COMBINED REPORTING

WITH THE CORPORATE INCOME TAX

Issues for State Legislatures

William F. Fox and LeAnn Luna*

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*Center for Business and Economic Research, University of Tennessee, Knoxville

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Executive Summary

In recent years, states across the country have debated the merits of separate versus combined reporting for the corporate income tax. Advocates of combined reporting assert that its adoption will close loopholes and prevent other inappropriate tax planning options and significantly increase tax revenues by eliminating or neutralizing the effects of transactions between related parties. Advocates of separate reporting contest these revenue estimates, and also argue that combined reporting unfairly distorts the amount of income or loss earned in a state and could result in taxation of income from affiliates' activity that is more accurately attributed outside the state.

These claims and counterclaims are complicated and confusing. As a result, NCSL recognized the need for an objective review and commissioned this study. The core purposes of the study are to explain the features of combined reporting and to analyze the key issues that states should consider when determining corporate tax structures, and specifically the relative merits of separate and combined reporting. The four key issues are:

- Accurate measurement of the profit and loss attributable to a corporate taxpayer's activity in the state.
- Consequences for state tax administration and taxpayer compliance costs.
- Effects on state economic performance.
- Effects on state corporate tax revenues.

<u>Background</u>

Forty-four states raise revenue with a corporate income tax (CIT), as do a relatively small number of local governments. Most states begin with federal taxable income in defining the state tax base, but considerable variation exists in the ways that states determine the taxable base for multistate and multinational corporations. Tax rates are divergent and range from a low of 4.0 percent in Kansas to a high of 12 percent in Iowa. The median state has a 7.4 percent maximum marginal corporate income tax rate. State corporate income taxes have historically provided a modest share of state tax receipts – consistently less than 10 percent of total state tax revenues.

* Center for Business and Economic Research, University of Tennessee, Knoxville. The authors are grateful to Zhou Yang for very important contributions to this report.

The share of tax revenues provided by corporate income taxes has fallen over the past several decades, and corporate income taxes have declined relative to national corporate profits. There are a variety of causes for these changes, but numerous studies have not been able to isolate precisely the relative roles played by the various factors. Among the explanations that have been offered are reductions in the federal tax base, state choices to provide tax credits and reduce the corporate income tax base (for example through concessions and changes in the apportionment formula for economic development purposes), declines in the relative contributions that traditional C-corporations play in the economy as businesses have more frequently chosen other pass through institutional structures (such as partnerships, S-corporations, and LLCs), and business tax planning (i.e., state, national and international).[1]

The relative corporate income tax declines have caused policymakers to refocus their attention on all aspects of their respective state tax systems, and particularly the CIT. While a number of the identified causes go beyond decisions made by businesses, some states have assumed that the erosion is primarily due to state tax planning. As a result, many states have adopted policies to lessen the extent of actual or perceived tax planning, and particularly planning that uses multiple business structures and exploits cross state tax differences. Firms often have business purposes for creating complicated organizational structures, but these structures can also be used for tax planning. Among the policies that states have used to attack real or perceived tax planning are (i) rules that add back deductions associated with entity isolation strategies such as the use of passive investment companies (PICs), (ii) efforts to assert economic nexus over PICs and businesses with customers in the taxing state, but no physical presence, (iii) audits of firms for transfer pricing problems or to ensure that transactions between related parties have business purposes using rules similar to the IRC Section 482, and (iv) imposition of combined reporting. Combined reporting has received much of the attention in recent years based on a perception that combined reporting is an effective means of limiting tax planning. Six states have adopted combined reporting since 2006, after 30 years since any new state had adopted the policy. Today, 22 states require combined reporting as part of their corporate income tax compliance.

A fifth option that states have not considered in the context of combined reporting is the use of special audits. There may be circumstances in combined reporting states where the combined report does not accurately reflect income appropriately attributable to the state. In such circumstances, states could consider allowing certain taxpayers to use separate reporting,

[1] We have investigated these factors in several papers. For example, see William F. Fox and LeAnn Luna, "State Corporate Tax Revenue Trends: Causes and Possible Solutions," *National Tax Journal* 55: 491-508 (September 2002) for an understandable and detailed description of some of the causes of corporate tax revenue declines.

which might be informed with special private sector audits. The reporting system would be based on a separate return system, but companies would have internal accounting rules that ensure transfer prices between affiliated companies accurately reflect the actual income producing activity in the state. An independent third party, such as an auditing firm, would review and certify these results, and the corporation would bear the cost of such an audit. It is important to note that some states already require special tax audits to verify certain deductions and tax credits. For example, 20 states require an independent CPA review of the film production costs before a taxpayer may claim a film production credit, and six states require certification or taxpayer reimbursement of state expenses related to eligibility verification under certain circumstances. Similar private sector audits could also be undertaken to verify intercompany transfer prices. States would have to revise their statutes to allow for such an audit and would have to provide the detailed guidelines that state revenue departments, taxpayers, and independent auditors would be required to follow.

Combined Reporting in Practice

Combined reporting requires that a business effectively disregards the legal existence of affiliates and report on a combined basis the operations of all related entities involved in a *unitary* business. In theory, combined reporting should make the taxation of a group of entities comparable to the tax that would be paid if the business were conducted as a single entity, but in practice, the existence of different tax structures across states and industries can affect the tax burden.

Imposition of combined reporting can increase, decrease or leave the tax liability the same (both within a state and in total) for any particular combined group relative to its tax liability under separate reporting. Businesses that have both profitable and unprofitable entities that will be combined for income tax purposes are a likely set to see a reduction in total tax liability with combined reporting as the losses in unprofitable affiliates will reduce the income in profitable affiliates (something not possible under separate reporting). Firms that have used tax planning to exploit state tax differences may be most likely to experience tax increases from combined reporting.

A series of implementation options and decisions determine how combined reporting will work in any particular state. Among these issues are : (i) the definition of the unitary group, (ii) whether to use Joyce or Finnigan rules, (iii) how international businesses and income are included in the combined group, and (iv) transition concerns. Defining the combined group is surprisingly difficult. Consistent with relevant judicial decisions, states can only combine corporations that are part of a unitary group. However, there is no bright line test of “unitary,”

and states have adopted different standards. A group of corporations may be considered unitary in one state but non-unitary in others and may be unitary in one year but not the next. Defining the unitary group is further made difficult by business ownership of interests in flow through entities (such as partnerships and LLCs) and business acquisitions or start ups of new businesses. Taxpayers face a significant amount of complexity and uncertainty in determining the members of the combined group, but they also gain some tax-planning opportunities because they can allow firms to enter and exit the unitary group by strategically altering the business activities conducted within each entity. This same complexity can work in favor of state tax administrators as well as they argue for inclusion or exclusion of certain businesses from the combined group based on the revenue results.

A key issue is whether firms must individually have nexus in the state before their apportionment factors can be included in the combined group's apportionment computation. Under Finnigan rules, the group as a whole is treated as the taxpayer, but under Joyce, each individual entity is regarded as the taxpayer.[2] Ten states currently use the Finnigan method, and the others follow Joyce rules.

The treatment of foreign affiliates is an important issue for states and for those firms with significant overseas operations. States elect to tax or exclude foreign entities as they permit or require businesses to make water's edge elections – an election to limit the combined report to operations within the U.S. In practice, water's edge elections or requirements only partially exclude foreign operations or entities from the combined report. For example, the foreign source income of domestic firms often is included and foreign affiliates with significant domestic activity can be included in the combined report despite a water's edge election. Further, elections to include or exclude foreign entities normally must be made for many years at a time, even though the firm's business conditions could be changing.

States that move from separate reporting to combined reporting must address a number of transitional issues. Relatively simple examples include how to treat prior year overpayments that should be reimbursed and how to calculate safe harbor estimated payments. More difficult questions involve tax attributes, including net operating losses and tax credits that were generated prior to combined reporting being enacted in a state. Should those tax benefits be available to the combined group as a whole, or only to the entity that created the benefit?

[2] The terms refer to two California rulings that addressed this issue, *Appeal of Joyce, Inc.*, California St. Bd. of Equal., SBE-XIV-215, 66–SBE-070 (Nov. 23, 1966) and *Appeal of Finnigan Corporation*, Cal. St. Bd. of Equal., 88-SBE-022, (August 25, 1988).

Evaluating Combined Reporting

We examine the effectiveness of combined versus separate reporting along four dimensions: (i) the capacity to develop a consistent, neutral measure of business profits, (ii) the effects on taxpayer compliance and state administration, (iii) the implications for output of state economies and (iv) the impacts on state corporate income tax revenues.

Corporate tax bases need to measure the taxable profits of corporate taxpayers accurately relative to one another so that the tax burden across taxpayers is distributed in proportion to their share of statewide corporate profits. The intent is to ensure that economic activity is taxed evenly across all sectors of the economy. Economists say that the tax burden is *neutral* across industries if the same tax burden is levied on all industries. Simply, this means that imposition of the tax does not favor one industry relative to another.

Separate reporting fails to measure profits properly if any of three conditions arise: (i) some related businesses earn profits and others experience losses, (ii) the combined group has shared costs (such as headquarters functions or shared inputs) and (iii) there are economies to producing different goods by related businesses (termed economies of scope). In the first case, separate reporting prevents profit making businesses from offsetting taxable income with losses from other entities, so that the amount subject to tax exceeds the combined profits of the overall business. The second and third cases are more complicated because firms may have no consistent basis for allocating costs and profits that are not uniquely linked to an individual entity. Also, the firm may not be able to determine the source of synergies between related firms. In practice, the costs and profits are separated between firms based on transfer prices if one related firm sells to another, but these prices can be subjective. These examples demonstrate that separate reporting may not result in an accurate measure of taxable corporate profits for multijurisdictional firms and in some cases for related firms within a single jurisdiction. Combined reporting is intended to overcome the problems by avoiding the need to separate shared costs or deal with economies of scope. Further, combined reporting can preclude certain tax planning strategies, such as the use of PICs to hold intangibles.

Combined reporting as it is generally imposed will not necessarily overcome the limitations of separate reporting. First, combined reporting, when used together with apportionment formulas, uses an averaging approach to determine the tax base for any state rather than trying to accurately measure the actual profits earned in a state. Apportioned combined reporting calculates an average income across both states and affiliated firms, rather than the actual profits of the businesses operating in the state. As a result, combined reporting could result in tax liability in a state where the actual company within the state is operating at a

loss. Similar issues arise for attributing income across countries for corporate income tax purposes, and these are generally resolved using separate accounting.[3] Another reason is that the combined group may not include all related firms because of judicial or Congressional restrictions (e.g., PL 86-272) or state statutes that exclude some related affiliates. Water's edge requirements and states' tendencies to exclude some industries, such as insurance and finance, are examples of reasons why state statutes can prevent some firms from being in the combined group.

Lawmakers contemplating a move to combined reporting should consider the immense complexity the reporting regime will introduce for some firms. Further, the complexity comes with a great amount of uncertainty. The subjective nature of defining the unitary group guarantees that taxpayers will at times find themselves disagreeing with auditors, and there are no clear rules to resolve these inevitable differences of opinion. Complying with the rules will be most difficult for the largest taxpayers, who so often are the targets of recruiting efforts by state development offices. Complexity alone is an insufficient reason to dismiss combined reporting as a potential solution to perceived abuses, but decision makers should weigh the complexity of combined reporting as they consider other methods, such as rules against PICs and asserting economic nexus, that might achieve similar results with a smaller burden on taxpayers and revenue departments tasked with enforcing the law.

Our statistical analysis shows that combined reporting reduces private GDP in states that levy corporate income tax rates above the state median rate. Combined reporting does not harm economic activity in states with tax rates below the median and may enhance economic activity. The conclusion is drawn from an extensive analysis of the 48 continental states for the years 1993 through 2009 using appropriate econometric techniques. The method we use for this analysis is the best approach, and allows us to fully account for all of the changes that have occurred in state tax structures and economies over recent years and permits us to isolate the effects of combined reporting alone. The approach measures the influences of combined reporting based primarily on states that changed policy towards combined reporting during the study years, and specifically New York (2007) and Vermont (2006), but does so in the context of all 48 continental states.[4] Of course, other states including Massachusetts, Michigan, West Virginia, and Wisconsin have subsequently adopted combined reporting.

Combined reporting can potentially affect state tax revenues through several channels, and our goal is to measure the net of these effects. First, combined reporting can lead to a

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[3] The U.S. requires firms to file consolidated returns domestically, but uses separate accounting rules internationally.

[4] New York forced combinations on a case by case basis before the new legislation that made combined reporting more mandatory.

more accurate measure of corporate profits. This should lead to greater tax liability for some combined groups but lower tax liability for other groups, meaning the influence on total tax revenues is uncertain. Second, combined reporting can help close or lessen the tax benefits from certain tax planning activities. This should increase tax revenues to the extent that combined reporting is an effective tool for closing loopholes. Third, tax revenues are expected to fall to the extent that adoption of combined reporting harms the state's economy or rise if combined reporting enhances the economy.

We find that combined reporting has no direct effect on state tax revenues, which means we find no evidence that combined reporting enhances tax revenues through the first two channels. A small decrease in tax revenues can be expected because of the fall in GDP in high tax jurisdictions and a small increase can be expected in lower tax rate jurisdictions. Further analysis of how combined reporting affects the economy and tax revenues is appropriate in coming years, and our expectation is that combined reporting will lead to a small increase in tax revenues, but at the cost of a modest decrease in the size of the state's economy.

Addback Requirements vs. Combined Reporting

We also investigated the effects of expense addback statutes on state GDP using the same statistical techniques. Addbacks are regarded as a partial replacement for combined reporting and are primarily intended to offset tax planning associated with the creation and use of single purpose entities, such as PICs, and other transactions among affiliates. Addback statutes apply to specifically identified intercompany expenses, such as royalties, interest, and management fees. When addbacks are required, the intercompany expense is disallowed for state income tax purposes. We find addback requirements have a very strong positive influence on tax revenues. That is, addback requirements are very effective at increasing state corporate income tax revenues. This is not surprising because the addback statutes increase tax bases by definition. Further, states with broader addback rules that disallow a greater number of expenditures increase revenues more than states with narrow statutes. The statistical results indicate that addback requirements are a more effective means of raising state tax revenue than is combined reporting. Addback statutes also have a strong negative effect on state GDP, and the results evidence that perverse effects on the state business climate explain at least part of the economic deterioration.

Addback statutes may result in a more accurate measure of income attributable to a state if the intercompany payments did not reflect real costs. Further, addback statutes will often bring a taxpayer's attention to the expenditure item, requiring the taxpayer to self assess

whether the amount is reasonable and traceable. Otherwise, the addback provision may not improve accuracy.

The tax planning opportunities that remain with combined reporting, together with the difficulty of determining the unitary group, may make combined reporting a less effective means of generating revenue than the adoption of an addback statute. It is also possible that the effects of combined reporting on tax revenues and the economy will look more parallel to those of addbacks once statistical analysis covering a longer time period is possible.

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Combined Reporting with the Corporate Income Tax: Issues for State Legislatures

William F. Fox and LeAnn Luna[*]

Introduction

In recent years, states across the country have debated the merits of separate versus combined reporting for the corporate income tax. Sixteen mostly western states have required corporations to file combined returns for many years, as other corporate income taxing states either allowed combined reporting or required separate reporting. After no change in the number of states imposing a combined reporting regime for nearly thirty years, six states have recently adopted combined reporting and many other states have considered combined reporting. Advocates of combined reporting assert that its adoption will close loopholes and prevent other inappropriate tax planning options and significantly increase tax revenues by eliminating or neutralizing the effects of transactions between related parties. Advocates of separate reporting contest these revenue estimates, and also argue that combined reporting unfairly distorts the amount of income or loss earned in a state and could result in taxation of income from affiliates' activity that is more accurately attributed outside the state.

These claims and counterclaims are complicated and confusing. As a result, NCSL recognized the need for an objective review and commissioned this study. The core purposes of the study are to explain the features of combined reporting and to analyze the key issues that states should consider when determining corporate tax structures, and specifically the relative merits of separate and combined reporting. The report was commissioned by the NCSL Task Force on State & Local Taxation of Communications and Interstate Commerce.

The first half of the report explains combined reporting and how it differs from separate reporting. Many key issues are discussed including water's edge versus worldwide combined reporting, Joyce versus Finnigan nexus rules, and the treatment of international affiliates. The second half evaluates combined reporting along four dimensions: implications for economic neutrality, administration and compliance, effects on economic production in the state, and impact on state tax revenues. The report begins with a brief discussion of state corporate income tax structures.

[*] Center for Business and Economic Research, University of Tennessee, Knoxville. The authors are grateful to Zhou Yang for very important contributions to this report.

Corporate Income Tax Structures

Currently, 44 states impose a corporate income tax (CIT), each with its own definition of the tax rates and tax base.[5] Most states begin with federal taxable income and make a series of adjustments to arrive at state taxable income. Common adjustments include the federal deduction for state income taxes, tax exempt interest income from municipal bonds and related expenses, and adjustments to depreciation of fixed assets. With some exceptions, the adjustments to arrive at state taxable income do not create controversy or provide much in the way of planning opportunities for corporate taxpayers. However, greater differences exist in how states deal with taxpayers who operate across state lines, and these differences provide ample opportunities for creative taxpayers to reduce their overall state income taxes.

Judicial rulings limit states to levying income tax on businesses with taxable nexus in the state. There is no question that taxable presence exists for firms that operate solely within a single state, but the issue of whether taxable presence exists arises for multi-state firms. States do not impose a single definition of nexus, and the level of activity that establishes nexus differs in each state.[6] Federal law provides some limits on the ability of states to subject certain businesses to the income tax. For example, Public Law 86-272 prohibits states from taxing businesses whose only connection with the state is the solicitation of sales of tangible personal property to customers in the state. In the past, most states required some physical connection, such as an office or permanent employees, to assert nexus. However, many states have broadened their nexus standards to assert taxing authority when the entity has only an "economic nexus," often seeking to tax corporations with only customers or intangible assets located in the state.

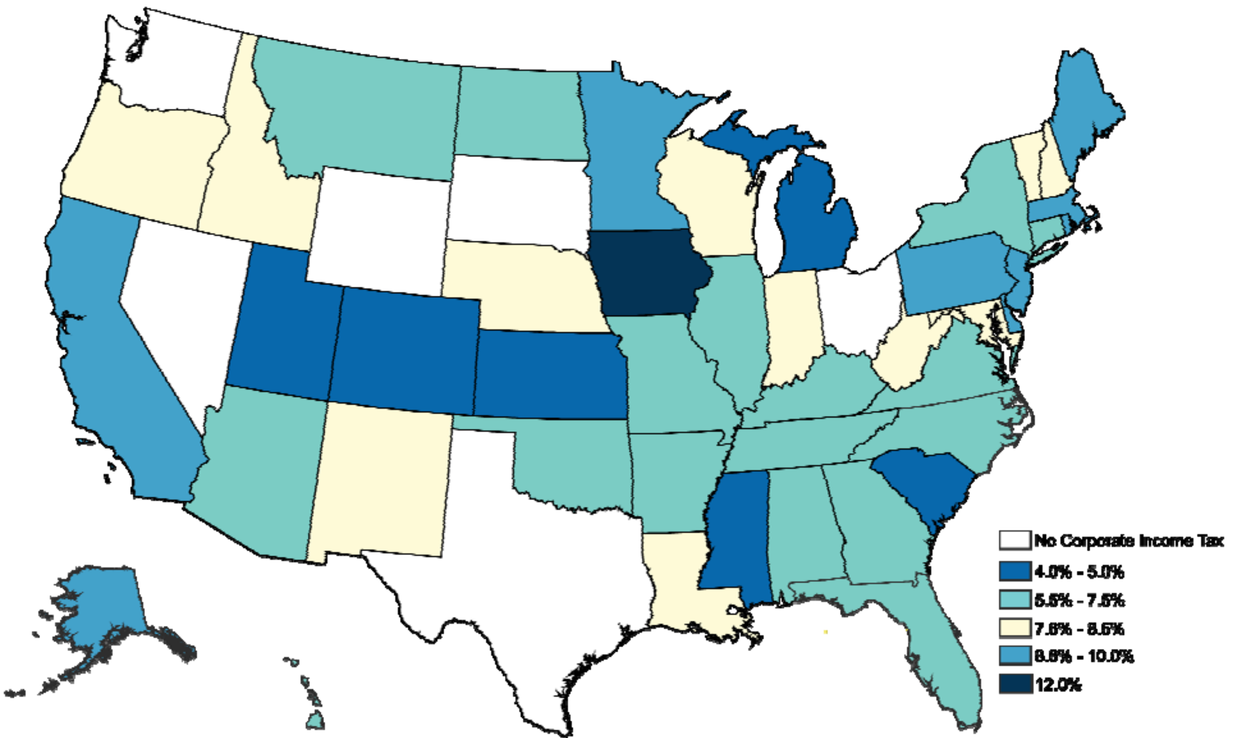
A group of related entities can file one of three ways: (1) each entity files its own separate return, (2) the group files a consolidated return, which groups entities together based on ownership requirements, or (3) the group files a combined return, which considers both ownership and business relationships to determine the filing group. Two methods are used for determining the amount of the income of a multi-state firm or group that is taxable in a particular state, depending on the type of income. Based on state statutes, regulations, and judicial rulings, nonbusinesss income, such as income from the sale of stocks and bonds held by the taxpayer as a long term investment, is *allocated* to a specific state. Ordinary business or operating income is traditionally *apportioned* across states based on a variation of the standard three-factor formula of payroll, property, and sales. The current trend is for states to at least double weight the sales factor, with a number of states using a single factor sales formula. The taxpayer calculates the amount of each factor in the taxing state versus the total amount of

[5] Three states recently adopted a tax on gross or net receipts. Michigan enacted a tax on both a corporate income and a receipts base. The focus in this report is on the CIT, and not these other taxes imposed on businesses.
[6] State assertions of nexus are subject to judicial review.

each factor in all states, applies weights to the factors, and calculates an apportioned share that is taxable in the state. A pro rata share of total income is apportioned to the state according to this ratio.

State CIT rates vary from a low of 4.0 percent in Kansas to a high of 12.0 percent in Iowa. The median state imposes a rate of just over 7.4 percent (see Figure 1).

FIGURE 1: State Corporate Income Tax Rates, 2010

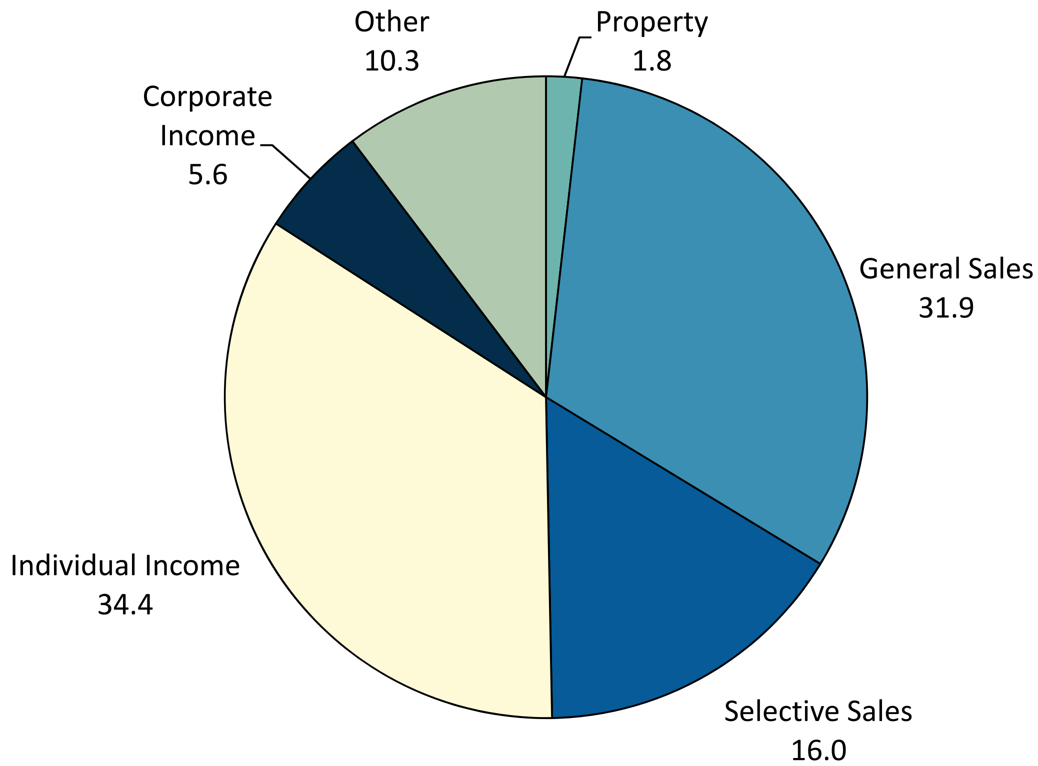


Corporate Tax Policy and Combined Reporting

State corporate income tax (CIT) revenues currently comprise only 5.6 percent of total state tax collections (see Figure 2) and just over one percent of local government taxes (almost all of which is collected by municipalities).[7] CIT revenues as a share of state tax revenues and as a share of profits have declined over the last two decades (see Figure 3), though some recovery took place during the economic expansion in the middle of the 2000s decade. There are a variety of causes for these changes, but numerous studies have not been able to isolate precisely the relative roles played by the factors. Fox and Luna (2005) find that part of this decline in CIT collections is likely due to the growing popularity of pass through entities like s-corporations, partnerships, LLCs and LLPs, which often results in the profits being taxed on individual returns. They find three additional factors that offer explanations for state corporate tax base erosion, including changes in the federal tax base, state tax policy actions, and aggressive tax planning strategies[8] (Fox and Luna 2002). They note that the trend decline in tax revenues relative to corporate profits as suggestive that tax planning is a reason for some part of the decline in the effective corporate tax rate. CIT revenues are also highly cyclical, with the revenues falling as a share of total taxes during recessions.

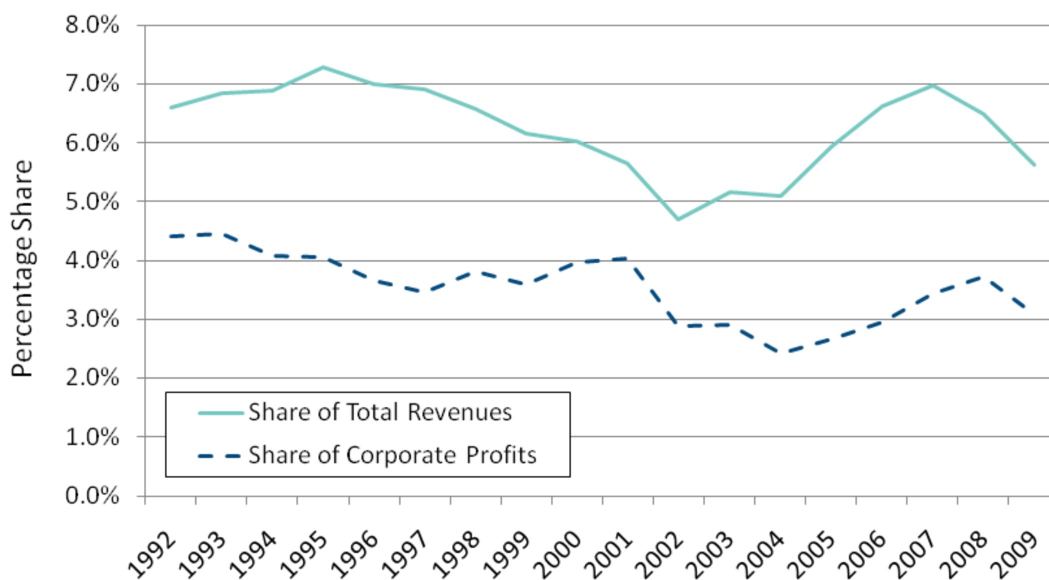
[7] The CIT is not only a modest share of total tax collections, but a relatively small share of taxes paid by businesses. Ernst and Young (2010) estimate that the CIT represents only about 9 percent of all taxes paid by businesses.
[8] Tax planning can be abusive, but much of it is firms making appropriate decisions to lessen their tax burdens.

FIGURE 2: Percentage Distribution of State Tax Collections, 2009



The longer term downward trend in revenues as a share of tax revenues, along with the decline in revenues caused by the recession, has led state policymakers to refocus their attention on all aspects of their tax system and particularly the CIT. But, state policies towards corporate income taxes have been conflicting, with some strategies apparently intended to raise additional tax revenues and others more focused on lowering taxes (at least for certain businesses) to encourage economic development.

FIGURE 3: Corporate Income Tax Revenues as Share of State Tax Revenues and Corporate Profits



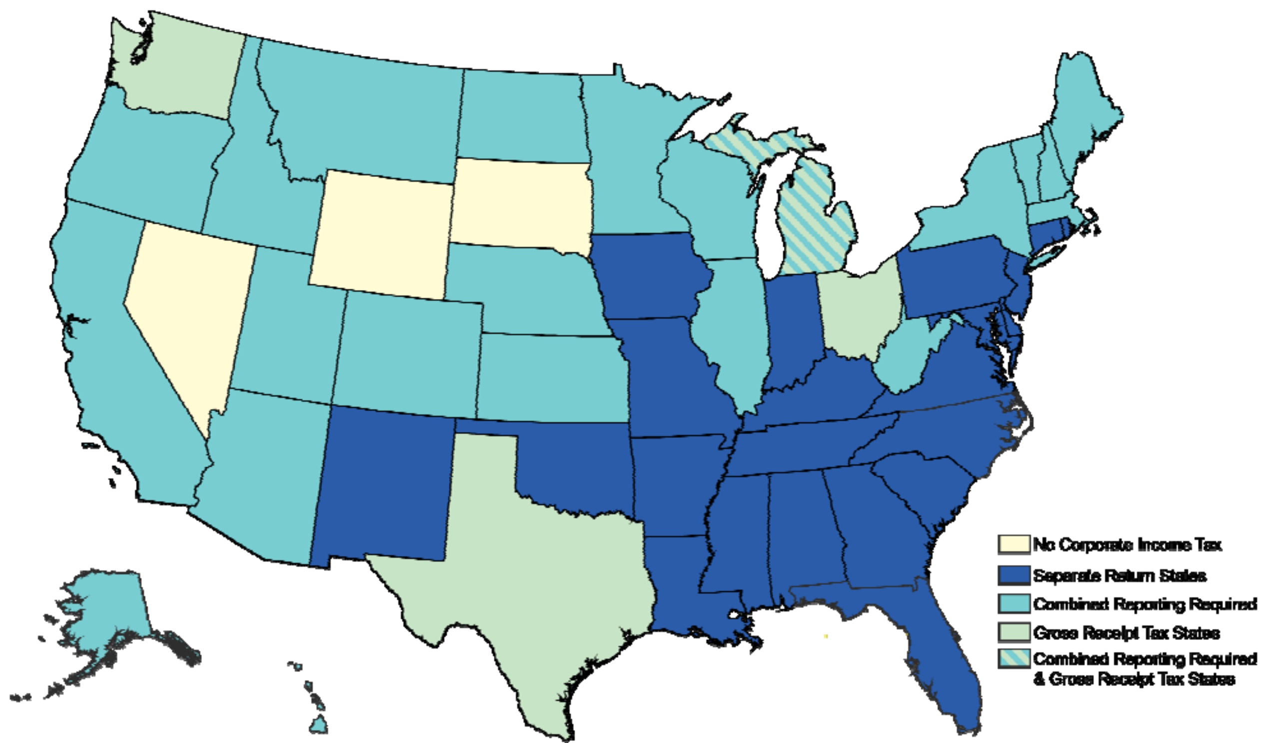
In general, states have concentrated their revenue enhancing efforts on changes that do not raise nominal tax rates or impose new taxes. These policies include efforts to broaden the set of taxpayers that are required to file in the state (such as through the gross receipts taxes or by including LLCs within the corporate tax structure) or to close perceived loopholes. Many states have implemented various policies in attempts to lessen tax planning. Among these policies are (i) rules that addback deductions associated with entity isolation strategies such as the use of passive investment companies (PICs), (ii) efforts to assert economic nexus over PICs and businesses with customers in the taxing state but no physical presence, (iii) audits of firms for transfer pricing problems or to ensure that transactions between related parties have business purposes, and (iv) imposition of combined reporting.

Combined reporting has received much of the attention in recent years based on a perception that combined reporting is an effective means of limiting tax planning. Nearly three decades passed without new adoptions of combined reporting, but six states, the first of which was Vermont in 2006, have enacted combined reporting in the last four years and thirteen states proposed it during 2009 and 2010. Figure 4 identifies the 22 states that require combined reporting.[9] In August, 2009 Wisconsin became the most recent state to enact

[9] Texas, Ohio, and Michigan (Michigan also has a corporate income tax) require combined reporting under their gross receipt tax states. Combined reporting serves a different purpose with gross receipts taxes and the discussion provided in this report does not address the issues arising with gross receipts taxes. Gross receipts tax states are excluded from our empirical analysis on revenues that is provided below.

combined reporting, effective for tax years beginning on or after January 1, 2009. Prior to 2000, combined reporting was predominately imposed only by states west of the Mississippi River (with eastern states adopting separate reporting). But with recent adoptions by Vermont (2006), New York (2007), West Virginia (2009), Michigan (2009), Wisconsin (2009), and Massachusetts (2009), separate reporting is used primarily in the Southeast and Midwest.

FIGURE 4: Mandatory Combined Reporting



Defining Combined Reporting

States must make decisions on how to determine the taxable income of related corporations. The options include separate reporting, elective consolidated reporting, and mandatory combined reporting. This section describes how combined reporting operates, contrasts combined reporting with separate reporting, and raises a series of implementation issues related to adoption of combined reporting. We discuss some of the general rules but do not attempt to give all of the rules or discuss the rules for a particular state. Combined reporting rules differ across all states and this discussion does not reflect the specifics of any state.

Combined reporting is commonly seen as a filing method because it requires certain related companies to file a single return as if related entities were collapsed into one entity.[10] However, the practical effect of combined reporting is as a method of allocating or apportioning the income of a controlled group of entities among the states in which the group does business. If the statutory requirements are met, combined reporting requires that a business report on a combined basis the operations of all related entities involved in a *unitary* business. The effect of combining those entities into a single reporting group is that the income of the group of entities is now apportioned to the states in which the group does business. Intercompany transactions are eliminated, and the taxable income of the group as a whole is determined by the aggregation of the unitary businesses. The income of multijurisdictional businesses is distributed based on the apportionment factors of the combined group. In theory, the resulting tax burden of the combined group of entities is comparable to the tax burden that would result if the entities were collapsed into a single firm, but in practice, the existence of different tax structures across states and industries can affect the tax burden. For example, tax credits and net operating losses may only be available to offset tax or income of the entity generating the losses, rather than the income of the combined group as a whole. See also the discussion of Joyce/Finnigan. Also, differences in state apportionment rules across industries can alter tax burdens.

Tables 1 through 3 illustrate a simple example that compares combined reporting to separate reporting for two related entities that both have nexus in the taxing state. For the example, we assume that both Company A and Company B are U.S. companies and are members of a unitary group. They have common ownership, and both firms have nexus in the taxing State T. State T uses a three-factor apportionment formula that double weights sales.

Table 1 presents the case where combined reporting has no effect at all on the tax paid in State T. Columns 1 and 2 show a summary of the tax returns of each entity if each entity filed a separate return. For example, the apportionment formula for Company A in a separate return state is calculated as follows: [0.64 (sales) +0.64 (sales) + 0.80 (property) + 0.667(payroll)]/4 = .6867. Using this apportioned share, $515 of company A's $750 in taxable income (.6867 X $750) is apportioned to State T. Firm B performs a similar calculation.

[10] Some states require each member of the unitary group to file their own return, but the tax is calculated based on the combined group's total income and apportionment factors.

TABLE 1: Combined Reporting Has No Effect on Tax Revenues

	A-Separate	B-Separate	Combined	A's Return	B's Return
Apportionment:					
Sales Factor:					
In-State Sales	800	7,700	8,500	800	7,700
Total U.S. Sales	1,250	15,000	16,250	16,250	16,250
Sales %	64.0%	51.3%	52.3%	4.9%	47.4%
Property Factor:					
In-State Property	1,000	3,000	4,000	1,000	3,000
Total U.S. Property	1,250	15,000	16,250	16,250	16,250
Property %	80.0%	20.0%	24.6%	6.2%	18.5%
Payroll Factor:					
In-State Payroll	500	2,000	2,500	500	2,000
Total U.S. Payroll	750	9,000	9,750	9,750	9,750
Payroll %	66.7%	22.2%	25.6%	5.1%	20.5%
Total Weighted Apportionment % (Double-Weighted Sales)	68.67%	36.22%	38.72%	5.28%	33.44%
Taxable Income Total	750	9,000	9,750	9,750	9,750
In-State Taxable Income	515	3,260	3,775	515	3,260
Total Taxable Income to State	3,775		3,775	3,775	

Column 3 presents the total tax liability that would be due under a combined return, though both companies still file separate returns but with combined factors.[11] Columns 4 and 5 present the hypothetical return that each entity would file under the combined reporting regime. Note that the numerator for the individual entities is the same under either separate reporting or combined reporting. However, the denominator changes for both Company A and Company B and represents the combined factor of both entities. Note also that in a combined reporting regime, both Company A and Company B apportion the combined income of the two firms, $9,750.

Tables 2 and 3 are added to illustrate that the total tax liability of related firms could stay the same (Table 1), go down (Table 2), or go up (Table 3) depending on the apportionment factors.[12] The in-state activity in state T is constant for Tables 1-3, and the only difference is the total U.S. payroll. In Table 2, the total U.S payroll for Company B increases from $9,000 to

[11] Some states permit a composite return to be filed for all entities in the unitary group.
[12] Also, note that the existence of profitable and loss-making firms can result in a lower combined tax liability.

$12,000. The increase in the out of state payroll factor dilutes the apportionment factor for both Company A and Company B, and results in less taxable income being apportioned to State T. In Table 3, total U.S. payroll for Company B is reduced from $9,000 to $6,000, and the result is more income is apportioned to State T. These three tables illustrate that when all firms in the unitary group have nexus with the taxing state or the state adopts a Finnigan approach, the effect of combined reporting on total state revenues is difficult to determine in advance. Some firms will pay more, others will pay less, and the total effect on state revenues is indeterminate.

TABLE 2: Combined Reporting Lowers Revenues

	A-Separate	B-Separate		Combined	A's Return	B's Return
Apportionment:						
Sales Factor:						
In-State Sales	800	7,700		8,500	800	7,700
Total U.S. Sales	1,250	15,000		16,250	16,250	16,250
Sales %	64.0%	51.3%		52.3%	4.9%	47.4%
Property Factor:						
In-State Property	1,000	3,000		4,000	1,000	3,000
Total U.S. Property	1,250	15,000		16,250	16,250	16,250
Property %	80.0%	20.0%		24.6%	6.2%	18.5%
Payroll Factor:						
In-State Payroll	500	2,000		2,500	500	2,000
Total U.S. Payroll	750	12,000		12,750	12,750	12,750
Payroll %	66.7%	16.7%		19.6%	3.9%	15.7%
Total Weighted Apportionment % (Double-Weighted Sales)	68.7%	34.8%		37.2%	5.0%	32.2%
Taxable Income Total	750	9,000		9,750	9,750	9,750
In-State Taxable Income	515	3,135		3,628	486	3,142
Total Taxable Income to State	3,650			3,628	3,628	

TABLE 3: Combined Reporting Increases Revenues

	A-Separate	B-Separate	Combined	A's Return	B's Return
Apportionment:					
Sales Factor:					
In-State Sales	800	7,700	8,500	800	7,700
Total U.S. Sales	1,250	15,000	16,250	16,250	16,250
Sales %	64.0%	51.3%	52.3%	4.9%	47.4%
Property Factor:					
In-State Property	1,000	3,000	4,000	1,000	3,000
Total U.S. Property	1,250	15,000	16,250	16,250	16,250
Property %	80.0%	20.0%	24.6%	6.2%	18.5%
Payroll Factor:					
In-State Payroll	500	2,000	2,500	500	2,000
Total U.S. Payroll	750	6,000	6,750	6,750	6,750
Payroll %	66.7%	33.3%	37.0%	7.4%	29.6%
Total Weighted Apportionment % (Double-Weighted Sales)	68.7%	39.0%	41.6%	5.9%	35.7%
Taxable Income Total	750	9,000	9,750	9,750	9,750
In-State Taxable Income	515	3,510	4,053	571	3,482
Total Taxable Income to State	4,025		4,053	4,053	

Businesses that have both profitable and unprofitable entities that will be combined for income tax purposes are a likely set to see a reduction in total tax liability with combined reporting. These firms will be able to offset income in the profitable firm with losses in the unprofitable firm. [13] But the actual tax impact for a combination of profitable firms is unclear. The final result depends not only on the income levels of firms now combined into one report but also depends on the entities' apportionment factors – sales, property, payroll.[14]

[13] Any out of state "loss" firm *without* nexus will be excluded from the combined report. See Joyce/Finnigan discussion below.

[14] For entities that operate only in one state, the total income taxed will be equivalent under both separate and combined reporting rules if all firms have identical income and tax rates are not progressive. The total tax could differ in some cases because of graduated income tax rates and other factors, but the differences will be minor in most cases. For multi-state firms, the filing method can make a more significant difference.

Practical Issues for States Adopting Combined Reporting

The examples above illustrate a simple example of combined reporting. In practice, states have many implementation options that can have significant effects on how combined reporting rules are applied in practice. These include defining the unitary group, which requires a number of specific legislative decisions, including such considerations as ownership percentages and operational relationships that must exist. States often elect to exclude certain firms, including those in the finance and insurance industries. In addition, states must decide whether to treat the individual members or the entire group as the taxpayer for purposes of apportioning income, credits, NOLs and other tax attributes (refer to the Joyce / Finnigan discussion). Further, states decide whether to implement throwback or throwout rules to capture sales that avoid tax in other states when the destination state cannot tax sales into that state. The treatment of foreign operations requires another set of practical decisions, such as whether the state allows or requires a water's edge election or worldwide combined reporting and the treatment of foreign-sourced dividends. More technical decisions include whether the state allows different apportionment formulas for various industries and how it facilitates the transition from separate reporting to combined reporting. We describe these practical issues for states adopting combined reporting in the sections that follow.

Defining the Unitary Group

Defining the unitary group is the first decision, and in practice is surprisingly difficult. Constitutional guidelines exist for determining the unitary group, but these broad guidelines allow for significant variation among the states' statutory definitions of what constitutes a unitary operation and which firms engaged in that unitary operation should be included in the combined report. Consistent with relevant judicial decisions, states can only combine corporations that are part of a unitary group. In *Butler Brothers v. McColgan*, 315 U.S 501 (1942), the United States Supreme Court developed the three unities test for defining the unitary group, consisting of unity of ownership (frequently interpreted as greater than 50 percent), unity of operation (centralized purchasing, advertising, accounting, and other staff functions), and unity of use (centralized executive force, systems of operation and other line functions). A firm must meet all three tests to be considered part of the unitary group. The Court has also looked to the existence of functional integration, centralization of management, and economies of scale within a group of affiliated entities.[15]

Both the states and the Multistate Tax Commission have sought to more specifically define what this means for real-world application. The Multistate Tax Commission model

[15] *Mobil Oil Corp. v. Commissioner of Vermont*, 445 U.S. 425 (1980).

statute seeks to make this practical by defining a unitary business as "a single economic enterprise that is made up either of separate parts of a single business entity or of a commonly controlled group of business entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts."[16]

States currently use several statutory definitions of "unitary" for purposes of combined reporting, but even in cases where the definitions are equivalent, there is significant variation in how the states and/or courts have interpreted the statutory definition. Because of the lack of bright line tests and the application of different standards, a group of corporations may be considered unitary in one state but non-unitary in others and may be unitary in one year but not the next.

Defining the unitary group is further complicated by flow-through entities, which have become increasingly popular. Business conducted by a partnership is considered to be conducted by the partners. Similar rules apply to LLCs (at least in some states) and other non-corporate entities. Furthermore, some states have the authority to force combinations in cases where the technical control tests are not met but effective control can be established by other means. States must prove that control exists in fact and excluding the entity results in an "avoidance or evasion of tax" by the taxpayer or group of taxpayers (see MTC model statutes, section 2.B).

States use different presumptions of unity for newly incorporated entities versus acquired entities. In many states, such as Wisconsin and West Virginia, newly incorporated firms are presumed to be part of the unitary group. Acquired firms are presumed to not be engaged in a unitary business. Those presumptions can be overcome, depending on the facts and circumstances in each case.

Taxpayers face a significant amount of complexity and uncertainty in determining the members of the combined group, but they also gain some tax-planning opportunities because they can allow firms to enter and exit the unitary group by strategically altering the business activities conducted within each entity. This same complexity can work in favor of state tax administrators as well. Because the rules are based on facts and circumstances considerations, state tax administrators can use the subjective rules to their advantage when defining the unitary group, often tying up audits for years (and even decades).

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[16] Multistate Tax Commission Allocation and Apportionment Regulations,(as revised through August 2, 2007), Reg, IV.1(b). Principles for Determining the Existence of a Unitary Business.

Throwback and Throwout Rules

The mechanics of the throwback and throwout rules are very different, but both seek to require a corporation to pay tax on income that another state does not tax. Whether to include these rules arises both with separate and combined reporting, though combined reporting likely reduces the cases in which the rules would arise. The *throwback rule* requires that any sale not included in the destination state's sales factor numerator must be "thrown back" to the state where the shipment of tangible personal property originated and is included in that state's sales numerator for purposes of apportionment. The *throwout rule* has a similar effect but removes the sales from the denominator, which effectively increases the weight of the sales apportionment factor in the home state. Examples of when these rules are applied include when a taxpayer does have sufficient nexus or is protected under PL 86-272, or the taxpayer's customer is the federal government.

Joyce versus Finnigan

In a combined report, all entities involved in the unitary business are combined for purposes of determining taxable income and the total apportionment factors. Two options, the *Joyce* and *Finnigan* approaches,[17] exist for calculating the sales factor numerator in a unitary combined report if any individual member of the group does not have nexus with the taxing state.[18] Under Finnigan, the group as a whole is treated as the taxpayer for apportionment purposes and all sales of members of the unitary group into the combined reporting state are included in the sales factor numerator. Under Joyce, nexus determinations are made at the level of each individual entity, and sales by an entity lacking nexus in the combined reporting state are excluded from the combined report numerator. Furthermore, tax attributes such as net operating losses and credits generated by an entity can either be available only to the entity generating the loss or credit (a Joyce approach), or to the combined group as a whole (a Finnigan approach). States may require a Finnigan approach for sales apportionment, but require a Joyce approach for other attributes, particularly net operating losses, charitable contribution carryovers, and other credits generated prior to the implementation of combined reporting. Only ten states currently use the Finnigan method, but some state tax commentators expect more states to adopt the Finnigan approach going forward in an attempt to broaden the tax base and raise revenue (Reeder et al., 2009).[19]

[17] The terms refer to two California Supreme Court rulings that addressed this issue, *Appeal of Joyce, Inc*., California St. Bd. of Equal., SBE-XIV-215, 66–SBE-070 (Nov. 23, 1966) and *Appeal of Finnigan Corporation*, Cal. St. Bd. of Equal., 88-SBE-022, (August 25, 1988).

[18] Conflicting views exist on whether Joyce and Finnigan are different methods of apportioning the income of a unitary group or are different approaches to nexus (Reeder et al., 2009). We do not express a view of this debate in this report.

[19] Finnigan states include Arizona, Indiana, Kansas, Maine, Massachusetts, Michigan, New York, Utah, and Wisconsin. California's law becomes effective January 1, 2011. Current state status on Finnigan versus Joyce is based on a series of statutory, judicial, and regulatory rulings and there may be some disagreement on which states fit into each category.

Table 4 provides an illustration of Joyce versus Finnigan. For purposes of this example, assume that Corporations A, B and C are members of a unitary group, but only Corps A and B individually have nexus in State T. Under both Joyce and Finnigan, all three firms, including the firm without nexus in the taxing state, are combined for purposes of determining the total amount of income to be apportioned and total apportionment factors. In Table 4, note that the sales factor denominator for both scenarios is $26,250. However, because C does not individually have nexus with State T, and under Joyce, the nexus determination is made at the entity level, C's sales in State T cannot be taxed by T and are excluded from the combined report numerator. Under the Finnigan approach, the nexus determination is made at the group level. Because both (or either) A and B have nexus in State T, the entire group, including Corp C, has nexus. Accordingly, the sales of all members of the unitary group are included in the numerator and denominator for purposes of apportioning income to T. In our example, the Finnegan sales numerator is $10,500 versus $8,500 with Joyce.

TABLE 4: Joyce vs. Finnigan

	A-Separate	B-Separate	C-Separate		Combined-Joyce	Combined-Finnigan
Nexus	yes	yes	No			
Apportionment:						
Sales Factor:						
In-State Sales	800	7,700	2,000		8,500	10,500
Total U.S. Sales	1,250	15,000	10,000		26,250	26,250
Sales %	64.0%	51.3%	20.0%		32.4%	40.0%
Property Factor:						
In-State Property	1,000	3,000	0		4,000	4,000
Total U.S. Property	1,250	15,000	10,000		26,250	26,250
Property %	80.0%	20.0%	0.0%		15.2%	15.2%
Payroll Factor:						
In-State Payroll	500	2,000	0		2,500	2,500
Total U.S. Payroll	750	9,000	6,000		15,750	15,750
Payroll %	66.7%	22.2%	0.0%		15.9%	15.9%
Total Weighted Apportionment % (Double-Weighted Sales)	68.7%	36.2%	10.0%		24.0%	27.8%
Taxable Income Total	750	9,000	6,000		15,750	15,750
In-State Taxable Income	515	3,260	0		3,775	4,375
Total Taxable Income to State		3,775			3,775	4,375

The different state approaches to the Joyce versus Finnigan and throwback and throwout rules produce some interesting and undesirable possible situations from the perspective of creating a consistent tax measure for states. For example, a sale from a Joyce state with a throwback rule to a Finnigan state can be included in the sales factor numerator in both states. Conversely, a sale from a Finnigan state to a Joyce state can be excluded from both states' sales factor numerators. In the former case, sales are taxed twice, and in the latter case the income escapes taxation.

Most states that have combined reporting rules employ a throwback rule, which adds the sales of items that are not or cannot be taxed at the destination to the origin state's numerator. West Virginia is an exception to the general rule and combines the Joyce rule with a throwout rule. The result may be perverse. Sales by a related firm to a state where it does not have nexus are not added to the numerator because of the Joyce rule. However, with a throwout rule, those sales are also deducted from the combined report denominator. The resulting apportionment factor ignores the out of state sales, but the income from those sales is fully included in the amount to be apportioned. The result is that West Virginia pulls in the income, but excludes the out of state sales factors that would normally dilute the amount apportioned to West Virginia.

International Considerations

The treatment of foreign affiliates is an important issue for states and for those firms with significant overseas operations. States elect to tax or exclude foreign entities as they permit or require businesses to make water's edge elections – an election to limit the combined report to operations within the U.S. Three states (Massachusetts, Utah, and West Virginia) allow firms to elect world-wide combined reporting (WWCR), [20] and four states (California, Idaho, Montana, and North Dakota) have mandatory WWCR unless the firm has elected water's edge treatment.[21] The remaining combined reporting states require firms to file on a water's edge basis, except for Alaska that requires WWCR for oil, gas, and pipeline companies.

In practice, water's edge elections or requirements are only partially intended to exclude foreign operations or entities from the combined report. While the water's edge election allows a unitary group to exclude foreign firms from the combined report, the foreign source income of domestic firms often is included. Furthermore, foreign firms with significant domestic activity can be included in the combined report despite a water's edge election or

[20] In general, the taxpayer cannot revoke the election for a certain number of years; the number of years varies among states but lock in periods of seven to ten years are common.
[21] The U.S. Supreme Court upheld the constitutionality of WWCR (See *Container Corporation of American v. Franchise Tax Board*, 103 S. Ct. 2993 (1983).

requirement. For example, West Virginia, California, and others require water's edge electing groups to include foreign firms that have an average of 20 percent or more of payroll, property and sales in the U.S. Some states also have a provision that requires foreign service firms to be included in the combined report if 20 percent or more of the entity's gross income is from intangible property or service related activities, but only if the income is deductible for U.S. federal purposes by other members of the unitary group.

The water's edge options address operating income and the related apportionment factors. A largely independent consideration for taxpayers with foreign source income or foreign affiliates is the treatment of foreign sourced dividends. In *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance (*1992), the Supreme Court ruled that states cannot levy a higher tax on foreign source dividends than on domestic dividends. In practice, states that offer a dividends received deduction for domestic sources also must offer equivalent breaks to dividends from foreign sources. Further, states that do not follow federal law and instead fully tax dividends between related parties may also fully tax dividends from foreign sources.

If the dividends are subject to the state CIT, two additional questions arise. The first question is whether to apportion or allocate the dividend income. The courts have ruled that apportioning income is only appropriate if the foreign affiliate is a part of a U.S. unitary group. If the foreign affiliate is not part of the unitary group, dividends will typically be allocated to the state in which the taxpayer's headquarters is located. Second, if the dividends are apportionable, how does the domestic unitary group calculate the apportionment factors? Specifically, can the unitary group include the property or payroll factors of the dividend paying entity in the numerator and or denominator of the unitary group's corresponding apportionment factors? Further, how are dividends treated for sales factor purposes? Do they add to the numerator and denominator, or are dividends simply added to the income to be apportioned?

Transition Issues for States Adopting Combined Reporting

As new states choose to move from separate reporting to combined reporting, a number of transitional issues must be addressed. Relatively simple examples include issues such as how to treat prior year overpayments and how to calculate safe harbor estimated payments. More difficult questions involve tax attributes, including net operating losses and tax credits that were generated prior to combined reporting being enacted in a state. Should those tax benefits be available to the combined group as a whole, or only to the entity that

created the benefit?[22] It is inconsistent with the premise of combined reporting to argue that for purposes of taxable income, separate legal entities are disregarded and all members of the unitary group are combined and treated as one, but for purposes of utilizing loss and credit carryforwards, the legal separations between entities matter. Thus, on an ongoing operational basis, the tax attributes should apply to the combined group, but this is a separate issue from how attributes created during separate reporting years are to be treated after transition to combined reporting. Combined groups reap a tax saving windfall at the expense of state tax revenues if they include unprofitable entities that bring net operating loss and credit carryforwards into the group at the time that combined reporting is adopted. On the other hand, significant compliance costs arise if the combined firm is required to keep entities separate within the combined group.

The enactment of combined reporting may result in an increase in a combined group's net deferred tax liability. As a result, states switching to combined reporting may want to include provisions for preventing distortions in financial reporting. For example, Massachusetts' law provides for a deduction in an amount necessary to offset the increase in the group's net deferred tax liability resulting from the change to combined reporting. Transition issues also arise when a firm acquires or sells a new business. As stated previously, firms and state administrators can take advantage of the subjective standards when the unitary group changes on an annual basis. State legislators must develop transitional rules not only to combat tax planning but also to protect firms from decisions made by tax administrators.

Effect of Combined Reporting on Tax Planning

Large, multi-state businesses have become quite adept in the modern economy at structuring their operations in a way to transfer income to low or no tax states. When the income shifting is accompanied by location decisions, the result is capital mobility and competition between states to attract businesses. Combined reporting rules are not intended to blunt the adverse revenue impact of actual changes in the location of factors of production that result from state differences in taxing business activity. Instead, some states favor combined reporting to combat what they believe is abusive income shifting made possible by the creative use of affiliate entities and various transfer pricing schemes that transfer income without the movement of factors of production. Combined reporting arguably closes loopholes that allow artificial income shifting. We address the effects of combined reporting on economic activity and tax revenues below.

[22] Harley Davidson reported a $22.5 impact of Wisconsin moving to combined reporting, which altered their use of existing tax attributes.

The passive investment company (PIC) strategy is a common planning tool that illustrates the need for combined reporting or some mechanism to limit abuses. The PIC strategy entails businesses locating intangible assets such as a trademark or a trade name in separately incorporated PICs generally located in a no-tax or a low-tax state. The PIC may not have much more than a post office box with few employees and no physical assets. The PIC charges operating entities, located in separate filing states, for the use of the intangible asset. The royalty expense is generally deductible as an operating expense; however, the income earned by the PIC is not taxed (if located in a state such as Delaware that does not tax royalty income), resulting in the creation of income that is not taxed in any state.

Table 5 presents a simplified example of the PIC strategy and how combined reporting defeats this planning technique. For purposes of this example, we begin with the same facts as Table 1, and assume that newly formed Passive Investment Company C is a PIC incorporated in Delaware and its sole function is to hold intangible assets and charge operating entities for the use of this intangible asset. The only "office" in Delaware is a P.O. Box and the functions of PIC C – managing the intangible assets – are assumed by existing employees. The only activity of PIC C is charging the operating entity, Company B, $6,000 per year for the use of intangible assets. Taxable income for Company B is reduced by $6,000, but the income earned by PIC C is not taxable in Delaware.[23] Under separate reporting rules, the royalties paid to the PIC reduce the income taxed by State T by $6,000. The total income taxable in State T is reduced from $3,775 (See Table 1) to $1,602.

However, under combined reporting, the intercompany royalties are eliminated, and PIC C has no activity and no taxable income for combined reporting purposes. Furthermore, the intercompany sales of PIC C are excluded from the combined report sales factors. The result of the combined report is that forming PIC C does not affect the group's state taxable income – PIC C is disregarded for tax purposes.

[23] Delaware does not tax the income of corporation whose activities in the state are confined to the maintenance and management of intangible assets and the collection and distribution of the related income.

TABLE 5: PIC Strategy

	A-Separate	B-Separate	PIC-C Separate	Combined	
Nexus in State T	**Yes**	**Yes**	**No**		
Apportionment:					
Sales Factor:					
In-State Sales	800	7,700	0	8,500	
Total U.S. Sales	1,250	15,000	6,000	16,250	*
Sales %	64.0%	51.3%	0.0%	52.3%	
Property Factor:					
In-State Property	1,000	3,000	0	4,000	
Total U.S. Property	1,250	15,000	0	16,250	
Property %	80.0%	20.0%	0.0%	24.6%	
Payroll Factor:					
In-State Payroll	500	2,000	0	2,500	
Total U.S. Payroll	750	9,000	0	9,750	
Payroll %	66.7%	22.2%	0.0%	25.6%	
Total Weighted Apportionment % (Double-Weighted Sales)	68.67%	36.22%	0.00%	38.72%	
Taxable Income Total	750	3,000	6,000	9,750	
In-State Taxable Income	515	1,087	0	3,775	
Total Taxable Income to State		1,602		3,775	

* Note that the sales of PIC C are entirely intercompany sales to B. Accordingly those sales are eliminated from the tax base for combined reporting purposes and are excluded from the group denominator.

Legislation has thwarted the PIC strategy in many states, but there are other planning techniques that are available and have generally not been legislatively closed, including a REIT strategy that involves transferring the title to real estate related assets to tax advantaged states or entities and charging operating entities rent with the income being non-taxable. The combined reporting rules are a broad attack on income shifting plans since a combined report collapses the separate entities into one for purposes of determining taxable income and the apportionment factors.

Even if states successfully target the most egregious practices one-by-one, this does not entirely eliminate the arguments for combined reporting versus other means of tax planning. Any transfer price between related companies is subject to manipulation for tax purposes. And in cases where there is no attempt at manipulation, transfer prices can still be a significant item in dispute during audit. In the common situation where goods or services are transferred

without an independent reference price (that is, the good or service is not sold at arm's length), the company must make a determination of value added at each transfer point. Obviously much of this determination is subjective and subject to challenge by income tax auditors who have an incentive to move income into the taxed state just as companies have an incentive to move income to the lowest tax location. The combined report eliminates this uncertainty for both revenue departments and taxpayers because the intercompany transaction is eliminated for income tax purposes and the overall combined income of the unitary group is subject to apportionment and tax.

Implications of Combined Reporting for Financial Reporting

Firms subject to Financial Interpretation Number 48 (hereafter "FIN 48") will have to consider this new pronouncement in their financial statements and related disclosures.[24] The first effect may be to make aggressive tax planning less desirable because it reduces the financial statement benefit. Beginning January 1, 2007, FIN 48 requires publicly traded firms to record a liability for an uncertain tax position.[25] For example, if a firm takes a tax position that might be successfully challenged during audit or litigation, the dollar amount of the potential tax, interest, and penalties that would be owed must be properly disclosed.[26] Furthermore, for FIN 48 purposes, firms must assume that every uncertain position will be audited and that examining jurisdictions have full knowledge of all facts and circumstances. These disclosures substantially reduce the attractiveness of taking aggressive tax positions because the tax saving arising from uncertain tax positions must be treated as a cost for financial reporting purposes. Firms are generally not required to report publicly the reason for state tax charges unless states pass legislation requiring such a report. Gupta et al. (2008) examine state corporate effective tax rates and find that FIN 48 helped slow the trend in multistate tax planning aggressiveness.

At the same time, due to the complexity of combined reporting, firms may find new FIN 48 issues arising. All of the practical issues of combined reporting discussed above could create uncertain tax positions under FIN 48. For example, the definition of the unitary group is subjective by nature and taxpayers and revenue departments have competing incentives in defining the unitary group. FIN 48 may require firms to calculate the tax liability of the unitary group under multiple scenarios and disclose a financial statement liability for the worst case scenario proposed by state auditors. Resolving these disputes can take years.

[24]FIN 48 was recently codified as Accounting Standards Codification 740, but practitioners still refer to the pronouncement as FIN 48.
[25] FIN 48 only applies to income taxes.
[26] Recognition of a tax benefit must have a more than a 50 percent chance of being sustained (i.e., "more likely than not.") For any tax position not meeting this threshold, the full amount of the tax benefit is recorded as a FIN 48 liability.

Is Combined Reporting Good Tax Policy?

The following four sections evaluate combined reporting along four dimensions. First, we consider whether separate reporting or combined reporting is more likely to result in a consistent measure of corporate profits across firms, both from a national perspective (and potentially worldwide) and from a state perspective. A consistent measure of profits is necessary to ensure even or neutral tax treatment of business. Second, we analyze the implications of combined reporting for administration of the CIT by state revenue departments and compliance by the taxpayer. Specifically, we examine the new compliance and administration responsibilities that arise under combined reporting. Third, we evaluate whether the output of state economies is affected by adoption of combined reporting. Finally, we estimate the implications of combined reporting for state CIT revenues.

We do not seek to reach a specific conclusion about whether combined reporting is good tax policy. Instead, we analyze each of these four areas, recognizing that they provide distinctive information regarding the desirability of combined reporting as an aspect of state CIT policy. Not surprisingly, these different components of the tax policy decision can, and do, point in somewhat different directions. Thus, the legislative challenge is to weigh the importance of the factors in each state to determine the best policy for that state.

Combined Reporting and Measurement of Business Income

Corporate tax bases need to accurately measure the taxable profits of corporate taxpayers relative to one another so that corporate income taxes distribute the tax burden across taxpayers in proportion to their share of statewide corporate profits. The intent is to ensure that economic activity is taxed evenly across all sectors of the economy. Economists say that the tax burden is *neutral* across industries if the same tax burden is levied on all industries. Simply, this means that imposition of the tax does not favor one industry relative to another, but investment in each industry is taxed in a consistent fashion. Neutral taxation prevents encouragement of investment in some industries relative to others because of differential implicit tax burdens. Varying tax burdens could arise because of explicit state policy choices to favor certain industries or certain types of entities, such as LLCs, but the uneven tax burdens could also result from unintended consequences of specific elements of the tax structure such as throwback rules or approaches to depreciation. Non-neutralities that arise should be limited

to those with a legislatively determined public purpose, and not because of unintended outcomes.[27]

The choice between separate reporting and combined reporting in terms of neutrality depends on which results in the more accurate measure of corporate profits. The total tax liability of a unitary business would generally be the same under combined reporting or separate reporting if (i) all members of the unitary group earn a profit, (ii) all members of the unitary group operate entirely within the taxing jurisdiction, and (iii) corporations are taxed with a flat tax rate that contains no zero bracket amount.[28] These conditions preclude firms from using their corporate structures or differences in tax structures across states to plan their tax liability.

However, the tax burden differs between separate reporting and combined reporting if one or more of these three elements is lacking, such as with multistate and multinational businesses that operate in jurisdictions with different tax structures. On a conceptual basis the combined return is generally expected to yield a more accurate relative measure of corporate tax bases if at least one of these elements is not in place. The presumption is that a unitary group's income cannot be properly measured by undertaking separate accounting for each business in the group. Combined reporting in actual practice may also fail to yield an accurate measure of corporate profits, so the conceptual preference for combined reporting is likely relative and not absolute.

Three well known issues exist with separate reporting that are at least partially solved by requiring firms to file on a combined basis. First, a potential problem with separate reporting is that some members of the unitary group may earn profits and others may experience losses. In this case, separate reporting results in too much income being taxed. The unitary business can use the losses of one entity to offset profits of a related entity if combined returns are filed, but losses will be currently unutilized if separate returns are filed. With separate returns, the unitary business is taxed on the total earnings of the profitable firms alone and with combined returns the firm is taxed on the earnings of *all* related businesses, including the loss making firms. The total taxable income of all entities with separate reporting exceeds the earnings of the entire company (by the sum of losses), and the tax liability is too high.

Second, shared costs may not be easily divisible across entities within the unitary business, resulting in some related firms netting more profits than they actually earn (because

[27] Many economists would also argue that it is best to avoid altering the tax burden across industries to achieve a public purpose. The key argument is that state governments do not have all of the information necessary to identify which industries should be winners and losers. Further, political considerations rather than economic factors may drive determination of the winners.
[28] Separate and combined reporting would also lead to the same total state tax liabilities for firms that operate in multiple states as long as the tax structures of the states are identical.

they are not allocated all of their costs) and others netting too little profit (because they are allocated more of the costs than they actually bear). Jointly purchased services (such as accounting or economic consulting services) and costs associated with the headquarters functions, such as the CEO and CFO, are among the costs that are difficult to precisely share. [29] Thus, with separate returns the distribution of the overall profits across states depends on which of the related members operate in a particular state and the associated apportionment factors. The tax base in a particular state could be either too large or too small because profits are calculated inappropriately for individual members. Combined reporting properly accounts for the costs (since the profits are effectively calculated as the sum of all revenues minus all costs), and the total earnings are accurately measured. Then, the remaining issue is whether the apportionment formula fairly distributes profits of the unitary business across states.

Third, in many cases a company operates multiple businesses because of the synergies associated with the various activities. These synergies often result in economies of scope, which can be thought of as the reduction in costs or gains in production that result from a firm producing related but different goods and services. The firm can assign the profits associated with these economies of scope to the businesses depending on the transfer prices that are established between the related entities. In many cases there is not likely to be any basis on which to assign the profits among the firms because at least part of the profits result from the synergies between the entities and not from the activities of any firm alone. A key issue then is that there may be no way to accurately separate the costs between the firms because it is not possible to know which of the related businesses is responsible for the economies of scope. Firms are able to allocate profits between the entities on whatever basis the firm considers appropriate, but of course, the results are subject to audit. The second and third issues raised here are the transfer pricing problem discussed in the previous section.

The problems with separate reporting described above arise even if corporations develop their overall set of operating structures solely for business purposes because there may not be a consistent means for determining the profits of the individual businesses. These problems become more troublesome if businesses choose to use the array of possible business organizations to plan their tax liabilities.

The foregoing discussion demonstrates that separate reporting will often not result in a consistent measure of corporate profits for multijurisdictional firms. Tax liabilities that are due will be distorted both across multi-jurisdictional firms and between multi-jurisdictional firms and single state firms, depending on the extent to which these issues (including tax planning) arise. Combined reporting is intended to avoid the problems of losses in some operating

[29] For example, in the case of headquarter functions, the entity in which the functions are performed is charged with the expense even if the functions relate to nationwide activity across several entities. Intercompany charges can spread the expense, but they are subjective and susceptible to measurement errors and or manipulation.

entities and the need to use transfer prices to account for shared costs and economies of scope. Further, it is expected to reduce tax planning.

Combined reporting may not overcome the problems with separate reporting unless the combined group includes all related businesses. The combined group may not include all related firms because of judicial or Congressional limitations or because of state statutes that implement combined reporting. Judicial findings based on the facts of a particular case could preclude some firms from being in the unitary group even if there are some economic relationships between the various firms. The courts may rule the relationships do not reach the minimum standards for unitary, even if the economic relationships affect earnings or the transfer prices do not accurately reflect true prices. Congressional actions can also preclude related firms from being in the unitary group. Firms protected by PL 86-272 are an example, at least under Joyce rules. Many structural elements built into state statutes also limit the ability of combined reporting to result in accurate profit measures within a state. For example, water's edge combined reporting generally excludes foreign affiliates from the combined group.[30] Domestic members of the unitary group will also be excluded from the combined report in several circumstances, either because of nexus constraints (e.g., Joyce rules) or because the type of entity is statutorily excluded, such as is often true for firms engaged in the finance or insurance industries.

If some affiliates are excluded from the combined report, some of the limitations associated with separate returns will apply to returns filed under a combined reporting regime. The ability of firms to plan their tax affairs given constraints on the combined group increase the likelihood that combined reports will fail to accurately measure profits. Practical problems of defining the combined group, as described in a previous section, further complicate the performance of combined reporting.

Finally, combined reporting is limited by the effectiveness of the apportionment formula. Combined reporting increases the chance that a firm must apportion income because corporations formed to do business in a single state will be combined with firms operating in other states. The result is that the income of all firms in the combined report is apportioned even if all the activity of a particular entity (or entities) is within a single state. With separate reporting, there is no need to apportion the income of an entity that has activity only in one state.

States have used several tools to lessen the weaknesses of separate reporting as an alternative to requiring combined reporting (or in addition to combined reporting). As

[30] Even with water's edge elections, states may require foreign entities with substantial U.S. presence to be included in the combined report.

described above, states use techniques such as adding deductions for related companies back, asserting nexus over PICs, and auditing transfer prices.

States could also consider the use of special audits in certain situations. For example, there may be circumstances in combined reporting states where the combined report does not accurately reflect income appropriately attributable to the state. In such circumstances, states could consider allowing taxpayers to use separate reporting, which might be informed with special private sector audits. The reporting system would be based on a separate return system, but companies would have internal accounting rules that ensure transfer prices between affiliated companies accurately reflect the actual income producing activity in the state. An independent third party, such as an auditing firm, would review and certify these results, and the corporation would bear the cost of such an audit. It is important to note that some states already require special tax audits to verify certain deductions and tax credits. For example, 20 states require an independent CPA review of the film production costs before a taxpayer may claim a film production credit, and six states require certification or taxpayer reimbursement of state expenses related to eligibility verification under certain circumstances. Similar private sector audits could also be undertaken to verify intercompany transfer prices. States would have to revise their statutes to allow for the use of such an audit and would have to provide detailed guidelines that state revenue departments, taxpayers, and independent auditors would be required to follow.

Combined Reporting and Administration and Compliance

Businesses objecting to the proposed implementation of combined reporting rules frequently cite increased complexity and uncertainty and the associated increase in compliance costs as their primary complaints. This section discusses many compliance and administrative issues that arise with combined reporting to illustrate by example the source of additional compliance costs. Higher state administrative costs and more skilled administrative activities are also expected. The most onerous burdens predominately arise in the task of defining the members of the unitary group and can hold up finalization of an audit for years.[31] Additional complexity is introduced in determining which members of the unitary group are included in the combined report, the taxable income of the unitary group, and allocating or apportioning the taxable income among the states in which the entities do business.

[31] For example, the representatives of one company interviewed for this report mentioned that an audit of their combined group is still unresolved after more than two decades.

Determining the Unitary Group

This section evidences some of the complexities in complying with combined reporting by describing examples of the often complex rules for determining the unitary group and how these rules can vary across states. In general, a company will be included in a combined report if it meets the following conditions: (1) the entity is part of a commonly controlled group, (2) the entity is conducting a unitary business with one or more entities in the group, and (3) the entity is not specifically excluded. To be in a commonly controlled group of corporations, most states require that the controlling corporation own more than 50 percent of the corporation's stock,[32] either directly or indirectly.[33] Determining if an entity meets the requisite ownership requirements is an objective task and relatively straightforward in most cases.

For those entities that meet this ownership threshold, the next step is examining the business relationships between the entities for evidence that the operations are unitary, or, as the MTC model statute phrases it, "sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit…." There are some objective factors that will indicate such a relationship, such as significant intercompany transactions or the transfer of significant assets between corporations, but most of the tests are very subjective.

Based on a series of Supreme Court decisions, states use a combination of different tests for identifying a unitary business: (1) the three unities test (unity of ownership, operation, and use), (2) the dependency / contribution test, and (3) the factors of profitability test. These tests are often subjective, overlapping, and varied among the combined reporting states. The Supreme Court did not provide a bright line test, but it declared that the prerequisite for a unitary group is a "flow of value, not a flow of goods." Kansas, for example, follows the dependency / contribution test. It looks at the out-of-state operations to see if those operations either benefit, or are benefitted by, the Kansas operations, or whether the business in Kansas is dependent on, or contributes to, the out-of-state business. If either of these tests is true, the entities are part of a unitary group.

In other states, taxpayers and auditors take a slightly different approach and address whether a firm makes a non-trivial contribution to another member's profitability and whether economies of scale and scope between members are present. Indicators of these factors include assisting with asset acquisitions, lending and guaranteeing assets, providing technical and strategic advice and sharing of intangible property. Other signs of a unitary business include centralized purchasing, marketing, advertising, and accounting; intercorporate sales

[32] Or have more than a 50 percent ownership interest if the entity is not a corporation.

[33] The stock attribution rules of Internal Revenue Code Section 318 are often used to determine if indirect ownership exists. Parent-subsidiary chains of corporations and brother-sister corporations are examples of commonly controlled groups.

and leases; services; debts; and use of proprietary materials. Finally, auditors must review centralized management policies, such as common employee and executive training programs, common recruiting, hiring, and personnel policies, and common employee benefit programs.

In addition to the three primary tests discussed above, states may make a series of presumptions regarding whether members of the ownership group (those owned more than 50 percent) are members of the unitary group. For example, Wisconsin presumes that a group of commonly owned persons or entities are part of a unitary business when the group's activities are all in the same general line of business, the members are engaged in different steps of a vertically structured enterprise, or there is strong central management coupled with centralized departments or affiliates with financing, advertising, or purchasing functions. The list of presumptions is straightforward, but their application will be difficult in a number of circumstances. Furthermore, a newly-formed corporation is presumed to be in the unitary business from the formation date in Wisconsin, but acquired corporations are presumed to be outside the unitary group in the year of acquisition.

The unitary group in one state might or might not carry over to determining the unitary group in other states. The statutory language can vary and so can guidelines handed down by the courts whose decisions are typically only binding on taxpayers within narrow geographic areas. However, the positions taken by states and taxpayers in other filings can matter. For example, Wisconsin presumes that if a taxpayer files a combined report in another state, that taxpayer will be required to file a combined report in Wisconsin. Furthermore, although Wisconsin has no statutory requirement that taxpayers consistently define the members of the unitary group in each state, Wisconsin taxpayers must list each entity that is either included in a combined report in another state and excluded from the Wisconsin report, or included in the Wisconsin report but excluded from the combined report in another state. Clearly, Wisconsin is concerned when taxpayers take a position in Wisconsin that differs from that taken in another state and reserves the right to challenge if this is an inconsistency.

The practical effect of the rules is that taxpayers and state revenue officials must go far beyond the presence or absence of economic transactions between related parties to determine the unitary group. Officials must have a detailed understanding of operational factors such as ownership and operational charts, intercompany reporting requirements and communications, the responsibilities and day-to-day duties of executives at the entity and group level, flows of funds, and intercompany loans or guarantees. In short, taxpayers and auditors are tasked with determining the benefit, if any, each related entity derives from being in the ownership group and where these benefits originate. Arguably, all members in a commonly controlled group of business entities derive objective or subjective benefits from being a member of that group. Whether these benefits are sufficient to establish unity is the

immensely difficult question that must be answered each year for every entity within the ownership umbrella. Both taxpayers and auditors must update this analysis annually to account for changes in ownership structure and operational relationships. Further, given the conflicting incentives of taxpayers and revenue departments, differences of opinions will inevitably arise with no clear way to resolve them.

Once the unitary group is defined, taxpayers must determine which members are eligible or required to be included in the combined report. Firms that might be, but not always, excluded from combined reports include those with a special apportionment method, such as insurance and finance companies and special entities, such as REITs, RICs, and REMICs. As discussed above, a water's edge election, if available, will exclude foreign firms, and/or domestic firms with significant foreign operations, but the exclusions are not absolute. Depending on the level of U.S. based activity, a water's edge election does not prevent some foreign entities from being included in the combined report. Anti-abuse provisions, such as those targeted at firms that receive a significant amount of service or intangibles related income, sometimes mandate the inclusion of entities that would otherwise be omitted from the combined group.

We use New York as an example to demonstrate the complexity of these tests. New York identifies a 10 step process that begins with determining all members of a related group and then examines the intercompany relationships between them (Exhibit 1).[34] Each step identifies entities that have significant relationships with individual members of the unitary group or the group as a whole. Entities that meet a minimum threshold are added to the group at each step. As the unitary group gets larger, the potential number of entities that have significant interaction with that expanding group gets larger as well. The example in Exhibit 1 illustrates this process. The combined group in Step 2 is four corporations; by Step 10, the group consists of 13 corporations. Excluded corporations can form their own unitary groups, and a member can be part of more than one unitary group. New York may also require a combined report with a related corporation even if there are no substantial intercompany transactions if the revenue department determines that a combined report is "necessary to properly reflect the taxpayer's…tax liability because of intercompany transactions or some agreement, understanding, arrangement or transaction. "

[34]Exhibit 1 is an excerpt from guidance published by the New York Office of Tax Policy Analysis, Taxpayer Guidance Division (TSB-M-08(2)C. The appendix includes the 10 step process as well as one example provided to illustrate the concepts.

Calculating and Reporting the Income of the Combined Group

Calculation of taxable income for the group is complicated first by practical issues such as combining the operations of multiple entities and eliminating intercompany transactions. If there are intercompany transactions between the unitary group and firms outside the group, taxpayers must still deal with transfer pricing issues. These tasks are complicated by corporations and pass-through entities that are not wholly owned by common owners. Furthermore, companies within an ownership group often have different fiscal year ending dates and accounting methods. Combining these disparate entities into one report presents a number of practical, operational issues that do not exist when each entity files separately. As with any filing method, businesses must determine whether income is apportionable (generally income from ongoing operations) or allocable (most often, allocable income is non-business income or income from the sales of assets that is not part of ongoing operations, such as the sale of a plant or office building).

The documentation and reporting requirements under combined reporting can also be onerous. Massachusetts, for example, has sixteen separate schedules for combined report filers and hundreds of pages of specific instructions. Each member of the unitary group prepares its own schedule of income and expense, with eliminations and adjustments that are reconciled to federal income. The combined report is generally the sum of these individual forms, but financial and non-financial companies (e.g., manufacturing firms) utilize different reporting schedules and are subject to different apportionment factors and tax rates. Another example where a combined report differs from a simple summing of the group's taxable income arises when the unitary group cannot utilize tax attributes (e.g., NOLs, tax credits) from members that generated the tax loss or credit in a pre-combined reporting tax regime. In this case, many states require firms to track the attributes to the specific corporation as if it were a separate company. A flowchart that was prepared by the Massachusetts Department of Revenue to summarize the reporting process is attached (See Exhibit 2).

Transition Issues

Filing and auditing combined returns requires a different set of skills and practices from those necessary to file separate returns. The audit staff in states that adopt combined reporting must be trained to audit the combined group and the combination of income rather than to focus on considerations like transfer pricing and the business purpose of PICs. For example, the audit group is required to discern how the various entities within a combined group operate, relate to one another and are organized. This can be very different expertise from the accounting skills more commonly used for separate reporting. Significant investment will often

be necessary to develop a staff that is capable of undertaking these audits and in some states it may be a significant challenge to develop a staff with the expertise necessary to effectively audit complicated businesses. Further, states need to develop new complicated forms and instructions, such as those illustrated for Massachusetts. All of this requires significant investment in administration. Expenditures on good administration are essential so that firms believe that they are being treated fairly and revenues are collected. But, these expenditures also represent resources that do not go to the bottom line of businesses nor allow states to provide better schools and infrastructure.

Businesses will also face significant start up costs associated with adoption of combined reporting. Many large multistate firms are already filing combined reports in some states so they understand the process. Their main challenge is to learn the specifics of combined reporting in the new state and to change their systems to accommodate the differences. Moderately sized more localized firms may not have filed combined reports before. They will need to develop the appropriate expertise and skills and begin filing returns in a new way. As with costs borne by the states, the additional resources needed to develop new skills and file different returns will reduce the bottom line for the corporation. Of course, small, single entity firms may see little or no difference in the way they file returns.

Combined Reporting and State Economic Performance

Statistical Approaches to Analyzing Combined Reporting

This section analyzes the effects of combined reporting on state economies and the following section addresses effects on state corporate tax revenues. These two sections are linked because we use similar and related statistical techniques to estimate the effects. We believe that statistical analysis of the actual experience of states that have adopted combined reporting is the only means of judging how economic activity and revenues are affected.

A number of states have undertaken estimates of the revenue implications of combined reporting by analyzing how a sample of current tax filers would be affected by adoption of combined reporting. States without combined reporting have either obtained data from a state which imposes combined reporting or have asked firms to report information on how they would file a combined return if one were required. The former approach has involved selecting a small sample of firms that operate in both the combined reporting state (Minnesota has been used as an example) and the prospective state. The information from returns filed in the combined reporting state together with the data from returns filed in the prospective combined reporting state are used to estimate tax liability in the prospective state.

Despite the apparent attractiveness of this approach for estimating revenues, it cannot be used to obtain reliable estimates of how combined reporting would affect revenues for several reasons. First, statistical analysis that is used to extrapolate to the entire population of corporations must be based on random samples of firms. The sample firms used by states in these analyses have generally been chosen because data are available for matching across the states and because the firms' tax liability is large. Effectively, the samples were chosen in a non-random fashion and in part based on the very feature of interest – the amount of tax revenue raised. Conclusions obtained from the analyses cannot be extrapolated to determine the overall effect on a state's tax revenues without a statistical correction for the lack of randomness.

Second, the combined group can often differ across states, as described above, depending on the unitary characteristics of the firms. Therefore, the set of related firms that file a combined return in one state need not parallel those filing a combined return in another state. So, the combined group and the denominator used in the apportionment factors obtained in one state need not apply in another state. The problems arising from lack of randomness and identification of the combined group do not arise if firms are required to file information for a prospective return (such as in Maryland) but firms file the information without the need to carefully consider the combined group. Firms may alter their corporate structures and find other ways to change their returns if they were compelled to file a combined return with actual tax implications.

Third, the effects of combined reporting on tax revenues must be studied in a dynamic setting that allows the economic activity of firms to change and allows for the possibility that firms may use other tax planning techniques to reduce their tax liability. The presence of combined reporting may change where firms operate, or the extent of operations in a location, and may alter the tax planning strategies undertaken by firms. Analysis based on previously filed tax returns (or prospective information) by its very nature is static, and does not allow for any behavioral changes on the part of taxpayers, whether they are in the way the firm structures its operation or in the extent to which firms operate in the state.

Finally, and related to the third point, static analysis of individual firms' tax liabilities does not permit estimation of how the state economy is affected by adoption of combined reporting. By its very nature, the approach only focuses on tax revenues and effectively assumes that firms do not respond to the tax structure.

We conclude that careful statistical analysis of how various state tax policies affect tax revenues and the economy is the only means for obtaining reliable estimates on how these factors are affected by combined reporting. The approach involves developing a database for the 48 continental U.S. states plus the District of Columbia that includes information on corporate tax revenues, economic activity (as measured by GDP), characteristics of state tax

systems, and other factors that can influence taxes and economic activity. The statistical analysis is conducted for the 42 states with a CIT for the years 1993 through 2009.[35] Then, we use statistical techniques to identify the effects of combined reporting, while holding constant other factors that might influence state tax revenues and the economy.[36]

Statistical Estimates of Combined Reporting

The effects of combined reporting on economic activity within a state can be examined by studying how state Gross Domestic Product (GDP), a broad measure of state production, is affected by adoption of the policy.[37] The analysis requires identifying all of the factors that can influence the performance of state economies and tax revenues so that the effects of combined reporting can be isolated from the influence of other economic and tax characteristics. Thus, a relatively large set of variables is included in the statistical analysis. Table 6 lists the fiscal factors that are expected to affect state economies and specifically state GDP.[38] Variables are also included for each year and each state to account for factors that systematically influence the economy but are not accounted for by the other variables.

TABLE 6: Variable Names and Acronyms

Variable	Acronym
State private gross domestic product	GDP
Top corporate income tax rate	CIT rate
Top personal income tax rate	PIT rate
Sales tax rate	Sales tax rate
Sales apportionment weight	Sales apportionment
Combined reporting	Combined reporting
Allow limited liability companies	LLC
Enforce throwback rules	Throwback rule
Allow deductibility of federal tax	Federal deductibility
Addbacks to the corporate income tax	Addback
Per person state government expenditures	Govexp

[35] Michigan implemented a CIT beginning in 2008, but we exclude Michigan from the empirical analysis of tax revenues for the entire time period.
[36] We conduct the analysis using two-stage least squares and fixed effects for time and state.
[37] The analysis focuses on private sector GDP, and not total GDP because higher tax revenues will result in a correspondingly larger public sector GDP.
[38] Other variables in the GDP equation include size of neighboring states, state median income, state population density, per worker manufacturing wages, and energy prices.

Table 7 provides the detailed statistical estimates for the interested reader. Table 8 contains the general direction of the various state tax policies for readers interested in the design of policy. The estimated effects are provided based on two equations. The first column of Tables 7 and 8 examine how each factor individually influences the economy. The second allows the various characteristics of the corporate tax structure to have interrelated effects on state economic activity. The following discussion focuses on characteristics of state corporate income taxes, and specifically the effects of combined reporting as seen in column 2, which permits examination of interrelated components of state tax structures. Only factors that have a statistically significant effect are discussed. It is important that readers consider the entire set of influences arising from any specific tax policy, rather than looking at each coefficient in column 2 by itself. For example, combined reporting must be analyzed in terms of its direct influence and its effect through its interaction with the CIT rate.

TABLE 7: Determinants of State Gross Domestic Product

Variable	No interactions	Interactions
Combined reporting	-0.023	0.185**
CIT*Combined reporting		-0.026***
Combined reporting*Sales appt		0.000
Combined reporting*Throwback		0.049
Combined reporting*Neighbors having combined reporting		-0.040
Neighbors having combined reporting	-0.018	0.006
Addback	-0.049***	-0.043***
CIT rate	-0.001	0.047***
CIT*Sales apportionment		-0.001***
CIT*Throwback rule		-0.018**
Sales apportionment	-0.001**	0.004***
Throwback rule	0.014	0.097
PIT rate	-0.010***	-0.006**
Sales tax rate	-0.010*	-0.011**
LLC	-0.057***	-0.057***
Federal deducibility	-0.030	-0.035
Neighboring states relative size	0.000	0.000
Population	0.000***	0.000***
Per capita Income	0.013***	0.014***
Population density	0.000***	0.000***
State expenditure per capita	-0.002	-0.001
Average wage for manufacturing workers	-0.020***	-0.018***
Energy price	-0.001	0.000
Constant	11.739***	11.368***
Observations	784	784
Adjusted R-squared	0.964	0.966

Note: All models include fixed effects for state and year.

***, **, * significant at 1%, 5%, and 10% level of confidence, respectively.

TABLE 8: Determinants of State Gross Domestic Product

Variable	No interactions	Interactions
Combined reporting		
CIT rate > 7.4 percent		-
CIT rate < 7.4 percent		+
Addback	-	-
CIT rate		-
Effect more negative if state has combined reporting, throwback rule and higher sales apportionment		
PIT Rate	-	-
Sales tax rate	-	-
Sales apportionment	-	
CIT rate > 4 percent		-
CIT rate < 4 percent		+
LLC	-	-
Throwback rule		
More negative at higher CIT rates		-
Population	+	+
Per capita Income	+	+
Population density	+	+
Average wage for manufacturing workers	-	-

Note: All models include fixed effects for state and year.

***, **, * significant at 1%, 5%, and 10% level of confidence, respectively.

The findings reported here are best understood in light of an existing extensive body of economic research that finds higher corporate income taxes reduce state economic activity.[39] This means that states should expect policies that raise more revenue from corporations and businesses to lower economic activity. It also implies that characteristics of the CIT structure that raise effective tax rates result in lower state GDP. A variety of the results reported below confirm the expectation that those specific elements of the corporate tax structure that result in higher business taxes harm the economy.

Combined reporting is found to have no effect on state economies when it is measured separately (column 1). However, when interacted with the CIT rate, combined reporting harms state economies at higher tax rates, and specifically at tax rates that are approximately above the national median corporate income tax rate (which is 7.4 percent). Combined reporting is found to have no additional effect when linked with other policies such as a throwback rule.

Statistical analysis of this type identifies the effects by looking at how the economy is influenced in states where a change in policy takes place. Thus, we cannot measure the effects in states that imposed combined reporting throughout our period of analysis, which spans from 1993 through 2009. As a result, we are primarily measuring the effects arising from the recent

[39]For example, see Michael Wasylenko (1997). Similar results have also been found for higher taxes at the national level.

adoption of combined reporting in Vermont and New York. New York's tax rate is just below the median and Vermont's is above the median. Other adopters have implemented the policy too recently for the effects to be measured in the data. This suggests that additional study is warranted as years pass, and it is possible to study New York and Vermont for more years and to examine other adopting states. Nonetheless, it is important to note that the effects of combined reporting are examined in the context of the corporate income tax as it is levied by states across the continental United States.

Addback requirements are seen by states as at least a partial alternative for combined reporting as a means to lessen tax planning.[40] Addbacks apply to specifically identified intercompany expenses, such as royalties, interest, and management fees. When addbacks are required, these intercompany transactions are essentially eliminated and the intercompany expense is disallowed for state income tax purposes. We investigate the effects of addback requirements on state GDP and find they have a strong negative effect on GDP. States implement a range of different addback requirements, with some requiring only addback of royalty payments and others extending the expectation to include interest payments and other intercompany expenses. For statistical purposes we defined the addback variable in two ways. First, the variable used in Tables 7 and 8 is a broad addback obligation that includes royalties, intangible-related interest, intercompany interest, and management fees. Currently, twelve states implement addbacks that are at least this extensive. Second, we examine the effect of any form of addback, which extends the variable to include 25 states (though the results are not reported in the tables). The results are very similar for both specifications of this variable, suggesting that addbacks have their influence through their effect on the business climate more than by increasing the actual tax costs. The results displayed below in Tables 9 and 10 show that a broad addback requirement is more effective than a narrow requirement at raising tax revenues.

Addback legislation has been implemented in more states and has been in effect over more years since 1993 than the recent adoptions of combined reporting. The research results for addbacks may be suggestive of the direction of effects that combined reporting will have when it can be studied across a longer window.

In the interaction model (column 2), increased weight on the sales factor increases economic activity, but the effect falls with the tax rate and is negative at relatively low state CIT rates.

The effects of high *nominal* or statutory tax rates are not found to be perverse in the equation with no interactions between elements of the tax structure (column 1). The main

[40] Addbacks are predominately (though not exclusively) used in separate reporting states as a partial alternative to combined reporting. Legislators target the expenses that they view as potentially abusive. For example, see the PIC strategy discussed above.

lesson of this finding is that nominal tax rates are not necessarily good indicators of the effective rate imposed on corporations. Components of the tax structure that increase the *effective* rate result in a loss in economic activity, so the effect of the tax rate for any particular state must be interpreted in terms of the overall tax structure. Indeed, throwback rules, sales apportionment and combined reporting reduce economic activity when combined with higher tax rates. Throwback rules do not appear to have an effect on economic activity when evaluated alone, but reduce economic activity when evaluated together with the tax rate, meaning throwback rules lower GDP more as the tax rate rises.

Economic activity is also found to be somewhat higher in larger states, higher income states, and more densely populated states. These results are consistent with greater economic output in states with higher aggregate demand. Economic activity is lower in states with higher manufacturing wages. This is consistent with less production in states with higher business operating costs, when all else is held constant.

Combined Reporting and State CIT Revenues

We analyze how combined reporting affects state CIT revenues in two ways. First, we report data on how state tax revenues responded in years after adoption of combined reporting to see if anecdotal evaluation of the data evidences a change in tax revenues. Second, we use more sophisticated econometric techniques, similar to those used in the discussion of combined reporting and GDP, in an effort to examine how combined reporting affects state tax revenues when isolated from all other influences.

Combined reporting can potentially affect state tax revenues through several channels. First, combined reporting can lead to a more accurate measure of corporate profits, such as by allowing corporations to offset some of the earnings in profit making affiliates with losses in others. Combined reporting can also disregard the technical problems of setting proper transfer prices. These effects should lead to greater tax liability for some combined groups and smaller revenues for other groups. The influence on total tax revenues is not certain, but there is no reason to expect a revenue increase from this channel. Second, combined reporting can help close or lessen the tax benefits from certain tax planning activities. This should increase tax revenues to the extent that combined reporting is an effective tool for closing loopholes. Third, tax revenues are expected to fall to the extent that adoption of combined reporting harms the state’s economy.

Performance of Tax Revenues With Combined Reporting

As noted above, we are only able to investigate performance of tax revenues after adoption of combined reporting in New York and Vermont.[41] These states have had combined reporting long enough to allow the revenues to be collected for at least the first year after the new requirement.

New York and Vermont each made several changes in their corporate tax structure in the years around adoption of combined reporting, confounding the revenue effects. The tendency of states to change multiple characteristics of their tax system at the same time emphasizes the need to use econometric techniques, where the effects of each policy can be isolated, to determine the effects of combined reporting. New York adopted combined reporting for tax years beginning in 2007 for companies with substantial inter-company transactions. New York also switched from double weighting on the sales factor to 60 percent weight in 2007 and subsequently to 100 percent weight on the sales factor. Vermont adopted combined reporting beginning with tax years after 2006. In addition, Vermont moved from equal weighting on the factors in the three factor formula to double weighting on the sales factor beginning in 2006. Vermont also lowered the highest marginal corporate income tax rate from 9.75 percent in 2005 to 8.9 percent in 2006 and 8.5 percent in 2007.

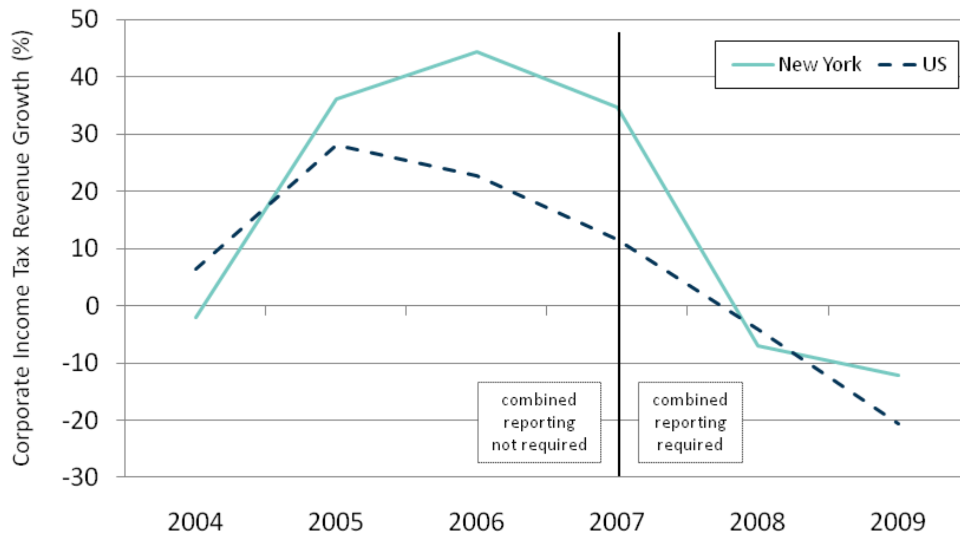
Corporate tax collections in New York (Figure 5) and Vermont (Figure 6) were growing at rates comparable to the national average, leading up to their policy changes. Any effect on revenues from adopting combined reporting is expected in the fiscal year after the tax year of adoption – that is, a change effective with tax year 2006 should be seen in state revenues in fiscal year 2006-07.[42] So, tax revenues should be analyzed beginning in the year after adoption. Collections were generally falling in New York and Vermont in the years after they adopted combined reporting, as they were in other states. Analysis of the data trends suggests that revenue patterns for both states were similar to the national average both before and after adoption of combined reporting.

Other recent adopters, Massachusetts, West Virginia, and Wisconsin, are still in the first year with combined reporting because each state adopted the policy for tax years beginning in January 2009. As we are writing this report, corporations are still paying tax liabilities associated with the 2009 tax year, so we do not have sufficient information on how corporate taxes are performing in these states and we also do not have the capacity to analyze the changes in these states using the statistical model. Nonetheless, tax collections through May 2010 in Massachusetts and April 2010 in Wisconsin are suggestive that revenues are performing better

[41] We are unable to examine how CIT revenues were affected by adopting combined reporting in Michigan in 2008, because the state did not have a CIT in earlier years.
[42] A small effect on revenues could be felt during fiscal year 2005/06, depending on the change in quarterly payments in the first half of calendar 2006.

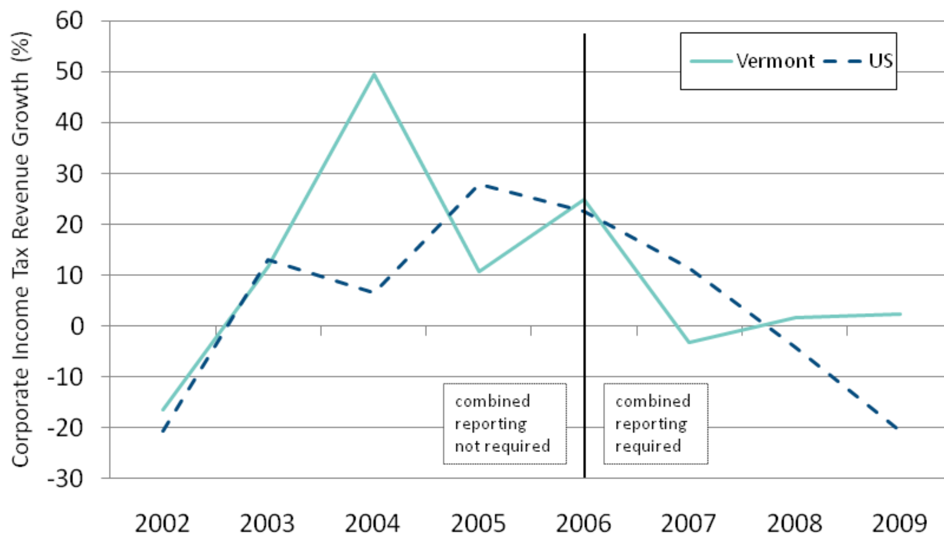
in these states after adoption of combined reporting than in the average state around the U.S. But, there are many possible explanations for this pattern.

FIGURE 5: New York Corporate Income Tax Collections



Source: US Census Bureau

FIGURE 6: Vermont Corporate Income Tax Collections



Source: US Census Bureau

Statistical Analysis of Revenue Effects

This section seeks to determine the effects of combined reporting on CIT revenue while holding constant the level of economic activity. Thus, we estimate how effective combined reporting is in helping state revenue departments capture tax revenues that are due from taxpayers (which could be either an increase or decrease relative to separate reporting), which results from the combination of more accurate measurement of company income and the closing of tax planning. Then, we address how tax revenues are affected by changes in the state economy resulting from adoption of combined reporting. Finally, we bring these two impacts together to yield an overall conclusion on how tax revenues are affected.

Table 9 reports statistical analysis of the relationship between combined reporting and corporate income tax revenues and Table 10 reports the general direction of the various state tax policies. These results are based on study of corporate income taxing states in the continental U.S. plus the District of Columbia.

We find combined reporting has no direct effect on tax revenues (the first two channels described above), whether tested by itself (column 1 of Tables 9 and 10) or when interacted with other variables (column 2). As noted above, the direct effect of combined reporting is essentially based on New York and Vermont adopting combined reporting relatively recently. The regression based analysis is consistent with the anecdotal evidence shown above; there is no evidence to this point that combined reporting is increasing tax revenues, given the size of the state economy.

The statistical analysis concludes that a one percentage point increase in private sector GDP raises CIT revenues by about 0.7 percent. This finding can be linked with the effects of combined reporting on GDP to identify a second influence on tax revenues – as GDP is changed so are tax revenues. The GDP discussion above finds that combined reporting could help the economy at low CIT rates, and hurt the economy at rates approximately above the current state median. This indicates that states with rates above the median will collect lower tax revenues than predicted and states with rates below the median may see some revenue increase. In summary, the findings indicate that any effect of combined reporting on state tax revenues is coming through the influences on state GDP, and there is no independent effect on the ability of state revenue departments to collect tax revenues.

Addback requirements are found to have a very strong positive influence on tax revenues. The analysis reported in Tables 9 and 10 focuses on a broad addback requirement that includes royalties, intangible-related interest, intercompany interest, and management fees. A separate analysis was performed based on all states that have at least a narrower addback, and specifically those requiring addbacks of royalty and intangible-related interest

payments. The estimated revenue increases from the narrower addback were much smaller and were not statistically significant in the first equation (without the interaction effects). The difference between the two addback findings evidence that requiring firms to addback more of the expenses associated with related PICs generates more revenues. Of course, this simply means that tax revenues rise when tax deductions are curtailed or eliminated.

The statistical results indicate that addback requirements are a more effective means of raising state tax revenue than is combined reporting.[43] The tax planning opportunities that remain with combined reporting together with the difficulty of determining the unitary group and of auditing compliance with combined reporting may mean it is a less effective means of generating revenue. Alternatively, as noted above, the conclusion for addbacks may be suggestive that we will find that combined reporting is more effective at raising tax revenues when we are able to study more adopting states for longer time periods.

The research also finds that throwback rules raise tax revenues. However, the revenue benefits of throwback rules diminish with higher tax rates and become negative with a rate above 10 percent.

TABLE 9: Determinants of State Corporate Income Tax Revenue

Variable	No interactions	Interactions
Combined reporting	0.153	0.407
CIT*Combined reporting		0.004
Combined reporting*Sales appt		-0.002
Combined reporting*Throwback		-0.336
Neighbors having combined reporting	0.093	0.033
Combined reporting*Neighbors having combined reporting		0.166
Addback	0.082**	0.122***
GDP	0.891***	0.673**
CIT rate	0.066***	0.083*
CIT*Sales apportionment		.0001***
CIT*Throwback rule		-0.100***
PIT rate	-0.013	-0.006
Sales tax rate	-0.038*	-0.044*
Sales apportionment	-0.001	-0.008
Throwback rule	-0.010	0.999***
Federal deducibility	-0.077	-0.072
LLC	-0.002	0.008
Neighboring states relative size	-0.001*	-0.001*
Constant	2.446	4.665
Observations	672	672
Adjusted R-squared	0.812	0.698

Note: All models include fixed effects for state and year.

***, **, * significant at 1%, 5%, and 10% level of confidence, respectively.

[43] We separately investigated the interrelated effects on tax revenues of having both combined reporting and addbacks. We found no additional impact from the two policies together.

TABLE 10: Determinants of State Corporate Income Tax Revenue

Variable	No interactions	Interactions
Combined reporting	No Effect	No Effect
Addback	+	+
GDP	+	+
CIT rate	+	+
Throwback rule		
CIT rate > 10 percent		-
CIT rate < 10 percent		+
Sales tax rate	-	-
Sales apportionment		
More positive at higher CIT rates		+
Neighboring states relative size	-	-

Note: All models include fixed effects for state and year.

***, **, * significant at 1%, 5%, and 10% level of confidence, respectively.

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Exhibit 1
New York State Department of Taxation and Finance 10-Step Analysis of the Combined Group

This excerpt is taken from New York State Department of Taxation and Finance, Office of Tax Policy Analysis, Taxpayer Guidance Division. TSB-M-08(2)C, March 3, 2008.

10-Step Analysis
Use the following steps to determine whether a combined report is required and, if so, which corporations are in the combined group:

1. Every taxpayer must identify all of the corporations to which it is related. When one or more of the related corporations are taxpayers, identify all of the corporations related to these taxpayers. Do this until all related corporations have been identified. If a taxpayer has no related corporations, it must file on a separate basis. This constitutes the Step 1 group of related corporations.

2. Identify all of the related corporations that have substantial intercorporate transactions with any taxpayer identified in Step 1. These related corporations and the taxpayers constitute the Step 2 tentative combined group.

3. Add to the Step 2 tentative combined group every related corporation that has substantial intercorporate transactions with any corporation identified in Step 2. This constitutes the Step 3 tentative combined group.

4. Add to the Step 3 tentative combined group every related corporation that has substantial intercorporate transactions with any corporation identified in Step 3. Repeat this process until it adds no more corporations to the group. This constitutes the Step 4 tentative combined group.

5. Identify each related corporation not in the Step 4 tentative combined group that has substantial intercorporate transactions with another related corporation not in the Step 4 tentative combined group. Compare all such groups and combine into one group those with common members ("unattached related group"). There may be more than one unattached related group.

6. If there are substantial intercorporate transactions between any one corporation in an unattached related group and the Step 4 tentative combined group, then all corporations in that unattached related group are included in the combined group. Do this for each unattached related group. As unattached related groups are included in the combined group, do this analysis between the expanded group and each unattached related group. The resulting group is the Step 6 tentative combined group.

7. If there are substantial intercorporate transactions between any one corporation in the Step 6 tentative combined group and an unattached related group, then all corporations in

the unattached related group are included in the combined group. Do this for each unattached related group. As unattached related groups are included in the combined group, do this analysis between the expanded group and each unattached related group. The resulting group is the Step 7 tentative combined group.

8. Add to the Step 7 tentative combined group each related corporation that has substantial intercorporate transactions with the Step 7 tentative combined group.

9. Repeat the processes set forth in Steps 4, 6, 7, and 8 until no more corporations can be added to the tentative combined group.

10. Eliminate from the tentative combined group those corporations that are formed under the laws of another country (alien corporations), that are taxable pursuant to a different article of the Tax Law (or would be taxable under a different Article if subject to tax), and corporations that compute their business allocation percentage using a statutory method that is different from the taxpayer's (for example, aviation corporations and railroad and trucking corporations compute their business allocation percentage using a different statutory method than manufacturing corporations). Also eliminate any REIT or RIC included in the tentative combined group, unless that REIT or RIC is required to file a combined report under section 209.5 or 209.7 of the Tax Law with a taxpayer that is required to be included in the tentative combined group. If two or more like corporations are eliminated, it is possible that they will constitute a combined group if they have substantial intercorporate transactions. For example, one group could consist of trucking corporations and another group could consist of manufacturing corporations. However, the law provides that alien corporations are not to be included in a combined group.

Example of the 10-step analysis. The State of New York provides the following (Example 4) as an example of the 10-step analysis discussed above.

Example: A is the only taxpayer, and 50% of A's receipts are from B, with another 4% from E. 30% of E's expenditures are to A and 20% to D. C has no transactions with anyone in the group. 50% of D's receipts are from A. 50% of F's receipts are from A. 100% of H's receipts are from F. 100% of R's receipts are from H. 20% of B's receipts are from L, 20% from M, and 20% from N. 100% of L's receipts are from M. 100% of M's receipts are from N. 40% of O's receipts are from R and 30% are from D. 60% of P's receipts are from O. 80% of L's expenditures are to Q. All of these corporations are in the Step 1 group of related corporations because they meet the stock ownership test.

The Step 2 tentative combined group consists of A, B, D, and F. As a result of Step 3, H is added to the tentative combined group. As a result of Step 4, R is added to the tentative combined group.

As described in Step 5, L, M, N, and Q is an unattached related group and O and P is an unattached related group.

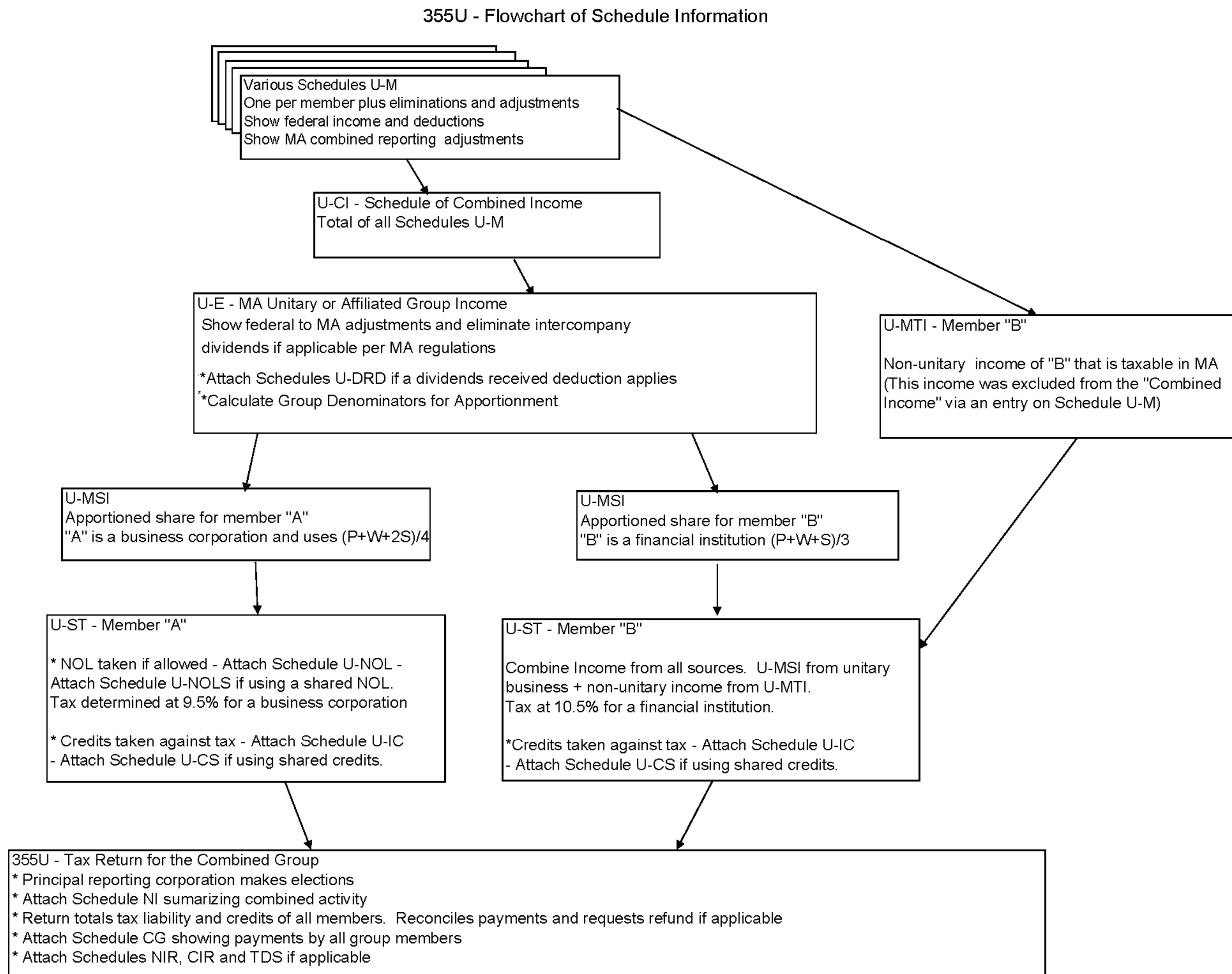
Corporations O and P are added to the tentative group pursuant to Step 6 because 70% of O's receipts are from R and D. The Step 6 tentative combined group is A, B, D, F, H, R, O, and P.

The corporations in the unattached unrelated group of L, M, N, and Q are all added to the tentative combined group pursuant to Step 7 because B has substantial intercorporate transactions with the unattached related group of L, M, N, and Q. The Step 7 tentative combined group is A, B, D, F, H, R, O, P, L, M, N, and Q.

Pursuant to Step 8, E is added to the Step 7 tentative combined group because 30% of its expenditures are from A and 20% are from D. The Step 9 tentative combined group is the same as the Step 8 tentative combined group.
Since no corporations will be excluded from the Step 9 tentative combined group pursuant to Step 10, the group of corporations that must file a combined report are A, B, D, F, H, R, O, P, L, M, N, Q, and E.

Exhibit 2

Massachusetts Department of Revenue Combined Reporting Flowchart



Source: http://www.mass.gov/Ador/docs/dor/Forms/Corp09/355u/Flowchart.pdf