active foreign business income. A domestic corporation meeting the 80-percent active foreign business requirement is referred to as an 80-20 company. *See* McIntyre, Int'l Treatise, *supra* note 25, at 3/A.1.

145. *Id.*

146. *See* Cal. Rev. & Tax. Code § 25110(a)(5) (West Supp. 2001).

147. *See, e.g.*, Utah Code Ann. §§ 59-7-101(33)(a)(i)(B).

148. *See* I.R.C. § 1504(d) (allowing certain Canadian and Mexican real property holding companies to join a consolidated group). *See, e.g.*, Idaho Code 63-3027B(a).

149. I.R.C. § 114(a) and (b) (2001). Foreign trade income is defined in I.R.C. §§ 941-943 (2001).

150. This export incentive replaces the foreign sales corporation (FSC) rules that were found to be a prohibited export subsidy by the World Trade Organization. In 2001, a WTO dispute settlement body held that the new incentive scheme was a prohibited export subsidy. The United States appealed

The interaction of a state's rules on allocable income and a water's edge election can lead to tax-avoidance opportunities. States employing a water's edge election should not permit taxpayers to use that election to convert what otherwise would be apportionable business income, subject to tax in a state, into allocable income that is not taxable in the state.

To illustrate the potential for tax avoidance from characterizing business income as nonbusiness allocable income, consider a unitary foreign affiliate that is excluded from a Louisiana water's edge combined report. If the water's edge election had not been made, the profits of the foreign affiliate would have been included in the income of the unitary combined group and an apportioned share would have been taxed by Louisiana. A subsequent dividend paid out of those profits to another member of the combined group would have been washed out. If the profits of the foreign affiliate are excluded from the water's edge combined report, however, a subsequent dividend paid out of those profits should be taxable. The proper result is reached by treating the subsequent dividend as apportionable business income and not as allocable nonbusiness income.[151]

A similar problem arises when a member of the water's edge combined group receives interest, royalties, and rents from a unitary foreign affiliate that is excluded from that group by the water's edge election. The solution to the problem is also similar. That is, the interest, royalties, or rents should be treated as unitary business profits and not as allocable income.[152]

IV. PRACTICAL PROBLEMS IN IMPLEMENTING A COMBINED REPORTING SYSTEM

If Louisiana decides to adopt a combined reporting system, the State should consider several conceptual and practical matters addressed in this Part. Section A discusses how a corporation having nexus with Louisiana that is a member of a combined group would compute its individual tax in a combined reporting regime. Section IV.A.1. focuses on how the aggregate income of a combined group is apportioned to individual members of the group. Section IV.A.2. deals with the proper treatment of net operating losses and other corporate attributes that can be attributed to some extent to combined reporting.

Section B addresses the issues that arise when members of a combined group do not all have uniform accounting periods. Section IV.B.1. offers guidance on

---

that decision to the WTO Appellate Body and lost. Under California's water's-edge regime, FSCs are included in the water's edge combined group. *See* Cal. Rev. & Tax Code § 25110(a)(1) (West Supp. 2001).

151. *See* Cal. Rev. & Tax. Code § 25110(b)(2)(B)(West Supp. 2001) (treating certain dividends received by a water's edge combined group as business profits). Louisiana currently treats certain categories of income as allocable income without reference to the relationship of those income items to the taxpayer's unitary business. This aspect of Louisiana's allocation rules may present constitutional problems that need to be addressed whether or not Louisiana adopts a combined reporting regime.

152. The proposed rule is similar in function to the look-through rules used by the Federal government in characterizing dividends, interest, rents, and royalties as general business income under the separate basket rules of I.R.C. § 904(d) (2001).

determining the annual accounting period for the group. Section IV.B.2. examines the problem of determining the combined income of a unitary *group* when some members employ different accounting periods from each other. Section IV.B.3. explains how to determine the combined income of *individual members* of that group when accounting periods of members are not uniform. Section IV.B.4. explores the problem of selecting the statutory starting date for the adopting of a combined reporting regime.

Section C recommends approaches for handling intra-group transactions. In general, intra-group transactions should have no tax consequences—that is, they should result in a wash. This so-called wash rule is developed in Section IV.C.1. Section IV.C.2. sets forth rules for adjusting the basis in the stock of members of the combined group to account for intra-group transactions. Section IV.C.3. considers transitional issues that arise when transactions initiated under a separate reporting rule are consummated after a state adopts a combined reporting regime.

A. Taxation of the Individual Members of a Unitary Group

The combined report prepared by a unitary group is not itself a tax return.[153] Tax returns based upon the income of the unitary group are typically filed by the group's individual members.[154] Section IV.A.1., below, addresses issues that arise in imposing tax liability on individual members of a unitary group with respect to unitary income. Section IV.A.2. addresses issues relating to the assignment within a unitary group of certain corporate attributes, such as net operating losses, which appear on the individual books of an individual member of that group.

1. Determining the Taxable Income of Individual Members of a Unitary Group

The apportionment formula that a unitary group employs in preparing its Louisiana combined report determines the amount of unitary income attributable to, and properly taxable by, Louisiana. To collect tax on that income, however, Louisiana must assess one or more corporations that are members of the unitary group and engaged in business in the State. One approach would be to designate one member of the unitary group as a principal member and impose tax on that member.[155] Although this approach is workable,[156] we do not recommend it for Louisiana, largely because it would represent an unnecessary departure from the

153. For discussion, see *supra* Part III.A.

154. Under some circumstances, a state may permit the unitary group to file a consolidated tax return. For a description of the California election rule, see Cal. FTB Pub. 1061 (1999) at 4, available at <www.ftb.ca.gov/forms/misc/index.htm> (last visited Feb. 25, 2001) [hereinafter Cal. FTP Pub. 1061].

155. It is useful to designate one member of a unitary group as the principal member for the purpose of determining the annual accounting period to be used by the unitary group in preparing its combined report. *See infra* Section IV.B.1.

156. Some may also object to this approach on esthetic grounds for it is not entirely consistent with the theory of the unitary business principle.

practices of other states using combined reporting without any significant policy gain.

Our preferred approach is to use a pro rata intra-state apportionment formula to attribute the share of the income of the unitary group among the Louisiana-taxable members of the group that have contributed to the generation of that income. Under the intra-state apportionment formula, the income assigned to each taxable member would be the income of the combined group apportioned to Louisiana multiplied by a fraction. The numerator of that fraction would be the Louisiana apportionment percentage of the individual group member, and the denominator would be the aggregate Louisiana apportionment percentage for the unitary group.

To illustrate the operation of the intra-state apportionment formula, assume that XCo, YCo, and ZCo constitute a unitary group and that the group earns income from its unitary business of $1,000. The Louisiana apportionment percentage for the group, computed under the formula discussed in Part III.D., above, is assumed to be 40% (0.4). If the apportionment formula is applied only to XCo (i.e., the formula is applied using only XCo's Louisiana factors), XCo's Louisiana apportionment percentage would be 30% (0.3). If the formula is applied only to the Louisiana factors of YCo, YCo's apportionment percentage would be 10% (0.1). ZCo has no Louisiana factors, so its percentage would be zero.

Under these facts, $400 of the group's unitary income would be apportioned to Louisiana (40% × $1,000). Of that amount, $300 ($400 × 0.3/0.4) would be taxable to XCo and $100 ($400 × 0.1/0.4) would be taxable to YCo. None of the unitary business income of the combined group would be taxable to ZCo ($400 × 0.0/0.4). Indeed, under these facts, it is unlikely that ZCo would have any reporting obligation to Louisiana, a State with which ZCo is unlikely to have any nexus.

In practice, the above formula can be simplified. The Louisiana taxable income of a unitary group (A) equals the total taxable income of the group as shown on the combined report (B) multiplied by the Louisiana apportionment percentage shown on the combined report (C). That is, $A = B \times C$. The Louisiana taxable income of a group member (D) equals A multiplied by the Louisiana apportionment percentage of that group member (E) divided by C. That is, $D = A \times E/C$. Simple algebra shows that $D = (B \times C) \times E/C = B \times E$. That is, the taxable income of a group member equals the total taxable income of the unitary group multiplied by the group member's Louisiana apportionment percentage.[157]

Although we favor the use of the intra-state apportionment formula described above, we do not believe that a unitary group should be allowed to use the formula to reduce tax that is apportioned to Louisiana on the combined report. For example, we do not believe that the insolvency of one group member should reduce the tax due to Louisiana on income apportioned to Louisiana. To prevent a loss of revenue when income is attributed to an insolvent corporation under the intra-state

157. For an application of this simplified formula, see California Schedule R (Apportionment and Allocation of Income) (2000), available at <http://www.ftb.ca.gov/forms/00_forms/00_100R.pdf> (last visited Feb. 27, 2001).

apportionment formula, we recommend that all "Louisiana-taxable" members of a unitary group be jointly and severally liable (solidary liability in Louisiana) for the full amount of the tax assessed with respect to unitary income apportioned to Louisiana on the combined report.[158]

Assume, for example, that XCo in the above example is insolvent. In that event, Louisiana should be permitted to collect the share of income tax attributed to XCo from YCo. The XYZ corporate group should not be able to avoid Louisiana tax on the Louisiana income it has earned simply because one member of the joint enterprise is insolvent. This joint and several liability rule is particularly important when the unitary group has deprived one of its members of the resources necessary to pay its tax obligations.

2. Treatment of Corporate Attributes

Section IV.A.2.a., below discusses whether certain corporate attributes, such as net operating losses, should be available to members of a unitary group other than the member to which they were initially assigned under the tax laws. Section IV.A.2.b. discusses the proper transitional rule to apply to certain corporate attributes that arose, at least in part, under the prior separate reporting regime.

a. Ongoing Treatment of Corporate Attributes

Corporate attributes, by definition, are assigned under the tax law to a particular corporation. In designing a combined reporting regime, a state should consider whether the corporate attributes assigned to one member of a unitary group could be used by other members of the corporate group. In our view, the proper treatment of corporate attributes depends on the circumstances under which they initially arose.

In general, we recommend that a combined reporting regime permit members of a corporate group to obtain the benefits of another member's corporate attribute if that attribute arose from activities that are treated as group activities under the combined reporting regime. If the tax attribute arose from what are treated as the separate activities of the group member, we recommend that the benefits of that attribute be limited to the member to which it was initially assigned. We discuss the application of this approach in the context of two important corporate attributes: net operating losses (NOLs) and excess investment tax credits.

158. In this respect, we propose that Louisiana follow the Federal consolidated return rule, which makes each member of the consolidated group severally liable for the tax on the consolidated income of the group. Treas. Reg. § 1.1502-6(a) (1966). Our recommendation on joint and several liability is based on practical realities and is not grounded on the unitary business principle. The fact that consolidated reporting is consensual and combined reporting is mandatory does not dissuadeus from recommending this useful rule.

i. Net Operating Losses (NOLs)

NOLs may arise from the combined activities of a unitary group or from the separate activities of a group member unrelated to the unitary business. In the first case, the NOL should be available to other members of the group if the member to which it was initially assigned is unable to use it. We suggest it be assigned to other members in proportion to their share of the group's unitary income in the year of assignment. The purpose of this pro rata rule is to provide certainty to taxpayers and to prevent possible abuses.[159]

For example, assume that PCo and SCo make up a unitary group. In year one, the group suffers an apportioned loss of $100, with $50 of the loss assigned to PCo and the remaining $50 assigned to SCo.[160] In year two, the unitary group enjoys an apportioned gain of $200. Because of changes in the apportionment percentages, only $30 of that gain is assigned to SCo. SCo would use $30 of the NOL to reduce its income to zero. Under our recommended rule, PCo would be permitted to utilize SCo's excess NOL of $20 to reduce its own income.[161] If SCo's excess NOL had arisen from losses incurred in a nonunitary business, however, PCo would not be permitted to use the NOL under our proposed rule.

ii. Investment Tax Credit

A corporation becomes eligible for an investment tax credit when it makes certain investments favored by the taxing state. In principle, an investment made by a member of a unitary group that qualifies for a tax credit may be viewed in one of two ways: as a subsidy to the unitary business, or as a subsidy to the individual member making the tax-favored investment. If viewed as the former, the credit should be available to other members of the group if the member to which it was initially assigned is unable to use it. As explained below, we believe the investment credit is best understood as a subsidy to the corporation making the investment. We conclude, therefore, that excess tax credits should remain with the member of the group that made the qualifying investment and should not be available to reduce the taxable income of any other members of the corporate group in the absence of specific statutory language to the contrary.

159. Many issues arise in determining the proper treatment of NOLs that are outside the scope of this Article. We focus here on general principles and not on the myriad of issues that arise in applying those principles.

160. In a combined report, losses, like income, are apportioned under the applicable apportionment formula.

161. This example assumes that NOLs should be assigned to members of a combined group using the current apportionment factors rather than the factors that existed when the losses were incurred. If the change from the historical factors to the current factors is sufficiently large, it may be appropriate to use the historical factors for assigning losses in order to reflect fairly the extent of the taxpayer's business activities in the taxing state. A tax department should have the authority to achieve equitable apportionment in such circumstances. *See* UDITPA, *supra* note 4, at § 18 (allowing adjustments if the apportionment rule otherwise applied does not "fairly represent the extent of the taxpayer's business activity in the state"); La. R.S. 47:287.94(C) (2001) (permitting separate accounting in certain circumstances to prevent a "manifestly unfair result").

One might imagine that a state actually intended to grant an investment tax credit to a unitary business as a whole rather than to the individual members of that unitary business. In that event, the entitlement to the credit would be assigned initially among members of a unitary group in accordance with the interstate and intra-state apportionment formulas.[162] We believe, however, that such an intent is implausible and should not be inferred unless the legislature has stated such an intent clearly. In our experience, state tax incentives are always intended to promote investment within the state and are not intended to promote investment generally without reference to its location.[163]

In addition, members of a multistate unitary enterprise generally should not want to interpret a state statute granting a tax credit to individual companies as intended for the unitary group. If that interpretation prevails, then some of the credit allowable to individual companies under the statute should be apportioned to income taxes owed to other states. The result would be that only the credit apportioned to taxes paid to the state granting the credit should be allowable in reducing taxes owned to that state. From the perspective of the multistate enterprise, the credit apportioned to taxes imposed by other states would be wasted.

Assume, for example, that XCo, YCo, and ZCo constitute a unitary group, that XCo and YCo have all their property and payroll in Louisiana but make sales outside the State, and that ZCo has no property, payroll, or sales in Louisiana. The Louisiana apportionment percentage for the group is seventy percent; XCo has a Louisiana apportionment percentage of fifty percent, YCo has a Louisiana apportionment percentage of twenty percent, and ZCo has a Louisiana apportionment percentage of zero. XCo makes an investment that qualified for an investment tax credit of $1,000. If that investment is considered to be an investment of the unitary group, then XCo should be allowed an initial credit of $500 ($1,000 × 70% × (50%÷70%) against its Louisiana tax and YCo should be allowed an initial credit of $200 ($1,000 × 70% × (20%÷70%) against its Louisiana tax. The remaining credit of $300 would be apportioned to ZCo.

From the perspective of the unitary group, the portion of the credit attributed to ZCo would be wasted because ZCo owes no Louisiana income taxes. The tradeoff for this loss of credit would be that any credit that XCo could not use would be available to YCo, and vice versa. For multistate enterprises, we strongly suspect that this advantage will not offset the loss of the credit apportioned outside of Louisiana.

In the interest of completeness, we note that one might imagine that a state legislature intended to grant the full investment tax credit, on a pro rata basis, only to the members of the unitary group having a tax liability in the state. Under that

162. A comparable result is achieved under the Federal consolidated return rules through a consolidated tax credit. *See* Treas. Reg. § 1.1502-3 (as amended in 2000).

163. We do not address in this Article whether this familiar locational bias presents potential discrimination under the Commerce Clause. For discussion of that issue, see Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Constraintson State Tax Incentives for Business*, 110 Harv. L. Rev. 377 (1996) [hereinafter Enrich, Saving the States]; Walter Hellerstein & Dan T. Coenen, *Commerce Clause Restraints on State Business Development Incentives*, 81 Cornell L. Rev. 789 (1996).

scenario, a unitary group would be able to use all of the credit to offset taxes imposed by the state. The legislative intent supporting this scenario, however, cannot be inferred from the legislature's adoption of the unitary business principle —indeed, it obviously would reflect a major departure from that principle. Such a legislative intent should only be "discovered" in the presence of clear evidence of its existence.

b. Transition Rules for Corporate Attributes Carried Over from Separate Reporting Regime

There are two main issues to address in designing transition rules applicable to corporate attributes. The first is the proper treatment under a combined reporting regime of corporate attributes that arose under the separate reporting regime. For example, how should a net operating loss (NOL) that arose in year one, a separate reporting year, be treated in year two, a combined reporting year? The second issue is the proper treatment of corporate attributes that have some link to a separate reporting year but did not fully mature until the combined reporting regime was in place. An example would be a sale arranged, but not closed, in year one (separate reporting year) and a recognition of the income from that sale in year two (a combined reporting year).

The appropriate rule for corporate attributes falling within the first category is that they should be treated as belonging to the entity that established them and should not be available to the combined group. Our rationale is that the corporate attribute, at the time it was created, was considered by the state and the taxpayer as an attribute of the corporation that established it. Our proposed transition rule would protect the reasonable expectations of the state and the taxpayer. Granting the corporate attribute to the unitary business is not required under any principle of fairness and would not result in any efficiency gain.[164]

Proper treatment of the second category of corporate attributes is harder to determine in the abstract. To promote simplicity, we recommend that corporate attributes that mature under the combined reporting regime be treated as if they had arisen entirely within that regime. For example, a sale contracted but not closed in a separate reporting year and closed in a combined reporting year should be treated as apportionable income includible in the combined report. Similarly, a loss that was recognized from the sale of property during the combined reporting regime should be included in the combined report even if the loss is attributable to a decline in value accruing during the separate reporting regime.

We recognize, nevertheless, that our proposed rule might produce an unreasonable result in some special cases. Assume, for example, that SCo, a corporation that has no nexus with State A, has made all the arrangements for a sale of a substantial portion of its assets. A few days before the sale is completed, State

164. For a brief analysis of fairness issues arising in the design of tax transition rules, see Michael J. McIntyre, *Transition Rules: Learning to Live with Tax Reform*, 4 Tax Notes 7 (Aug. 30, 1976). For a more detailed treatment, see Michael J. Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. Pa. L. Rev. 47 (1977).

A adopts a combined reporting regime. Under the new regime, SCo and TCo form a unitary combined group. Assume also that TCo has most of its apportionment factors in State A and those factors are substantially larger than SCo's factors, which are not located in State A. Under these facts, a substantial portion of the income derived by SCo on the sale of its assets would be apportioned to State A. In such circumstances, the tax department of State A should be given the flexibility to fashion a relief measure that achieves substantial fairness.[165]

The tax department also should have the authority to prevent taxpayers from obtaining an unfair benefit from the transition to the new system. To prevent unfair results, it should have the discretionary authority to impose an equitable settlement on the taxpayer, similar to the discretionary authority to adjust inappropriate results that is reserved to the tax department under section 18 of UDITPA.

As an illustration of the need for such discretionary authority, assume that PCo has entered into an installment agreement that requires a payment of $10 million to be made to XCo, an unrelated person, at the end of year one. PCo is taxable in State L on all of its income—that is, all of PCo's apportionment factors are located in State L. If XCo makes the payment to PCo as agreed, PCo will be taxable in State L on all of the income derived from the installment sale. Assume, however, that PCo and XCo, for legitimate business reasons, change the agreement so that XCo makes the payment to PCo at the start of year two. Assume also that State L adopts a combined reporting regime beginning in year two. PCo is engaged in a unitary business with QCo. All of QCo's apportionment factors are located outside of State L, and those factors are large relative to PCo's factors. As a result, most of the income derived from the installment sale would be apportioned to states other than State L unless the tax department has the authority to adjust that result to achieve fairness.

B. Issues Arising When Members of a Unitary Group Do Not All Use the Same Accounting Period

Corporations that are members of the same unitary group may not all have the same annual accounting period. For example, one member of a unitary group may compute its income for financial accounting purposes and Federal income tax purposes using the calendar year, whereas another member of the same unitary group may use a fiscal year that does not start on January 1 and end on December 31. The lack of accounting-period uniformity within a unitary group presents three issues that a state adopting combined reporting must address.

As an initial matter, a state must specify the accounting period to be used by the unitary group in these circumstances. That issue is addressed in Section IV.B.1., below. In addition, a state must develop rules for determining the

165. A case with somewhat analogous facts is *Firstar Corp. v. Comm'r of Revenue*, 575 N.W.2d 835 (Minn. 1998). In that case, the Minnesota Supreme Court granted relief to the taxpayer—a result we approve, at least in principle. Unfortunately, the Minnesota Supreme Court, in an attempt to avoid a constitutional question, improperly interpreted the Minnesota apportionment statute. The *Firstar* problem can be avoided by giving the tax department the discretion proposed in the text.

combined income of the unitary group for its accounting period when some members of that group are using a different annual accounting period. That issue is addressed in Section IV.B.2., below. A related issue, addressed in Section IV.B.3., arises when the combined income of a unitary group for its accounting period must be assigned to the overlapping accounting periods of nonconforming members of the unitary group.

Section IV.B.4. addresses issues that arise in setting the initial starting date of the combined reporting regime when a separate-reporting state, such as Louisiana, introduces combined reporting. If all members of unitary groups used the calendar year as their annual accounting period, the new regime could begin on January 1 of the first year following its adoption. The choice of a starting state is more complex, however, when some members taxable under the new regime have adopted a fiscal year as their annual accounting period.

1. Determining the Annual Accounting Period for a Unitary Group

Income for tax purposes is measured over some accounting period. In general, the accounting period for a corporate taxpayer is a either a calendar year or a twelve-month fiscal year, although a short fiscal year may be used at the start or end of a taxpayer's corporate existence. A unitary group that files a combined report must adopt an annual accounting period for the purpose of computing the income included in the combined report. If all the members of the unitary group compute their separate incomes according to the same accounting period, then the choice of an accounting period for the unitary group is obvious. The choice is less obvious, however, when the accounting periods of the members are not uniform.

The Federal government addresses a similar issue under its consolidated return rules.[166] It has resolved the issue in large part by requiring all members of a corporate group filing a consolidated tax return to adopt the same taxable year.[167] The Federal solution greatly reduces the scope of a state's problem because corporations generally use the same annual accounting period for state purposes as they use for Federal purposes. The state problem remains, however, whenever the Federal consolidated group is not coterminous with the state combined group.[168] In addition, the problem arises for both the Federal government and the states for the transitional year in which members of a corporate group are adopting a uniform annual accounting period.

The California approach, which we endorse with some modifications, is to require a unitary group to use the annual accounting period of its "principal member."[169] If the unitary group has a hierarchal structure, with a parent

166. *See* I.R.C. § 1501 *et seq.*

167. Treas. Reg. § 1.1502-76(a)(1) (as amended in 2000) ("[t]he consolidated return of a group must be filed on the basis of the common parent's taxable year . . . .").

168. The Federal consolidated group is based on stock ownership; no federal concept of a unitary business exists. Corporations not eligible to be included in a consolidated return may be members of the combined group.

169. Cal. Code Reg. § 25106.5(b)(12). For a detailed explanation of the California rule, see FTB

corporation at the top of the hierarchy and subsidiaries and lower-tier corporations under it, the parent corporation would be the principal member.[170] This rule is easy to apply and promotes uniformity among the states.

If the unitary group does not include a common parent corporation for all members of the group, the selection of the appropriate accounting period for the unitary group is more complex. We suggest as a default rule that the unitary group, for the purpose of adopting its initial accounting period, designate as its principal member the member having the largest aggregate amount of property, defined in accordance with the rules for identifying property in the apportionment formula. The accounting period of the principal member in that year would become the accounting period for the unitary group. We recommend that the accounting period of the group, as determined under this rule, remain unchanged regardless of how the composition of the group may evolve in subsequent years. Thus we counsel against a change in the unitary group's accounting period even if the "principal member" leaves the combined group in some future year or is no longer the member with the most property.

Under our proposed rule, each member of the combined group must determine the aggregate amount of its property. For purposes of simplicity and uniformity, we recommend that "property" for this limited purpose be property of the type included in the denominator of the property ratio used in Louisiana's apportionment formula.[171] For example, intangible property not included in the formula would not be taken into account for this purpose as well. To conform to the treatment of the property factor in the many states that follow UDITPA, we recommend that the original cost of an item of property be used to set the "value" of the property for this limited purpose.[172] The Louisiana rule is to include property in the apportionment formula at original cost minus a reserve for depreciation.[173] Although we are not suggesting here that Louisiana modify its current rule for purposes of apportionment, we do recommend that it abandon it for the limited purpose of determining the principal member of a unitary group in order to promote uniformity among the states.

Under California law, the accounting period for a unitary group not having a parent member is the accounting period of the member having the largest amount of property in that State (as determined under the rules for computing the numerator of the property ratio in the apportionment formula).[174] The weakness of this approach is that if all states adopted a comparable rule, the accounting period of a unitary group might not be the same in all of the states where the unitary group conducts its unitary business. Our proposed rule, in contrast, promotes uniformity and, as a result, computational simplicity.

Pub. 1061, *supra* note 154, at 5.

170. *Id.* The Federal approach is similar. *See* Treas. Reg. § 1502-76(a)(1)(as amended in 2000) ("each subsidiary must adopt the common parent's annual accounting period for the first consolidated return year for which the subsidiary's income is includible in the consolidated return").

171. *See supra* Part III.D.

172. *See* UDITPA, *supra* note 4, at § 11.

173. La. R.S. 47:287.95(G) (2001).

174. FTB Pub. 1061, *supra* note 154, at 5.

The operation of our proposed rule for unitary groups that do not have a parent corporation as a member is illustrated by the following example. Assume that ACo, BCo, and CCo are brother-sister companies. ACo has aggregate property of $50, determined under the rules that apply in determining its aggregate property in the apportionment formula of UDITPA. BCo and CCo have aggregate property, respectively, of $60 and $70. Under these facts, CCo would be the principal member of the combined group for the group's initial taxable year. Its accounting period would become the accounting period for the combined group, and that accounting period would not change in future years even if CCo no longer held the most property or if CCo left the combined group.

Our proposed rules for determining the accounting period of a combined group are relatively easy to apply and are designed to promote uniformity among states using the combined reporting method. As a further contribution to uniformity, we recommend that Louisiana allow a unitary group to elect its principal member when it files its first combined report if it has already selected a principal member in another state.[175] The purpose of the election is to allow a unitary group to reduce its accounting burdens by using the same annual accounting period in Louisiana that it is using in other states in which it is filing a combined report.

Regardless of the method used to select the initial annual accounting period, a unitary group should not be permitted to change its accounting period after its first filing period without the consent of the tax department. The tax department, moreover, should have the authority to require a unitary group to change its accounting period if such a change is necessary to reflect clearly the income of the unitary group. The department also should have the authority to require members of a unitary group to adopt the accounting period of its principal member if the unitary group is exploiting the lack of accounting-period uniformity within the group to distort its income.

We do not believe that a state should follow the Federal lead and require all members of a unitary group to adopt the same annual accounting period. The Federal consolidated return rules are voluntary. As a result, a corporate group that has strong business reasons for not adopting a uniform annual accounting period for its constituent members can achieve its business goals by declining to file a consolidated return. A combined report, however, must be mandatory to work effectively. As a result, a state should design its combined reporting rules to accommodate the business needs of its taxpayers. As discussed in Section IV.B.2. below, a state can encourage a unitary group to adopt a uniform annual accounting period by removing the tax benefits associated with having multiple annual accounting periods within a corporate group.

---

175. California allows a more comprehensive election. *See* Cal. Code Reg. § 25106.5(b)(12)(B) (allowing a combined group to elect its principal member in the initial year of a combined report "so long as consistently treated as such for the year of the election and thereinafter").

2. Determining Combined Income When Members Employ Different Accounting Periods

The combined income of a unitary group for an accounting period is simply the sum of the unitary income of each member of the unitary group for that accounting period. When the annual accounting period used by a member of a unitary group differs from the accounting period used in preparing the combined report, however, some method must be adopted for determining the income of that group member that relates to the accounting period employed in making the combined report. The following example illustrates the issue.

Assume that PCo, a parent corporation, and SCo, its wholly-owned subsidiary, are engaged in the operation of a unitary business in Louisiana. PCo uses the calendar year as its annual accounting period. SCo uses a fiscal year that starts on July 1 and ends on June 30. The unitary group uses the calendar year in preparing its combined report because that is the accounting period of PCo, its principal member. For calendar year 2002, PCo has unitary income of $30. For its fiscal year 2001/2002, SCo has unitary income of $12. It has unitary income of $24 for fiscal year 2002/2003. In determining the unitary group's combined income for calendar year 2002, it is necessary to determine the portions of SCo's income for fiscal years 2001/2002 and 2002/2003 that relates to calendar year 2002.

There are at least two possible ways to resolve the issue illustrated above. One way would be to require the nonconforming members of a unitary group to determine their income for purposes of the combined report by reconstructing their books of account. In the above example, SCo would determine its unitary income for calendar year 2002 by determining the income it would have earned in that year had it adopted a calendar year as its annual accounting period. We reject this approach as unnecessarily burdensome on taxpayers and subject to potential abuse.[176] The alternative way to resolve the issue set forth above is to use a formula to determine the income of a nonconforming member that relates to the annual accounting period of the principal member of its unitary group. Under the formula, a portion of the income from the nonconforming member's two overlapping years would be assigned to the taxable period used to compute the combined report. We recommend a formula that treats income from the two overlapping periods as earned uniformly throughout each year. This pro rata formula would determine the amount of income of a nonconforming member that would be included in the combined report for an annual accounting period as follows:

$Y_c = (Y_1 \times m_1 \div 12) + (Y_2 \times m_2 \div 12)$, where

Y_c is the income of the nonconforming member included in the combined report;

176. We are assuming that nonconforming members cannot adopt the accounting period used by the principal member without excessive difficulty. If that assumption is not valid, we would expect nonconforming members to adopt the accounting period of the principal member of their unitary group.

Y_1 is the income of the nonconforming member for its first overlap year;

Y_2 is the income of the nonconforming member for its second overlap year;

m_1 is the number of months of the first overlap year that fall within the accounting period used in preparing the combined report; and

m_2 is the number of months of the second overlap year that fall within the accounting period used in preparing the combined report.

If the above formula is applied to the facts of the example above, then SCo would include \$6 of its income in the combined report for fiscal year 2001/2002 (\$12 × 6/12) and \$12 (\$24 × 6/12) for fiscal year 2002/2003, for a total inclusion in the combined report of \$18. PCo would include its entire unitary income of \$30 for calendar year 2002, bringing the total income of the unitary group included in the combined report to \$48 (\$18 + \$30).

We recommend a similar approach be followed with respect to the factors of the nonconforming member. The property factor will be a pro rata portion of the non-conforming member's property numerator and denominator values for its respective separate accounting periods, reflecting the beginning and ending average property values for those separate accounting periods. For example, using the example above, SCo would first calculate its property factor for fiscal year 2001/2002. Half of that amount would enter into the group's property factor when calculating the group's apportionment formula for calendar year 2002. SCo also would calculate its property factor for fiscal year 2002/2003 and half of that amount would enter into the group's property factor when calculating the group's apportionment formula for calendar year 2002. SCo would follow a comparable approach with respect to its payroll and sales factors.

As this discussion indicates, a member of a unitary group with a nonconforming annual accounting period must compute its income and factors for both of the accounting periods that overlap the accounting period used in preparing the combined report. As a practical matter, the member may not have complete information about its income and factors for the second overlapping period when the combined report is being prepared.[177] For example, SCo in the example above may not know its income for fiscal year 2002/2003 at the time the combined report for fiscal year 2002 is being prepared. To avoid delays in the completion of the combined report, members with nonconforming accounting periods should be required to make their best estimate of their income for their second overlapping period.[178] They would file an amended return to reflect actual income figures for that period when those figures become available if the actual income and apportionment data result in a material change in the tax liabilities of the members

177. Extensions of time to file the combined report may lessen the magnitude of having to prepare a combined report before all data from non-conforming members are available.

178. This is the California rule. *See* Cal. Code Reg. § 25106.5-4(c)(4).

of the group. If the change in income from the estimate is not material, it would be reflected in the tax return filed for the next accounting period.

We anticipate that most unitary groups would find the pro rata formula convenient to use. To avoid potential hardship, however, we suggest that nonconforming members be permitted to elect to determine the amounts to be included in the combined report by reconstructing their books of account to reflect the taxable year of their principal member.[179] This election to use a reconstruction method should be binding for all future years unless the nonconforming member receives the consent of the tax authorities to change the election. In addition, the tax authorities should be permitted to require the nonconforming member to use the pro rata formula if the member fails to provide information adequate to justify its reconstructed books of account. Further, the tax department should be authorized to require a combined group that makes a change its accounting period for any reason to make adjustments in its income so as to ensure that the change does not result in a material distortion or omission of income.

3. Attributing the Combined Income of a Unitary Group to Members of the Unitary Group When Accounting Periods of Group Members Are Not Uniform

As discussed in Section IV.A.1., above, the combined report is not a tax return. The income computed on the combined report is apportioned among the members of the unitary group using an intra-state apportionment formula. Adjustments must be made in the application of the intra-state formula when the members of a unitary group do not have a uniform annual accounting period. These adjustments are similar in concept to the adjustments described in Section IV.B.2., above.

A member of a unitary group with a nonconforming annual accounting period should include in its income an amount from each of the combined group's annual accounting periods that overlaps its own accounting period. In general, the amount would be determined by application of a pro rata formula, similar to the formula described in Section IV.B.2., above.

Assume, for example, that PCo and SCo form a unitary group. PCo is the principal member of the group. Its annual accounting period, and the annual accounting period used to prepared the combined report, is the calendar year. SCo uses a fiscal year ending June 30 as its annual accounting period. For its fiscal year 2002/2003, SCo is taxable on one-half of its apportioned share of the combined group's income for calendar year 2002 and one-half for calendar year 2003. If SCo's apportioned share of the combined income for 2002 is \$3,000 and for 2003 is \$4,000, it should include \$3,500 (½ × \$3,000 + ½ × \$4,000) in income for its fiscal year 2002/2003. The portion of the combined income for 2003 that SCo did not include in income for its fiscal year 2002/2003 would be included in income for fiscal year 2003/2004.

As a practical matter, a member of a unitary group with a nonconforming annual accounting period will not know the income that will be reported on the

179. *See* Cal. Code Reg. § 25106.5-4(b).

combined report for the second overlapping accounting period when it files its tax return. For example, SCo in the above example would not know the unitary group's combined income for calendar year 2003 when it files its own tax return for fiscal year 2002/2003. In such circumstances, the nonconforming member should make a good faith estimate of the unitary group's combined income for the second overlap year. It should be required to file an amended return if the estimated amounts depart in a material way from the actual income amounts. Otherwise, it should reconcile the estimate and the actual income when it files its next tax return.

4. *Selecting the Starting Date for Combined Reporting*

To designate a single date, like January 1, 2002, as the effective date for the adoption of a combined reporting regime unnecessarily creates tax accounting problems for a unitary group that is not using the calendar year as the accounting period for itself and all of its members. To reduce those problems, the date for filing the first combined report generally should be the first day of the taxable year of the principal member of the unitary group that begins after December 31 of a specified year. For example, if the taxable year of the principal member of a unitary group runs from July 1 to June 30 and the state adopts a combined reporting rule for taxable years beginning after December 31, 2002, then that unitary group would begin filing a combined report for its fiscal year beginning on July 1, 2003.

This approach permits members of a unitary group having a common annual accounting period to begin their first taxable year under the new regime without having to include in that taxable year any income realized and recognized for a reporting period governed by the old regime. The accounting simplicity from starting the new system at the start of the group's taxable year is obvious. We believe that a substantial majority of unitary groups would be able to take advantage of this accommodation.

Benefits from this approach also accrue to the principal member of a unitary group that does not have a uniform annual accounting period. For the principal member, the proposed starting date would fall at the start of its annual accounting period, thereby reducing the accounting burdens on it.[180] We do not see how one can avoid some inconvenience, however, to the members of the unitary group that do not have the same accounting period as the principal member. Members of the group with a different accounting period are likely to confront some significant accounting problems because they will have to file a separate report for a portion of the first year of operation of the new regime and a combined report for the remaining portion of that year. The obvious solution to those problems is for these

180. We proposed in Section IV.B.1. that the tax department be granted the right to impose a particular accounting period on a combined group when necessary to reflect clearly the income of the combined group. The department might find it necessary to invoke this power if a combined group selects an inappropriate principal member simply to forestall application of the combined reporting regime.

taxpayers to adopt an accounting period that conforms to the period used by the principal member.

C. Adjustments For Intra-Group Transactions

The general rule in combined reporting is that transactions between members of a combined group, to the extent these transactions are part of the unitary business, are either totally ignored or deferred. Generally, the transactions are treated as a wash. This section addresses some refinements that a state should make in the wash rule to avoid duplicative taxation and to prevent tax avoidance.

Section IV.C.1. provides a general description of the operation of the wash rule. Section IV.C.2. describes the interaction of the wash rule with the rules for determining basis and discusses the adjustments that are needed in the basis rules to avoid both the undertaxation and the overtaxation of income. Section IV.C.3. addresses transitional problems.

1. Description of the Wash Rule

In general, the wash rule applies to transactions between members of the combined group that occur as part of the unitary business. For example, if PCo and its subsidiary, SCo, are members of a combined group, the proceeds and income from a sale by PCo to SCo of inventory property used in the unitary business would not be included in the combined report. A subsequent sale by SCo of the inventory property to retail customers, however, would be recognized. The gain would be computed by giving SCo a basis in the inventory property equal to PCo's basis. The proceeds of the sale would be included in the receipts (sales) factor of the apportionment formula.

The wash sale rule does not apply to transactions between members of the combined report that occur outside of the unitary business. For example, if PCo in the example above sells an investment asset to SCo that is not related to their unitary business, the gain or loss on the sale would be recognized currently but would not be included in the combined report. It would be included in PCo's separate income and would be taxable in accordance with the rules applicable to that type of income.[181]

In some circumstances, the wash rule helps the taxpayer. For example, eliminating intra-group dividends paid out of income derived from a unitary business prevents the group from being taxed once when the income is earned and again when the income is distributed as a dividend from one member of the unitary group to another. As illustrated in the example above, the wash rule also can prevent premature realization of income when inventory property has been sold to one member of the unitary group but still remains within the same unitary business.[182]

In other circumstances, the wash rule protects the government from taxpayer abuses. For example, it prevents taxpayers from recognizing losses on the intra-

181. The tax authorities should have the discretion to adjust the terms of a transaction between members of a combined group to reflect income properly if the wash rule is not applicable to that transaction.

182. *See* Cal. FTB Pub. 1061, *supra* note 154, at 6.

group sale of assets that continue to be used in the unitary business. Also, in some circumstances, the wash rule ensures that transactions between members of the combined report do not impact the apportionment of income of the unitary business through inappropriate changes in the property or sales factor.[183]

For example, if PCo and SCo constitute a unitary business, PCo's sale of an asset used in the unitary business to SCo not only will have no effect on the recognition of income or loss but also will have no effect on the original cost of the asset. The sale will have no effect on the property factor in Louisiana, which is the taxpayer's original cost in the asset minus the reserve.[184] If the sales proceeds otherwise would have been included in the sales factor,[185] the wash rule prevents the proceeds from affecting the sales factor. Without the wash rule one member of the combined group might sell an asset to another at a loss in order to realize the loss and to produce a more advantageous sales factor in the apportionment formula.[186]

The wash rule also prevents inappropriate changes in the tax attributes associated with the intra-group sale of unitary assets. For example, under the wash rule, a unitary group would not recognize gain on the sale of depreciable property from one member of a unitary group to another, and the purchaser would not acquire a stepped-up basis in the asset for purposes of depreciation deductions. Gain or loss would be recognized when the buyer or seller ceases to be a member of the unitary group or when the asset is no longer used within the unitary business.[187]

Under recently adopted regulations, California does not employ the wash rule to intra-group sales of depreciable property. Consistent with the wash rule, it does exclude the proceeds from the sale of depreciable property from the income of the combined group. Contrary to the wash rule, however, it allows the buyer to take a stepped-up basis in the depreciable property. To prevent a double benefit, the seller is required to recognize income each year for the incremental increase in the allowable depreciation deduction that the buyer claims on account of the increase in its depreciable basis.[188] This same approach is used by taxpayers filing a Federal consolidated return.[189] California's apparent purpose in departing from the wash rule is to allow a unitary group to conform

183. For a more complete description of the types of transactionsthat are treated as a wash, see Cal. FTP Pub. 1061, *supra* note 154, at 5-6; 18 Cal. Code Reg. § 25106.5-1.

184. La. R.S. 47:287.95(G) (2001).

185. Under some circumstances, sales of capital assets are not reflected in the sales factor. *See* MTC, *supra* note 86, Reg. IV.18.(c).(1).

186. In the absence of a vigilant tax department, a combined reporting regime that permits a water's edge election may encourage some taxpayers to try to secure advantages in the apportionment formula through transactions with an affiliated company that is excluded from the combined group because of the water's edge election. This possibility is one of the unfortunate costs of permitting a water's edge election. As noted in *supra* Part III.E., we recommend the water's edge election for practical and political reasons, not for tax policy reasons.

187. Cal. FTB Pub. 1061, *supra* note 154, at 5-6.

188. *See* 18 Cal. Code Reg. § 25106.5-1 (2001).

189. *See* Treas. Reg. § 1.1502-13(c)(7)(ii)(Ex. 4) (as amended in 2000).

its accounts kept for California purposes with the accounts it keeps for purposes of its Federal consolidated return.

For its general rule, we recommend that Louisiana adopt the less complex wash rule described above rather than the California rule. We do appreciate the benefit, however, of coordination with the Federal consolidated return regulations. To achieve that goal, we recommend that a unitary group filing a Federal consolidated return be permitted to elect, with the permission of the tax department, to use the California rule. The tax department should be authorized to impose conditions on the election that it believes are necessary to reflect income clearly or to prevent abuse.

2. *Adjustments to the Basis of Affiliate Stock*

One policy goal of tax basis rules in an income tax is to prevent taxpayers from being subject to duplicative taxation on the disposition of assets acquired with money or other property that had previously been subject to the income tax. Another important policy goal is to limit allowable losses on the disposition of an asset to the amount paid for that asset out of previously taxed income. As explained below, it is sometimes necessary to make certain basis adjustments for intra-group transactions to achieve these goals for members of a unitary group filing a combined report. The Federal government in its consolidated return rules requires adjustments similar to the ones we recommend for Louisiana.[190]

In furtherance of the general policies set forth above, it is sometimes appropriate in a combined reporting system to allow a parent corporation to increase its basis in the stock of its subsidiary when the income of that subsidiary has been included in the pre-apportionment income of the unitary group. Similarly, it is sometimes necessary to require a parent corporation to reduce its basis in the stock of its subsidiary when a loss incurred by that subsidiary has been deducted from the pre-apportionment income of the unitary group.[191]

To illustrate the duplicated gain issue, consider PCo, a parent corporation that forms SCo, a subsidiary, with a contribution to capital of $100. Accordingly, PCo's basis in the SCo stock is $100. PCo and SCo are engaged in a unitary business in State L and other states and file a combined report in State L. SCo earns $500 of pre-apportionment unitary business income, and the value of its stock thereby increases by $500, from $100 to $600. The $500 of unitary business income earned by SCo is added to the unitary group's pre-apportionment taxable income. The group apportions this amount to State L and other states under the applicable apportionment formula.

Assume that PCo sells its SCo stock to an unrelated buyer for $600. In the absence of a basis adjustment, PCo would recognize gain on the sale of $500 ($600 – $100), which would be included in the pre-apportionment income of the unitary

190. *See* Treas. Reg. § 1.1502-32(b) (as amended in 1999).

191. The basis adjustment rules for earnings and distributions are strongly analogous to the rules developed by the Federal government for preventing duplicative taxation of gain derived from the sale of a CFC. I.R.C. § 961(a) (2001). *See* McIntyre, Int'l Treatise, *supra* note 25, at § 7/B.4.2.

business. The result would be duplicative taxation of the profits of $500 earned by SCo. To prevent that result, PCo should be allowed to increase its basis in its SCo stock by $500 (the amount of SCo profits included in the pre-apportionment income of the unitary group). If the SCo stock sold for $700, however, PCo would recognize a gain of $100 — an appropriate result because that additional $100 in gain was due to a previously untaxed appreciation in the value of SCo's assets.

Rather than duplicative gain, duplicative loss can also occur without proper basis adjustments. To illustrate, assume that PCo in the example above owns all of the stock of TCo. It formed TCo by contributing $100 in exchange for the TCo stock. As a result, its basis in the TCo stock is $100. TCo suffers a pre-apportionment unitary business loss of $50 on the PCo and TCo unitary business. That loss reduces the pre-apportionment business income of the unitary group by $50. It is also likely to reduce the value of the TCo stock from $100 to $50. Assume that PCo sells the TCo stock for $50. Unless PCo's basis in the stock is reduced by $50, PCo will realize a $50 loss on the sale of the stock, thereby reducing the pre-apportionment income of the unitary group a second time by $50.

California, the leading state practitioner of combined reporting, apparently does not make the adjustments to basis that we recommend for Louisiana. The California statute does not specifically provide for these basis adjustment, due, we assume, to legislative indifference. The California tax authorities attempted to prevent the double use of a loss, as described above, by invoking their general interpretive powers. California's attempt failed.[192] The California experience suggests that a state that is adopting a combined reporting rule should include a basis adjustment rule in the enabling legislation. The details of the rule, however, should be worked out in department regulations.[193]

If a combined reporting state provides for an upward adjustment in a parent company's basis in the stock of its subsidiary to reflect the unitary income earned by that subsidiary, it should make a corresponding reduction in that basis when the income is distributed to the parent. For example, assume that SCo in the example above earns $500 of unitary taxable income and PCo increases its basis in the SCo stock by that amount. If SCo distributes the $500 of income to PCo, then PCo should be required to reduce its tax basis in its SCo stock by $500 to reflect the reduction in SCo's assets. Without that reduction in basis, PCo would have a loss of $500 if it sold the SCo stock for its presumed fair market value of $100. A reduction in the basis of the SCo stock from $600 to $100 would properly reflect PCo's remaining investment in SCo after the distribution and would eliminate an improper loss on the sale of the SCo stock.[194]

192. Appeal of Safeway Stores, Inc., No. 62-SBE 014 (Cal. State Bd. of Eq. Mar. 2, 1962). In *Safeway Stores*, the second loss (on the stock) occurred as a part of a liquidation of the subsidiary. Under California law, the loss may possibly have been a nonbusiness loss. If so, *Safeway Stores* may not prevent the California tax authorities from requiring a basis adjustment when both of the losses clearly constitute business losses includible in a combined report.

193. A state may prefer to deal with the duplicative gain and loss issue entirely by regulation. In that case, the statute's delegation of regulatory authority to the tax department should be unambiguous so that the resulting regulations would be given the force of law by the courts.

194. The adjustment to basis should be made whether the distribution is made by payment of a

3. *Transition Issues*

When a state adopts combined reporting, it must decide what adjustment should be made for intra-group transactions that were initiated at least in part under the old regime. In our view, transition relief is appropriate to avoid duplicative taxation under the old and the new regime. It is inappropriate, however, when its effect is to extend a benefit obtainable under the new regime to transactions consummated under the old regime. In the grey areas between these extremes, we recommend flexibility and pragmatism.

Section IV.C.3.a. addresses transition issues arising from the general wash rule discussed in Section IV.C.1., above. Ordering rules used to determine whether a dividend has been paid out of profits accumulated before or after the adoption of combined reporting are addressed in Section IV.C.3.b. Transition issues relating to basis adjustments are addressed in Section IV.C.3.c.

a. *Transition Issues Under the Wash Rule*

In general, transition rules are not necessary or desirable to modify the tax consequences under the wash rule of an intra-group transaction that was concluded prior to the adoption of a combined reporting regime. A separate reporting system typically contains its own rules to prevent duplicative taxation. The shift to a combined reporting regime should not be the occasion for redesigning those rules. The wash rule should not be applied retroactively to transactions that occurred under the separate filing regime absent a showing that the latter rules would be ineffective in blocking duplicative taxation due to the adoption of combined reporting.

Consider, for example, the wash rule that eliminates a sale of inventory property between members of a combined group. Assume that PCo sells inventory property to SCo, its subsidiary in year one, and SCo sells that property to unrelated persons in year two. Year one is a separate reporting year and year two is a combined reporting year. PCo and SCo constitute a unitary group, so the sale from PCo to SCo would have been ignored if the wash rule had applied to year one. Taking the sale into account in year one, however, was a perfectly acceptable result under a separate accounting regime. Protection against duplicative taxation is provided, moreover, by allowing SCo to take a tax basis in the inventory property equal to the price paid to PCo. Under these conditions, it would be cumbersome and unnecessary to retroactively apply the wash rule to the sale between PCo and SCo and to undo the basis adjustment made under the prior regime.

Transition relief is appropriate, however, when the application of the combined reporting regime to transactions having some link to the prior separate reporting regime present a special risk of duplicative taxation. We believe that such a risk may arise when a dividend is paid after the adoption of combined reporting out of

dividend or through some alternative mechanism.

profits that were earned under the prior separate reporting regime. If those dividends would have been exempt from tax under the prior separate reporting regime, they also should be exempt under the combined reporting regime.

Under current Louisiana law, a corporation may exclude a dividend from its income to the extent that the dividend was paid out of income previously taxed by Louisiana.[195] If Louisiana adopts combined reporting, it will need a transition rule to preserve that policy with respect to dividends received under the combined reporting regime and paid out of income earned under the separate reporting regime.[196]

The proposed transition rule would apply to exclude that part of any dividend that is paid out of profits that were taxed by Louisiana because of the operation of its apportionment formula under the separate reporting regime. The proposed transition rule should not apply to a dividend that was paid out of profits accumulated prior to the adoption of the combined reporting regime that were never taxed by the State.

Consider, for example, PCo and its subsidiary, SCo, members of a unitary group. In year one, a separate reporting year, SCo earned profits of $400. Louisiana taxed SCo on $100—its apportioned share of those profits under the separate reporting regime then in place. In year two, Louisiana adopted combined reporting. In that year, SCo distributed a dividend of $400 to PCo. Under these facts, we believe that $300 of the dividend should be included in the combined report and $100 should be excluded in order for the treatment of dividends to be consistent with the dividend policy of current Louisiana law.

b. Ordering Rules

In some cases, a member of a unitary group making a distribution to its parent corporation may have untaxed profits accumulated under a separate reporting regime and also taxed profits accumulated under the combined reporting regime. To deal with such a situation, a state needs to employ an accounting convention that determines the category of accumulated profits out of which a particular distribution is deemed to be made. The rules specifying that convention are typically referred to as ordering rules. We propose the following ordering rules:[197]

> (1) Dividends are treated as paid out of current earnings and profits to the extent thereof.
>
> (2) If the dividends paid exceed current earnings and profits, then the dividends are treated as paid out of earnings and profits accumulated in

195. La. R.S. 47:287.73(C)(1)(2001) and L.A.C. 61:1115. This method of eliminating duplicative taxation is being litigated in California in *Farmer Brothers Co. v. FTB*, Los Angeles Superior Court Case No. BC237663, as violating the Commerce Clause because relief is extended only to dividends paid from in-state sources.

196. We are not necessarily endorsing the practice of Louisiana and many other states of exempting only that portion of a dividend that is paid out of income previously taxed by the state. The proper treatment of such dividends is a matter beyond the scope of this Article.

197. *Cf.* Cal. Rev. & Tax. Code § 25106 (West Supp. 2001).

preceding years, beginning with the year closest (i.e., reverse chronological order) to the current year.

To illustrate the operation of the above ordering rules, assume that SCo began operations in year one and the current year is year five. SCo has earnings and profits for each of those years of $1,000. In year five, SCo paid a dividend of $2,500 to PCo, its parent corporation and a member of its unitary group. Under the ordering rules, $1,000 of the dividend will be treated as paid out of the earnings and profits arising in year five, $1,000 out of the earnings and profits arising in year four, and $500 out of the earnings and profits arising in year three.

As with most accounting conventions, there is some element of arbitrariness to the above rules. We favor the first ordering rule because it allows a unitary group to be taxed on dividends under the combined reporting regime as long as the dividends paid by a member of the unitary group do not exceed its current earnings and profits. We believe the results achieved under combined reporting are desirable and the sooner they apply to corporations the better. The rule is also relatively simply to administer and conforms to the Federal ordering rule for dividends.[198] We favor the second rule because it corresponds to the dividend ordering rules of the Internal Revenue Code[199]and taxpayers are presumably well versed in its application.

c. Transition Issues under the Basis-Adjustment Rules

In general, the basis rules described in Section IV.C.2. should not be applied retroactively to give a member of a unitary group an addition to, or subtraction from, its basis in the stock of another member of the unitary group to take into account events occurring before the adoption of combined reporting. The purpose of the basis rules is to prevent duplicative taxation of combined profits or duplicative use of combined losses. These rules, by their own terms, do not apply to companies that are not part of the unitary combined group. It would be anomalous to provide these rules to transactions that occurred when those members were not being taxed as members of that group.

Assume, for example, that PCo owns all of the stock of SCo and that the two companies are engaged in a unitary business. In year one, a separate reporting year, SCo earns income of $600. In year two, a combined reporting year, PCo sells its stock in SCo to unrelated persons. PCo would not be entitled to an increase of $600 in its basis in the stock of SCo because the $600 of profits were not included in the combined report. There is no strong reason for fashioning a special transition rule to deal with this case because the potential for duplicative taxation was part of the tax regime in place when the income of $600 was earned. In these circumstances, PCo should not receive a basis adjustment.

Similarly, we would not require a member of a unitary group to reduce its basis in the stock of a subsidiary because the subsidiary suffered a loss under the

198. I.R.C. § 316(a) (2001) (flush language).

199. *Id.*

prior separate reporting regime. Assume, for example, that PCo and its two subsidiaries, SCo and TCo, form a unitary group. PCo acquired the SCo stock in a taxable transaction for $1,500. In year one, a separate reporting year, SCo suffered a loss of $500. That loss had the effect of reducing the value of SCo stock from $1,500 to $1,000. In year two, a combined reporting year, PCo sold the SCo stock for $1,000. The sale produces a loss of $500 unless PCo is required to adjust its basis downward by $500 for the loss incurred in year one. We recommend that no basis adjustment be made. The potential for a duplicative loss was part of the tax regime in place when the loss of $500 occurred. Assuming the sale was made as part of the unitary business, the loss of $500 should be includible in the combined report.

V. CONCLUSION

Saving nickels, saving dimes
Workin' till the sun don't shine
Lookin' forward to happier times
On Blue Bayou.[200]

The Louisiana corporate income tax will not be a stable source of revenue for government spending programs unless Louisiana protects it from the encroachments of the corporate tax planners. Over the past decade, multistate tax planning has become increasingly concentrated in the large, multinational accounting firms and a small number of specialized law firms. Those accounting firms no longer make their large profits from compliance work—the traditional function of accountants. They now have dynamic and growing state practices geared to minimizing state corporate taxes for their multi-state and multinational clients.[201] A state that does not respond to the emerging reality of scorched-earth tax avoidance is almost certain to lose the ability to raise more than "nickels and dimes" from its corporate income tax.

Happier times are ahead, however, if Louisiana adopts a combined reporting regime. Combined reporting offers a formidable defense against many of the most pernicious forms of tax avoidance. In this Article, we have presented a detailed proposal for implementing a combined reporting regime in Louisiana. Whenever possible, we have borrowed design features that have been used successfully by California and the other combined-reporting states. Our proposal, however, has some distinctive design features of its own. We are confident that this spicy concoction will not suit the taste of the out-of-state tax evaders.

No one should expect that multinational and multi-state firms will embrace a proposal to enact a combined reporting rule. Many of them will oppose it for the same reason we support it—because it will increase the tax liability of multi-state

200. Roy Orbison, "Blue Bayou" (1963).

201. One recent study indicates that $1 of investment in tax planning typically results in a cut in state taxes of $100. *See* Sanjay Gupta & Lillian F. Mills, *Multistate Tax Planning: Benefits of Multiple Jurisdictions and Tax Planning Assistance* (unpublished study, June, 2000).

businesses engaging in tax-avoidance schemes. Opponents of corporate tax reform in the business community usually assert that adoption of reforms they oppose will be bad for a state's "business climate." The Louisiana Legislature should expect that this loose charge will be made if it moves to adopt combined reporting. At best, the charge is unproven.[202] At worst, it suggests that the only corporate tax that is compatible with a good business climate is a tax that corporations are able to avoid.

202. In his Senate confirmation hearings, Treasury Secretary-designate Paul O'Neill stated: "As a businessman I never made an investment decision based on the tax code... If you give money away I will take it, but good business people don't do things because of inducements." Joseph Kahn, *Treasury Choice Varies from Bush on Tax Outlook*, N.Y. Times, Jan. 18, 2001, at A-1, A-16. Roger Smith, former Chairman of General Motors, whose Saturn plant was sought after by nearly every governor, stressed that "tax breaks can't make a silk purse out of a sow's ear." Detroit Free Press, Mar. 18, 1985, at 1A. According to Smith, "we're going to be in business for the long term... you've got to look at more than just what the great big cookie is that's coming in on the plate." *Id.* Consistent with this philosophy, the first state GM eliminated as a site for the Saturn plant was Florida,a state that is perceived as having an extremely favorable tax climate (*e.g.*, nopersonal income tax, no estate tax, a double-weighted receipts factor, and no worldwide combined reporting). For an overview of the business climate literature, see Enrich, Saving the States, *supra* note 163, at 392-97; Pomp, *supra* note 111, at 393.