State *of* Louisiana

TAX INSTITUTE

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REPORT TO THE LOUISIANA LEGISLATURE ON CORPORATE INCOME TAX COMBINED REPORTING

IN RESPONSE TO Directives Contained In the Report Issued On January 27, 2017 by
The Task Force on Structural Changes in Budget and Tax Policy
Created By **HCR 11 OF 2016 FIRST EXTRAORDINARY SESSION**

Published by

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From the State of Louisiana Tax Institute

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June 14, 2019

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Senator John Alario
President of the Senate
P.O. Box 94183
Baton Rouge, LA 70804

Re: HCR 11 of 2011

Dear Mr. Speaker and Mr. President:

The Louisiana Tax Institute respectfully submits its report to the legislature in response to the 2011 House Concurrent Resolution No. 11, relative to the recommendations made by the Task Force on Structural Changes in Budget and Tax Policy in its Final Report (submitted on January 27, 2017).

The Task Force also recommended the Tax Institute study the restructure, phase out or elimination of the corporate franchise tax and present its findings by January 2019. While this report is not yet complete, the Tax Institute anticipates the report will be ready for presentation in the upcoming months.

Thanking you in advance for your patience and consideration, we remain,

Sincerely,
Members of the Louisiana Tax Institute

LOUISIANA TAX INSTITUTE

REPORT TO THE LOUISIANA LEGISLATURE ON CORPORATE INCOME TAX COMBINED REPORTING

IN RESPONSE TO Directives Contained In the Report Issued On January 27, 2017 by The Task Force on Structural Changes in Budget and Tax Policy Created By **HCR 11 OF 2016 FIRST EXTRAORDINARY SESSION**

Prepared For the Louisiana Legislature
And Submitted On April 10, 2019
Baton Rouge, Louisiana

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June 14, 2019

MANDATORY UNITARY COMBINED REPORTING

I. General Background

HCR 11 of the 2016 First Extraordinary Session of the Louisiana Legislature created the Task Force on Structural Changes in Budget and Tax Policy ("Task Force") and directed the Task Force to make recommendations regarding Louisiana's budget practices and tax policies. In fulfilling its duties, the Task Force issued a report on January 27, 2017 and included the following corporate income tax directive to the Louisiana Tax Institute ("Tax Institute").[1]

> *Corporate tax recommendations:*
>
> *(2) Direct the Department of Revenue, with the Louisiana Tax Institute, to study moving from single-entity taxation on the corporate level to a system of combined reporting with findings due by January 2019.*[2]

Combined corporate income tax reporting may take several forms, including consolidated reporting, nexus combination reporting, and mandatory unitary combined reporting ("MUCR"). The 2017 Task Force directive to the Tax Institute to study combined reporting is widely understood to mean a directive to study the MUCR form of combined reporting. Henceforth in this report, all mentions of combined reporting unless otherwise noted are references to MUCR. The theoretical basis for MUCR, its advantages and disadvantages, and the potential impact of MUCR on Louisiana corporate income tax collections are all discussed in more detail later in this report.

Pursuant to the Task Force directive and beginning in March 2017, the Louisiana Department of Revenue ("LDR") and the Tax Institute undertook a study of MUCR and its potential impact on Louisiana.

II. Louisiana's Current Corporate Income Tax Convention: Separate Entity Return Filing

Louisiana has historically followed a separate entity corporate income tax reporting methodology ("separate reporting"). Separate reporting requires each corporation and each entity subject to

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[1] The Louisiana Tax Institute was created as an advisory board on tax-related matters within the Louisiana Department of Revenue pursuant to Act No. 568 of the 2016 Regular Session of the Louisiana Legislature.

[2] This passage is excerpted from *Louisiana's Opportunity: Comprehensive Solutions for a Sustainable Tax and Spending Structure,* issued by the Task Force.

Federal income tax ("FIT") as a corporation that has Louisiana income tax nexus, to file a separate Louisiana corporation income tax return.[3]

Entities with Louisiana income tax nexus that are subject to FIT as corporations are subject to Louisiana's corporation income tax ("CIT") base rate of four percent on the first $25,000 of Louisiana net income. The tax rates then progressively increase on the next three tiers of income, topping out at an eight percent rate on income in excess of $200,000. CIT returns are presently due on or before the fifteenth (15th) day of the fifth (5th) month following the close of an accounting period (May 15th for a calendar year taxpayer).

A corporation filing a Louisiana income tax return must disclose its federal taxable income, federal income tax, gross revenues, total assets and other information that appears in its federal income tax return.[4] Louisiana Schedule B is used to calculate a Louisiana multistate taxpayer's Louisiana income tax apportionment percentage. Louisiana Schedule D is used to calculate net income, which starts with a corporation's various sources of gross income that are then reduced by allowable deductions. Net income is then subject to additional adjustment such as loss carryforwards and the FIT deduction. Also on Schedule D, income is classified as either allocable income or non-allocable income. Louisiana Schedule E requires corporate taxpayers to reconcile financial statement income to Louisiana taxable income. Louisiana Schedule F requires corporate taxpayers to reconcile federal taxable income to Louisiana taxable income. Louisiana taxable income is then used to determine the amount of Louisiana income tax owed, after considering the effects of any available income tax credits, prior income tax payments, etc.

Apportionment aside, Louisiana CIT collections are therefore determined by activities conducted in Louisiana by entities actually conducting business in Louisiana and not by the activities conducted by entities without Louisiana income tax nexus.

III. Louisiana Corporate Income Tax Collections – Recent History

An eleven year compilation (FY 2006-07 to FY 2016-17) of CIT cash collections from LDR's various Annual Reports indicates that CIT collections are highly variable (Figure 1). CIT collections hit a low in FY 2010-11. While CIT collections in FY 2013-14 showed a quick rebound, collections declined again in FY 2014-15 to lows that closely resembled FY 2010-11. Continuing the trend of volatile variability, CIT collections in FY 2016-17 were 58% higher than the previous fiscal year.

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[3] This requirement applies irrespective of whether an entity taxed as a corporation has net income. Also, Subchapter S Corporations and certain other qualifying pass-through entities, including partnerships, limited liability companies and limited liability partnerships, may exercise the option of causing their individual, non-corporate taxpayer owners to pay Louisiana income tax at individual income tax rates through their owners' individual income tax returns. Such returns are not the subject of this report.

[4] If a corporation filing a CIT is included in a federal consolidated income tax return, it must prepare its CIT using information from a *pro forma* separate federal income tax return.

This eleven-year review clearly demonstrates that the CIT has not been a predictable and stable source of tax revenue for Louisiana.

Louisiana is not the only state to exhibit variability of corporate income tax collections. State corporate income tax is by its very nature subject to a high level of fluctuation. Corporate income tax collections in other states, both separate reporting states and MUCR states, also demonstrate a high level of variability.

Although no single factor explains the variability in CIT collections during the FY 2006-2017 period, a myriad of contributing factors can be identified. These factors include the following in no particular order of relevance:

- The 2008 economic downturn and its lingering effects on business
- The 2010 Louisiana oil spill disaster
- Multiple Louisiana Amnesty Programs
- Oil and gas commodity prices at depressed levels for an extended period
- Continued erosion of CIT collections with credits and incentives
- Apportionment methodologies that source income out of state
- Inability of the CIT system to capture income from changing forms of commerce
- Tax planning that sources otherwise taxable income outside of Louisiana.

IV. Recent Legislative Changes to Address Corporate Income Tax Variability

In response to both the variability and the level of CIT collections, multiple statutory changes have been made to Louisiana's separate reporting methodology in the last four years. These changes include in no particular order of relevance:

- Adjustment to the CIT rate
- Ordering of refundable tax credit utilization
- Temporary percentage limitations on certain tax benefits (*e.g.* dividends received deduction and other deductions)
- Permanent two-tiered percentage limitation on NOL utilization
- "Add-back" statute to eliminate the deductibility of certain related-party expenses
- Single sales factor apportionment for most multistate taxpayers
- "Throwout" rule to apply to certain sales in the apportionment of multistate income
- Market-based sourcing to apportion income from the sales of certain services and intangibles.

All of the measures listed above were designed to either permanently increase CIT collections (*e.g.*, disallowance of certain related party expenses) or to at least accelerate CIT collections (*e.g.*, limitations on NOL utilization).

Louisiana's rolling conformity to the Internal Revenue Code and hence to the Tax Cuts and Jobs Act ("TCJA") of 2017 is also widely expected to increase CIT collections. The actual impact of TCJA on CIT collections will become more apparent later in 2019 as 2018 CIT returns are filed or extended.

It is still too early to evaluate the effect of many of the statutory changes listed above on CIT collections. It is especially difficult to isolate the impact of specific statutory measures, particularly because corporate taxpayers experience fluctuations in business activity and profitability and the overall Louisiana economy fluctuates at the same time that statutory changes are being implemented. If the statutory changes work as expected, CIT collections should increase.

V. Task Force Recommendation to Study Combined Reporting

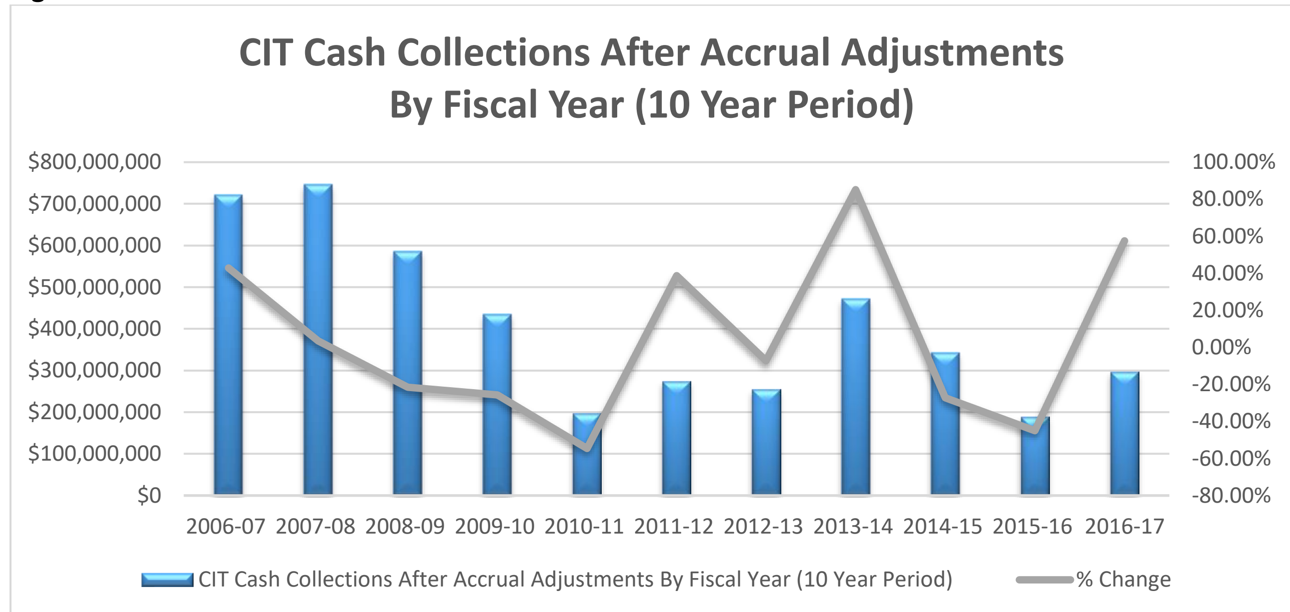
The Task Force signaled a search for a sustained long-term solution to CIT volatility when it formally recommended that LDR and the Tax Institute study combined reporting. One of the corporate income tax recommendations was to direct LDR and the Tax Institute to study "moving from single-entity taxation on the corporate level to a system of combined reporting…" The Task Force recommendation further provided as follows:

> Under combined reporting, corporations are taxed based on their apportioned share of income of their "unitary group" which includes a variety of criteria, including common ownership, common management and common lines of business. Combined reporting solves the profit-shifting incentive because related companies are part of a unitary group in which intercompany transactions are eliminated. Instead a state will apportion the entire unitary group using a combined return to determine its share of its tax base.

Discussions during Task Force meetings (and prior to the issuance of the January 2017 report containing the recommendation to study combined reporting) expressed a concern that some multistate, multi-entity businesses were exploiting Louisiana's separate reporting system. The concern was that such taxpayers were shifting income out of Louisiana separate reporting entities and into other affiliated entities filing corporate income tax returns in states other than Louisiana where such income would be taxed more favorably.

The Task Force report containing the recommendation to study combined reporting was issued after enactment of the aforementioned major 2016 corporate tax legislation, but before the impact of such legislation could be accurately measured.

Figure 1



VI. Overview of Separate Reporting and MUCR

General

Separate reporting and the various forms of combined reporting, including MUCR, are the two general types of corporate income tax reporting available to a state to tax the income from economic activity conducted by a business in the state. Both of these general types of corporate income tax reporting have advantages and disadvantages, but neither system is perfect. A state's choice between these general forms of reporting affects only businesses that are structured to contain multiple legal entities taxed as corporations. A business structured as a single legal entity is unaffected by the choice between separate and combined reporting. Even a multistate business structured as a single legal entity is unaffected by the choice.

The choice between separate reporting and combined reporting should not be confused with other elements of how a state chooses to define corporate taxable income. Irrespective of whether a state chooses separate reporting or combined reporting, the state must still designate:

- The criteria that determine income tax nexus,
- Which types of income and what amounts of income are taxable or exempt (*e.g.,* dividend income and foreign income),
- Which types of income are business income (*i.e.,* apportionable) or nonbusiness income (*i.e.*, allocable) (*e.g.*, rents, royalties and partnership income),
- Which types of expense and what amounts of expense are deductible and when such items of expense are deductible (*e.g.*, depreciation expense and related party expense),

- The manner in which flow-through entity income is classified and apportioned (*e.g.*, classified at the entity level or owner level and apportioned at the entity level or owner level),
- The ordering, timing and amounts of NOL utilization, whether NOL carrybacks are allowed and the number of years in any NOL carryforward period, and
- An income apportionment methodology, including which factors to use to apportion income (*e.g.* property, wages and sales), whether to use point of sale or destination sourcing for sales factor apportionment, whether to use cost of performance or market-based sourcing for sales factor apportionment, and whether to use throwback or throwout for sales factor apportionment.

There is no generic form of separate reporting and no generic form of combined reporting. The choices made among the items listed above can materially impact corporate income tax collections irrespective of whether they are used in conjunction with separate or combined reporting.

Regardless of the method of corporate income tax reporting adopted by a state, the chosen method should tax an amount of income that fairly represents the activity actually conducted by a taxpayer in the state. Longstanding Due Process and Commerce Clause constitutional boundaries exist to determine both whether a corporate legal entity is taxable and the extent to which the entity is taxable. The complexity of the constitutional boundaries is compounded when an entity is engaged in a multistate business or is part of a larger group of related entities.

<u>Separate Reporting</u>

Separate reporting requires any legal entity with income tax nexus in a state to singularly report its taxable income to the state without regard to the income of other legal entities that may be related to the reporting entity through common ownership or other means of affiliation. Advocates of separate reporting assert that separate reporting compliance is simpler for taxpayers and that separate reporting administration is simpler for taxing authorities.

Critics of Louisiana separate reporting claim that separate reporting provides a tempting opportunity for taxpayers, particularly large multistate, multi-entity taxpayers, to improperly shift income out of Louisiana. Improper income shifting may result from a taxpayer incurring a non-arm's length expense (*e.g.*, interest expense, royalty expense, rent, etc.) in a transaction with a related party taxpayer conducting business in a state other than Louisiana, in a state in addition to Louisiana, or in a foreign country. Under this scenario, the Louisiana taxpayer improperly reduces its Louisiana taxable income, and the income realized by the related party either bears no tax or bears tax at a reduced rate. Improper income shifting should not necessarily be conflated with arm's length transactions with related parties in the regular course of business; not all related party transactions are tax motivated.

Historically, Louisiana CIT collections may have been adversely affected by taxpayer use of certain tax planning schemes that were devoid of business purpose or economic substance. To its credit, LDR has successfully challenged many such schemes. LDR's persistent challenges have acted as a deterrent to these schemes.

LDR has a variety of tools available to combat improper tax planning between and among related parties, including Internal Revenue Code §482 and La. Rev. Stat. Ann. §480. In addition, effective January 1, 2016, Louisiana corporate taxpayers are prohibited from deducting certain otherwise deductible related party expenses (*e.g.,* interest expense, intangible costs and management fees) unless the subject expenses meet one or more specific exceptions to non-deductibility. These new restrictions are commonly referred to as "add-back".

It would be an oversimplification to blame separate reporting for either the low levels of CIT collections or the volatility of CIT collections. As discussed in more detail below, it would also be imprudent to expect that replacing separate reporting with MUCR would automatically result in higher CIT collections or less volatility in CIT collections.

MUCR

Historical Perspective - Wisconsin was the first state to enact a corporate income tax and did so in the early twentieth century. Many states quickly followed, and, by the time World War II began, a majority of states had enacted a corporate income tax. Early enacting states all required separate reporting. Separate reporting was generally deemed by both states and taxpayers to capture an amount of tax that was an accurate representation of the economic activity in a given state. Even as late as World War II, much of the commerce conducted in the United States was conducted by single entity businesses. In addition, many large businesses were structured as single legal entities with multiple divisions rather than as multiple legal entities.

The first hints of a unitary tax reporting concept found their origins in property taxation rather than income taxation. States struggled with the notion that a particular piece of taxable property located in a particular state was worth more as part of an overall business enterprise than as an isolated piece of property in one state, particularly if the business operated in multiple states. Jurisprudence developed around the concept of a state being able to consider the taxable value of an individual item of property based upon the overall value of the business. The premise was that the value of all the pieces was worth more than the pieces individually. The twin concepts being addressed were the overall value of a business (from a property tax perspective) and how to apportion such value among the states.

California was the first state to require unitary reporting for income tax purposes and it did so initially without the benefit of specific statutory authority. The movie-making and movie distribution business was flourishing in California in the 1920s and 1930s. Movies were typically made in California and distributed and shown both in California and elsewhere. California was frustrated for corporate income tax purposes because the movie business was being structured

into multi-entity businesses, most of the income from which was being realized by the distributing entities in states that were beyond the reach of California taxation. To overcome this, California adopted for corporate income tax purposes some of the same unitary principles already used in property taxation. As a result, the state was able to subject to California income taxation the entirety of a multi-entity business and to apportion the entire group's income to California. California's approach was premised on the notion that simply taxing income from the activity conducted by one or more isolated entities in California was not representative of the economic activity conducted in California.

Proponents of MUCR would argue that single entity reporting does not reflect the reality of many large, modern businesses. Just as in the case of the property tax, the value created by the entire enterprise does not neatly decompose into the income of the separate entities. Economic theory recognizes that there are economies of scale and scope and spillovers of value across entities, which make it difficult to assign common costs of production. The presence of these synergies is one of the primary rationales for the unitary business principle, as well as for apportioning income of the unitary group.

Opponents of MUCR would argue that the inclusion of non-nexus members in a MUCR filing group may cause MUCR to distort the actual economic activity in a state, even after considering the effects of apportionment. The distortion may result from the fact that all members of a MUCR filing group are not proportionately profitable at the same level.

MUCR was not immediately popular outside of California. Other states slowly adopted MUCR, but for many years the concept did not spread to other states or regions and was confined primarily to western states. New life was breathed into MUCR in the early 2000s when several northeastern states adopted MUCR in fairly quick order (*e.g.*, Massachusetts, New York, and Vermont). At present, twenty-six states have adopted MUCR, with Kentucky and New Jersey being the most recent additions (Figure 2). A number of states, including Indiana, Iowa, Louisiana, Maryland, and Pennsylvania, have considered MUCR in the recent past, and all decided not to adopt MUCR.

As also indicated in Figure 2, no state in the southern United States other than Kentucky has adopted MUCR.[5] Arkansas and Mississippi, the states contiguous to Louisiana that impose a corporate income tax, do not require MUCR. Texas, another state contiguous to Louisiana, requires a form of unitary reporting for franchise tax purposes. Texas is not, however, included in the total of twenty-six MUCR states because the Texas franchise tax is not considered an income tax under Texas law. The Texas franchise tax is more akin to a modified gross receipts tax.

[5] MUCR is required in Kentucky effective January 1, 2019, but an effort has been mounted in Kentucky to retroactively repeal MUCR and to revert to the prior system of corporate income taxation.

The basic underpinnings of MUCR are unchanged in more than fifty years, but there have been numerous state court cases and U.S. Supreme Court cases to refine MUCR and its application. The most basic premise of MUCR is that taxing a single legal entity in isolation may not properly capture the overall activity of a business in a state when the business is conducted by more than one legal entity and such multiple entities are related in one or more of several ways. MUCR replaces separate reporting's taxation of a single legal entity with the taxation of a "single economic enterprise," a concept that transcends the concept of a separate legal entity.

The single economic enterprise that is subject to tax under MUCR may consist of one or more separate legal entities, all of which are operating in some form of unitary business endeavor. As discussed in more detail below, the composition of the MUCR group is the result of a process that must be repeated annually, a process that is not a mechanical one and one that also requires much judgement.

Separate reporting limits a state to taxing on a separate entity basis the income of legal entities that have income tax nexus in the state. If an entity with nexus in a separate reporting state is taxable in other states, the entity's income must be apportioned between or among the states. As such, separate reporting apportions the income of a single legal entity.

MUCR is different than separate reporting in many ways, but the primary difference is that MUCR may result in the apportionment of the income of multiple legal entities after such income is calculated as if the multiple legal entities operate as one business. The entities included in the MUCR filing group may include entities that do not have income tax nexus in the MUCR state on a standalone basis. When MUCR is properly applied, taxing the income of non-nexus entities does not violate constitutional principles for two reasons, with such reasons acting in concert.

The first reason is that the MUCR group is defined using the single economic enterprise concept under which all MUCR group members must be an integral part of an overall business that meets certain tests of unity (as discussed in more detail below). The second reason is that fair apportionment attempts to divide the group's income among the states in which the group is present and does so in such a way that income is fairly apportioned among the states.[6]

Taxable Income Calculation - Once the MUCR group composition is established, calculating the group's taxable income is an exercise similar to the exercise used in separate reporting. The exercise is typically conducted in the following sequence for either method of reporting:

1. As appropriate, adjust the separate entity's federal taxable income or the MUCR group's federal taxable income for any differences between federal and state taxable income (*e.g.,* depreciation, dividends received, NOLs, etc.) to compute adjusted state income.

[6] The concept of fair apportionment is a highly subjective concept and is beyond the scope of this narrative.

2. In the case of a MUCR group, eliminate the effects of any transactions between members of the MUCR group as part of the process of computing state taxable income in the MUCR state. (Intercompany eliminations are consistent with the single economic enterprise concept.)

3. Divide adjusted state income into business and nonbusiness income components to compute apportionable business income.

4. Apply the appropriate apportionment rate to calculate apportioned income.[7]

5. Add back any nonbusiness income specifically allocable to the state to apportioned income to derive pre-NOL taxable income.

6. Apply any available state NOL to pre-NOL taxable income to compute state taxable income.

7. Apply the applicable income tax rate to state taxable income to compute pre-credit state income tax liability.

8. Apply any available state income tax credits to pre-credit state income tax liability to compute state income tax liability.

MUCR Group Composition - One primary difficulty for both taxpayers subject to MUCR and taxing authorities administering MUCR is defining the composition of the MUCR group. Always at issue are which affiliated legal entities should be included in a MUCR group and which affiliated legal entities should be excluded from a MUCR group.[8] The task is especially difficult in the case of large complex businesses with many legal entities, particularly when the many legal entities are engaged in many different lines of business and manufacture or sell many different types of products or services.

To illustrate the difficulty associated with MUCR group composition definition, any quick review of unitary state jurisprudence will produce thousands of cases in which taxpayers and taxing authorities disagree over the composition of MUCR groups.

In defining a federal income tax consolidated filing group, the Internal Revenue Code and related Treasury Regulations provide objective, bright line tests to define a federal consolidated filing group. The federal rules of inclusion are based upon factual rules of common ownership of subsidiary entities. Large, complex multistate businesses conducting business in MUCR states

[7] For simplicity, this step ignores the mechanics of computing the apportionment rate applied to MUCR income.

[8] "Affiliated" is a reference to different legal entities being related to one another via some measure of common ownership, typically 50% or more direct or indirect ownership by a common parent.

typically have multiple federal consolidated filing groups and multiple unitary filing groups. Federal consolidated filing groups and MUCR filing groups typically have different compositions due to the different rules of federal and state inclusion.

MUCR group definition is more nuanced than federal group composition. Indeed, while the general principles of MUCR group definition are clear, the specific applications and interpretations of these principles are often difficult. The various MUCR states may have different rules of group inclusion, but most state MUCR statutes address group definition and apportionment by broadly stating that income is taxable to the full extent allowed by the U.S. Constitution.

Over the years, the courts have developed various criteria for MUCR group inclusion, some combination of which are a prerequisite for unitary group inclusion. These criteria, only some of which specifically appear in MUCR statutes, include the following:

1. Three unities test (unity of ownership, unity of operation, and unity of use)[9] - Unity of ownership generally requires that each member of the MUCR group (other than a common parent company) be directly or indirectly owned by at least one other member of the group at or above a certain percentage of ownership, typically 50%. Unity of operation generally requires that one or more group members perform administrative functions (*e.g.*, legal, accounting, finance, tax, payroll, human resources, marketing, etc.) for other group members. The administrative member may itself be a common link among otherwise disparate members. Unity of use is generally taken to mean multiple companies being subject to centralized management and policy making for matters other than day to day management (*e.g.*, strategic planning).

2. Contribution or dependency test[10] - This test requires that in-state entities contribute to or are dependent on entities operating in other states. An example might include an in-state entity buying fuel for company vehicle use from a related out of state entity (*i.e.,* related through common ownership). Another example might be an in-state entity serving as an internal finance company to a related out of state borrower.

3. Flow-of-value test[11] - This test requires that there be a non-passive flow of value between members (*i.e.,* where flow of value is something other than contributed capital or dividends). One example might be flow of value between multiple subsidiaries of a large multi-entity dairy where one subsidiary supplies unpasteurized milk, another affiliate pasteurizes the milk, another entity packages the pasteurized milk in cartons and still

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[9] See *Butler Bros. v. McColgan,* 315 US 501 (1942).

[10] *Edison Cal. Stores, Inc. v. McColgan, 176 P.2d 697 (Cal. 1947).*

[11] *Container Corp. of Am. v. Franchise Tax Bd.,* 463 US 159 (1983).

another affiliate delivers the milk to third party customers. In this example, each subsidiary in the sequence added something of value during the process.

4. Factors-of-profitability test[12] - This test is a confluence of the other tests and includes such factors as functional integration, centralized management and economies of scale.

The criteria listed above are not necessarily conjunctive, but the more criteria satisfied by any given entity, the greater the likelihood that such an entity should be included in a MUCR group.

The different applications and interpretations of these tests of inclusion often put taxpayers and taxing authorities at odds in defining MUCR groups. Each party has different objectives and each party is tempted, in the absence of bright line tests, to define the group in the most advantageous way. Each party will search for facts to support its position.

Taxpayers may seek to include loss companies in the MUCR group while taxing authorities may seek to exclude such companies to avoid erosion of the tax base. Similarly, taxpayers may seek to include certain companies in the filing group if the effect of inclusion is apportionment factor dilution that offsets the impact of additional entity inclusion on the apportionable tax base. Many of these disputes are settled at the audit level, but major disputes can lead to controversies and extended litigation.

The Multistate Tax Commission has developed model language to assist states in defining a unitary business, determining group membership, etc.

In its January 2017 report, the Task Force commented that MUCR "… solves the profit-shifting incentive because related companies are part of a unitary group in which intercompany transactions are eliminated. This observation oversimplifies MUCR because the conclusion appears to assume that all parties to an intercompany transaction will be included in the same MUCR group. Just as large, complex, multistate businesses often have multiple federal consolidated filing groups, such businesses frequently have multiple MUCR filing groups. Transactions between different MUCR groups pose the same challenges to taxpayers and taxing authorities as do transactions between related separate entities. If Louisiana adopts MUCR, it may still be necessary to use IRC §482, La. Rev. Stat. Ann. §480 and related party expense add-back authority. These tools would not be rendered obsolete or unnecessary by MUCR adoption. Group definition affects not just the tax base and its apportionment, but also affects whether related party transactions remain an ongoing source of potential disagreement between taxpayers and taxing authorities.

States may choose to provide more clarity about the MUCR group definition by allowing taxpayers the option of making a multiyear irrevocable "affiliated group election." An affiliated group election is typically a water's edge election under which every domestic affiliate meeting

[12] *Allied-Signal, Inc.* v. Director, Div. of Taxation, 504 U.S. 768 (1992).

certain ownership criteria (irrespective of the results of the other tests for unity) is automatically included in the MUCR group. Taxpayers are bound by the results of the election for its duration and taxing authorities are precluded from challenging group composition. Such elections, if made by taxpayers, remove group composition as an issue of disagreement between taxpayers and tax authorities.

Every MUCR state must decide how to treat foreign affiliates that, despite having a significant presence outside of the United States, would otherwise satisfy the aforementioned tests for unity. Multiple approaches have been developed to address whether to include foreign affiliates in MUCR groups. One approach is to provide taxpayers the option of making water's edge election to include only domestic affiliates in the MUCR group. The election could be an annual election or binding election for a set number of years. Absent the election, the MUCR group would include qualifying foreign affiliates. To prevent foreign entities that have substantial operations in the U.S. from avoiding taxation, states employ an 80/20 rule along with water's edge elections. The 80/20 rule allows foreign entities with eighty percent (80%) or more of their property, payroll or sales factor assigned to locations outside the United States to be excluded from the combined group. Inclusion or exclusion of foreign affiliates may affect both the tax base and the apportionment rate. States often want to include foreign affiliates in the MUCR group in order to broaden the base and reduce profit shifting tax planning.

Several states have also introduced "tax haven" legislation under which foreign affiliates with a presence in certain designated countries (*e.g.,* Bermuda, Cayman Islands, Maldives, etc.) would automatically be included in the MUCR group. The objective here is to force inclusion of affiliates located in countries deemed to be havens for either not taxing certain income or taxing income at very low rates, thereby reducing tax liabilities in MUCR states. Tax haven legislation is at risk of violating the constitutional prohibition of state regulation of foreign commerce.

MUCR Apportionment - Every MUCR state uses the sales factor as at least one of the factors to apportion group income to the state. MUCR states have chosen between two nexus-related methodologies in sales factor apportionment, commonly referred to as the "Joyce" method and the "Finnigan" method.[13]

The sales factor denominator is identical for both Joyce and Finnigan methods. Under Joyce, each taxpayer is considered separately when determining which entities have nexus in a state (*i.e.*, considered separately based on that entity's activities in the taxing state and without regard to the activities of other related entities in the taxing state). Also under Joyce, the sales factor numerator includes only sales derived by entities with nexus in the reporting state (*e.g.*., excluding sales in the state derived by entities protected by P.L. 86-272). Under Finnigan, the

[13] Joyce and Finnigan were separate California court cases in which the respective methods were upheld. (See *In the Matter of the Appeal of Joyce, Inc.,* 66-SBE-070, 11/23/1966 and *In the Matter of the Appeal of Finnigan Corporation,* 88-SBE-022. 08/25/1988.)

group is considered in its entirety such that one entity's nexus is determinative of the entire group's nexus for apportionment purposes. As such, Finnigan may result in sales factor numerator inclusion of sales that would be excluded under Joyce; that is, under Finnigan the sales factor numerator would include all sales in the reporting state, even sales by entities that do not have standalone nexus in the state. As a result, Finnigan often results in a higher sales factor numerator.[14] Overall, then the Joyce method generally leads to lower apportionment rates.

Twelve of the MUCR states use Finnigan while the remaining states use Joyce. With more states adopting apportionment formulas that either heavily weight sales or use sales as the only factor, the decision to use the Finnigan method or the Joyce method has become more important.

Another aspect of MUCR to be considered is the treatment of both nonrefundable state income tax credits available to members of the group and charitable contributions made by individual group members. At issue is whether a MUCR state chooses to impose credit utilization limitations and charitable deduction limitations at the group level or at the individual entity level. Entity level limitations are generally less taxpayer friendly.

Transition Issues - When a state transitions from a separate reporting convention to MUCR, there are many transition issues that generate "winners" and "losers" from the transition. These transition issues include, but are not limited to:

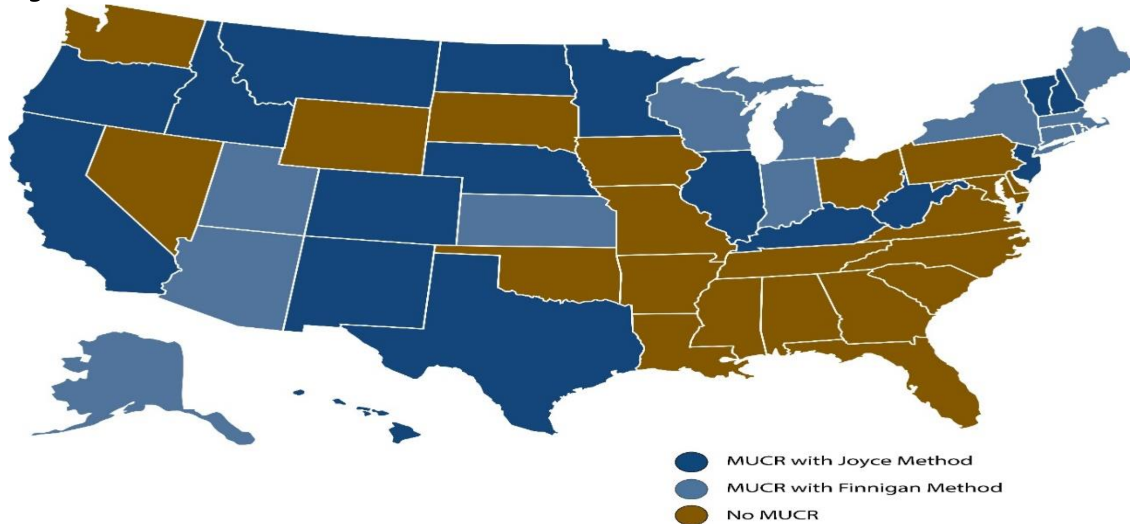
- how to translate separately determined state NOL and credit carryovers available at the end of the last day of separate reporting into unitary group NOL and credit carryovers available to a MUCR group at the beginning of the first day on which MUCR is effective
- how a corporate taxpayer, one that is preparing financial statements in accordance with generally accepted accounting principles ("GAAP") and that is subject to state income tax in a separate reporting state transitioning to MUCR, must compute deferred income taxes on MUCR group "temporary differences", and how such a taxpayer must record the

[14] Beyond the scope of this general discussion is the impact of throwback and throwout rules on Joyce and Finnigan apportionment.

resulting adjustments in its financial statements in the calendar quarter in which MUCR legislation is enacted;[15] [16]

- whether the state transitioning to MUCR will provide certain affected taxpayers an income tax deduction or credit to mitigate any adverse impact of the deferred income tax adjustment resulting from the transition. [17]

Figure 2



[15] One example of a temporary difference is the difference between book depreciation and tax depreciation. If an asset can be depreciated more quickly for tax purposes than for GAAP purposes, the net tax book value of such asset is lower than the net GAAP book value of such asset, particularly in the early years of the asset's depreciable life. The taxpayer must record a deferred income tax expense and a related liability for this asset. The taxpayer will theoretically incur less current tax in the early years of ownership of this asset because of the accelerated tax depreciation. The taxpayer will theoretically incur more current tax in future years because book depreciation will eventually exceed tax depreciation. Deferred tax expense is provided for all temporary differences and is meant to capture the fact that although tax deductions may presently exceed book deductions, book deductions will eventually exceed tax deductions as the temporary differences reverse. An example of a permanent difference between GAAP treatment and tax treatment is a nondeductible penalty; the penalty may be an expense for the calculation of GAAP income, but the penalty is never deductible for tax purposes. No deferred taxes are provided on permanent differences.

[16] Depending on the temporary difference, the deferred income tax item can be either an expense or a benefit resulting, respectively, in a deferred income tax liability or a deferred income tax asset.

[17] GAAP (ASC 740, *Income Taxes*) requires recordation of the effects of a legislative change (*e.g.* tax rate, reporting convention, etc.) in the quarter in which legislation is enacted, not in the quarter in which the legislation is effective.

VII. Estimated Revenue Impact from MUCR Adoption -* Pro-Forma *MUCR Returns in Maryland, Rhode Island, and Other States

States considering MUCR adoption struggle to determine the impact of MUCR adoption on corporate income tax collections. Separate return states considering adoption do not have at their disposal the information available that would enable the calculation of a reliable estimate of the impact of MUCR adoption, historically or prospectively. Absent such information, states have several choices:

1. Adopt MUCR without a reliable estimate of the fiscal impact, but with the knowledge that most adopting states have not experienced material increases or decreases in corporate tax collections after adopting MUCR.

2. Direct large multi-entity, multistate taxpayers (*i.e.*, taxpayers most likely impacted by MUCR) to provide *pro forma* MUCR tax returns for one or more years. The *pro forma* returns would be designed to mimic MUCR returns as if MUCR had already been adopted. Such returns would then be reviewed and the results aggregated to estimate the potential impact of MUCR. States that have attempted to require such *pro forma* filings have experienced low participation rates. Because taxpayers have sparse guidance on the mechanics of that state's particular form of MUCR under consideration, the information gathered is of suspect accuracy. There was also concern that because the *pro forma* returns were not determinative of an actual tax liability, filers did not take great care in providing accurate information. In addition, the efficacy of the returns is suspect if the test years are abnormal years due to economic fluctuations.

Recent state experiences have varied. Maryland and Rhode Island, both separate reporting states at the time, studied the possibility of adopting MUCR as a means toward resolving budgetary issues not unlike those facing Louisiana. Both states also attempted to gather information about the impact of MUCR by requesting that certain representative taxpayers provide *pro forma* MUCR information.

<u>Maryland</u>

A representative from the Maryland Comptroller's office testified before the Tax Institute and observed that, during the 2007 Maryland Special Legislative session, "among other issues, lack of information on fiscal impact…prevented action" on MUCR. Rather than passing legislation to enact MUCR without a reliable fiscal note, Maryland undertook a corporate income tax information reporting program. Corporations required to file a Maryland income tax return who were also members of a multi-entity corporate group were required to file an information report which listed group members, the worldwide sales of each member, the Maryland sales of each member, a list of states in which any group member filed a state income tax return and the names of group members in combined or consolidated returns in each combined or consolidated state. Maryland's Comptroller was then required to summarize and submit this and other information to the Maryland General Assembly.

After widespread taxpayer noncompliance by Maryland taxpayers toward the MUCR information reporting, and after determining that the information return requirements were overly burdensome on both Maryland taxpayers and the State, Maryland introduced bills in its 2008 Regular Session to ease the reporting burdens and to modify the reporting requirements. These bills modified the information reporting requirements into a *pro forma* combined return requirement. The Comptroller's office was charged with using the *pro forma* information to estimate the revenue impact of MUCR in a series of five reports that reviewed information for tax years 2006 through 2010.

With its fifth report, issued in 2013, Maryland's Comptroller's concluded that the revenue impact of MUCR could be positive, negative, or revenue neutral. The Comptroller also determined that, "Maryland's corporate tax base was not directly comparable to that of the nation as a whole, and given varying national economic conditions, aggregating activity from other states can have varying impacts on Maryland's base."

Andrew Schaufele, Director of the Maryland Bureau of Revenue and Estimates, concluded in a March 2013 report entitled *Report on Combined Reporting to Governor, President and Speaker*, that compared to separate reporting MUCR would have increased corporate income tax collections in some years and reduced it in others. Based on five years of assembled date, the report concluded that MUCR would have resulted in lower collections in two or three of the five years.

Based upon the uncertain impact of MUCR on Maryland corporate income tax collections and other factors, Maryland abandoned its interest in MUCR.[18]

<u>Rhode Island</u>

Rhode Island enacted MUCR in 2014 for tax years beginning on or after January 1, 2015. Prior to MUCR enactment, the state's tax administrator was directed by the Legislature to study combined reporting and its effects on Rhode Island's budget. Certain corporations were required to file *pro forma* MUCR returns for the 2011 and 2012 tax years. C Corporations and businesses taxed as C Corporations for federal income tax purposes, which were part of a combined group engaged in a single or common business enterprise (*i.e.*, a "unitary" business) were required to submit a *pro forma* MUCR return.[19]

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[18] Maryland is now again considering MUCR. See Maryland Senate Bills 76 and 377.

[19] Rhode Island's general definition of a combined group was a group of two or more C corporations in which more than 50% of the voting stock of each member corporation is directly or indirectly owned by a common owner or owners. Corporations could also look to one of two unitary tests to make that determination. Rhode Island's guidance on how to prepare a *pro forma* MUCR return was much more specific than the guidance provided by Maryland for its information and *pro forma* returns.

At the conclusion of the study, Rhode Island's tax administrator concluded that MUCR would have produced higher state revenue overall in 2011 and 2012 had MUCR been in effect in those years. The administrator also concluded that approximately 29% of corporate taxpayers would have paid more income tax, 6% less tax, and about 65% the same amount of tax. Although the study was silent on formally recommending whether MUCR should be adopted, the Legislature subsequently enacted MUCR as part of an overall reform package that also cut the corporation income tax rate from 9% to 7%, repealed the business franchise tax, imposed the $500 minimum tax on S corporations, and required the Tax Division to create a nonbinding appeals process to resolve apportionment disputes.

<u>Other States</u>

Indiana concluded its study of MUCR with an October 2016 report determining that the "econometric results suggest that combined reporting may have an initial positive impact on corporate income tax revenue but…the impact will only be short term and will decline to zero in the long run." [20]

Kentucky did not perform a *pro forma* MUCR study like several of the states previously discussed, but in April 2018 the Kentucky Legislature passed legislation requiring MUCR for tax years beginning on and after January 1, 2019. The Kentucky legislation allowed a corporation (1) to file a combined return if it is a member of a unitary business group, (2) make an election to file a consolidated return with all members of an affiliated group, or (3) file a separate return if it does not qualify to file a combined or consolidated return for taxable years beginning on or after January 1, 2019.

New Jersey recently adopted MUCR effective January 1, 2019 and did so without conducting a *pro forma* return filing study.

Overall, the *pro forma* studies conducted by other states produced a variety of inconclusive results of the revenue impact of MUCR. Given the results of these studies, there is no strong evidence to indicate that moving from separate reporting to MUCR would materially increase Louisiana's CIT collections. The possibility also exists that adoption of MUCR might result in lower Louisiana CIT collections. Other states' struggles with estimating in advance the revenue impact of MUCR adoption suggest that Louisiana faces the same uncertainty as other states, even if an attempt to gather *pro forma* information is undertaken.

<u>Two Keys Elements Determinative of MUCR Effect</u>

The difficulty in estimating the revenue impact of MUCR is due to the difficulty of knowing how the adoption of MUCR will affect two key elements that are determinative of CIT collections.

[20] *A Study of Practices Relating to and the Potential Impact of Combined Reporting,* Office of Fiscal and Management Analysis, Indiana Legislative Services Agency, October 2016.

Consider that, if Louisiana adopts MUCR, for any affected taxpayer, Louisiana will be in effect trading an apportioned piece of the taxable income of a corporate entity with Louisiana nexus for an apportioned piece of the taxable income of a group of entities, only one or more of which individually have Louisiana income tax nexus.

The two key elements that will determine the revenue impact of MUCR are the MUCR group's tax base and the MUCR group's Louisiana apportionment rate. In transitioning from separate reporting to MUCR, these two elements likely move in opposite directions for a typical taxpayer. The MUCR group's apportionable tax base includes the income and losses of more legal entities (after eliminating the effects of intercompany transactions between group members), but the MUCR group's Louisiana apportionment rate is likely lower than the single entity's Louisiana apportionment rate. Henceforth, the inclusion of the income or losses of more legal entities is referred to as "base broadening."

The uncertainty of any MUCR revenue impact is whether, on average, the impact of base broadening under MUCR is stronger than the impact of MUCR apportionment factor dilution. If base broadening is more powerful than factor dilution, Louisiana tax collections would increase. Alternatively, if factor dilution is more powerful than base broadening, Louisiana tax collections would decrease. Further, the strength of these opposing forces could shift from year to year.

Regardless of the revenue impact, MUCR adoption may have a significant impact on two aspects of the CIT. First, MUCR adoption will likely result in a significant broadening of the apportionable long-run CIT base. As part of the base broadening, opportunities to engage in improper profit-shifting activities that lower the apportionable corporate tax base are reduced by the use of MUCR relative to separate entity reporting. This suggests that MUCR adoption will likely broaden the long-term corporate income tax base. Second, economic theory suggests that the inclusion of multiple corporate entities under MUCR has the potential to reduce the volatility of corporate tax revenues, comparable to the reduction of risk when a portfolio of assets includes more assets rather than fewer assets. However, both of these effects are uncertain and difficult to quantify, and existing studies of these effects give conflicting results.

One way to approach these uncertainties is to make the simplifying assumption that any change in CIT collections resulting from MUCR adoption would be attributable to reasons other than apportionment. If so, the choice between separate reporting and MUCR can be based on whether Louisiana is content (a) to accept whatever tax collections result from the apportioned income of single entities conducting business in Louisiana (*i.e.,* continue separate reporting) or (b) whether Louisiana instead desires the tax collections that result from the apportioned income of a single economic enterprise consisting of multiple entities (*i.e.*, a unitary group), many of which have no connection to Louisiana other than through their unitary relationship with entities conducting business in Louisiana.[21]

[21] To illustrate, assume that an unprofitable single entity widget manufacturer conducting business in Louisiana is part of a highly profitable unitary business consisting of many entities operating in many states other than

Irrespective of whether Louisiana chooses to adopt MUCR, the Institute recommends that Louisiana **not** undertake a *pro forma* return filing study of the projected impact of MUCR. Similar studies already conducted by other states required significant taxpayer and tax authority resources, appeared to be unreliable and produced inconclusive results.

VIII. Summary: The Advantages and Disadvantages of Separate Reporting and Mandatory Unitary Combined Reporting

Each system of reporting has advantages, each system has disadvantages, and neither system is perfect. The information contained in the preceding sections of this report is intended to provide background information on how each system of reporting functions, particularly MUCR, because that system is unfamiliar to many.

Before choosing to remain a separate reporting state or to adopt MUCR, Louisiana should consider its objectives. Would a switch be motivated, for example, by a desire to increase corporate tax collections or to bring more stability to corporate income tax collections? Would a switch be motivated primarily by a desire to reduce tax planning opportunities? What might be the economic development consequences of MUCR adoption?

The advantages and disadvantages of each system of reporting should be weighed against whether the chosen system accomplishes the desired objectives. The information presented below is meant to facilitate that analysis.

The advantages and disadvantages noted below are presented primarily from the State's perspective, with occasional references to taxpayer perspective when relevant. The advantages and disadvantages apply in the context of multistate, multi-entity businesses and not in the context of single entity businesses that would be unaffected by MUCR adoption.

Separate Reporting

Advantages – Under separate reporting:

- Both taxpayers and the LDR are familiar with the current system.

Louisiana. Under separate reporting, Louisiana would likely collect no income tax from the single entity widget company operating in Louisiana. Conversely, under MUCR Louisiana would collect corporate income tax from the unitary group of which the Louisiana widget manufacturer is a part because of the group's overall profitability. If the facts are changed so that the Louisiana widget manufacturer is highly profitable and the overall unitary business is historically unprofitable or simply having a bad year, Louisiana would collect positive tax revenue under separate reporting, but no revenue under MUCR.

- The LDR is already equipped with tools to address improper separate reporting tax planning.[22]
- Multi-entity businesses operating in Louisiana are unable to utilize tax losses recognized by some entities to absorb taxable income recognized by other entities.
- Louisiana may collect CIT from a profitable business entity operating in Louisiana even if the overall business operations conducted outside of Louisiana by related entities are unprofitable.
- A poor national economy not affecting Louisiana may not adversely impact Louisiana tax collections.

Disadvantages – Under separate reporting:

- The corporate tax base is more susceptible to long-term erosion. Louisiana may collect no corporate income tax from an unprofitable business entity operating in Louisiana even if the overall business operations conducted outside of Louisiana by related entities are profitable.
- A strong national economy not also benefiting Louisiana may adversely affect Louisiana tax collections.

MUCR

Advantages – Under MUCR:

- There are fewer opportunities for improper profit-shifting, thereby protecting the long-term viability of the corporate tax base.
- Many large multistate businesses conducting business in Louisiana already have experience with MUCR, since twenty-six states currently require its use.
- Louisiana tax collections will be based on the overall profitability of the business, so that Louisiana may collect corporate income tax from a business even if the business operations conducted by separate entities in Louisiana are unprofitable.
- A strong national economy not also benefiting Louisiana will not adversely affect Louisiana tax collections.

Disadvantages – Under MUCR:

- Because LDR has no MUCR history or experience, it may be difficult initially for LDR to administer the new system.[23]

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[22] Similar to separate reporting, MUCR is not immune to nexus controversy.

[23] It would be necessary for LDR auditors assigned to audit MUCR returns to be retrained. A minimum of several years would be required to train auditors and provide them with adequate experience before they would be fully proficient in auditing the MUCR returns of large, complex, sophisticated Louisiana taxpayers. In auditing MUCR returns, auditors must delve in to nontax and operational aspects of taxpayer businesses in order to determine if group composition in returns as filed is proper. Auditors must also examine activity conducted outside of Louisiana by MUCR group members without Louisiana nexus.

- Given uncertainties in legal interpretations of MUCR practice, there may be legal disputes on the composition of the unitary business.
- By adopting MUCR, Louisiana will become more of a tax outlier among its southern state peers.
- Although MUCR may reduce the opportunity for tax planning accomplished via related party transactions, tax planning opportunities will still remain under MUCR.

IX. Closing Observations

The choice of which system of corporate income tax to use – separate entity reporting versus combined reporting – is a difficult one. As discussed at length in this report, there are advantages and disadvantages of each system. The main advantage of the current system of separate entity reporting is that it is a system known both to Louisiana taxpayers and the LDR. It is also a system that is common to other states in the south. However, separate entity reporting is a system that presents opportunities for profit-shifting activities. These advantages and disadvantages mirror those of combined reporting. The main advantage of MUCR is that it reduces the likelihood of profit-shifting activities, thereby protecting the long-term viability of the corporate base even while having uncertain impacts on immediate and long-term corporate revenues. At the same time, MUCR is a system that will require learning on the part of both taxpayers and the LDR, and it is also a system that is uncommon in southern states. The choice of which system to use in Louisiana requires making informed judgements about these tradeoffs.