taxanalysts a pinch of SALT

Combined Reporting: Amid All the Fuss There Are No Clear Winners

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Welcome to a new year, new state legislative sessions, and more combined reporting proposals. The list of states adopting combined reporting continues to grow — Michigan, Massachusetts, New York, Vermont, West Virginia, and Wisconsin[1] are among the most recent adopters (or expanders) of combined reporting. While state legislators are implored to adopt combined reporting as the cure-all to "fix" the corporate income tax, there is evidence that adoption of combined reporting may not, in fact, be an antidote to make a meaningful difference to increase corporate income tax revenue. The recently released "Fox report" commissioned by the Tennessee comptroller of the treasury found that combined reporting does not (all things considered) produce more tax revenue. Thus, we encourage legislators to look before leaping into the combined reporting pool.

In this Pinch of SALT, we will provide a brief overview of combined reporting followed by a discussion of its perceived benefits along with the results of recent studies on combined reporting which highlight its unpredictable results. Finally, we will discuss why combined reporting is not the remedy to cure the illness plaguing the states.

What Is Combined Reporting?

Combined reporting is an income tax filing method. It requires commonly owned entities that have specific characteristics of an integrated and interdependent business — a unitary business — to "combine" income and apportionment factors in computing state taxable income. Many complex questions result from the enactment of combined reporting — composition of the unitary group (including water's-edge versus worldwide reporting), attribute (for example, net operating losses and credits) usage under old and new systems, apportionment calculations (*Joyce* versus *Finnigan*), and financial statement issues (and the availability of credits associated with financial statement effects). Each of those questions must be addressed when combined reporting is enacted.

Why States Are Proponents of Combined Reporting

States and commentators offer several reasons for the adoption of combined reporting:

- Combined reporting is a way to close so-called loopholes. Because combined reporting includes the income and apportionment factors of related parties (that maintain a unitary relationship), intercompany transactions are deferred or eliminated and thus do not produce immediate effects on income tax.
- Increased tax revenue (compared with separate reporting). In an era of expanding budget deficits, claims of revenue enhancement may be the most attractive justification to adopt combined reporting.
- Combined reporting ensures a level playing field for all businesses. Commentators have claimed that large multistate corporations are able to maintain a lower effective tax rate than smaller businesses by separating their operations (and income) into multiple corporations that are taxable by only a limited number of states.

[1] Vermont enacted combined reporting effective in 2006, New York in 2007, and Michigan in 2008. Combined reporting became effective in Massachusetts, West Virginia, and Wisconsin in 2009.

- Encouragement of economic development. Proponents of combined reporting argue that increased state tax revenue will enhance the state's infrastructure and attract a higher quality workforce.[2]

While each of those arguments appear on their face to support the adoption of combined reporting, questions arise whether the purported benefits are real.

Combined Reporting Produces Unpredictable Revenue Results

Several reports and studies of combined reporting that have emerged from states, taxpayer associations, and economists call into question the hyped additional tax revenue expected to be produced by adopting combined reporting. The studies' results are consistent — none have produced compelling evidence that the adoption of combined reporting (in isolation) will result in a significant increase in long-term revenue. Rather, the studies suggest that the adoption of combined reporting produces unpredictable results.

The Fox Report

"An Evaluation of Combined Reporting for Tennessee" (Fox report),[3] prepared by economist William F. Fox and Prof. LeAnn Luna et al., has gained significant publicity in recent months. The study was commissioned by the Tennessee comptroller of the treasury. Using statistical analysis and an examination of data from Vermont and New York, the report evaluated how combined reporting affects state tax revenue.[4] Based on their review, the authors were unable to conclude that adopting combined reporting produces a significant increase in revenue. Instead, they concluded that combined reporting "probably increases tax revenue, but by a relatively small amount and perhaps only for a short period."[5] Interestingly, the report noted that in Vermont and New York revenue decreased by $2.7 million and $680 million, respectively, the year combined reporting was enacted.

The Cline/COST Report

In a report published in June 2008 that was commissioned by the Council On State Taxation, economist Robert Cline studied the revenue and competitive effects of combined reporting.[6] That study was commissioned in hopes of providing a better understanding of the complex issues in the combined reporting debate.[7] The report looked at a variety of issues associated with combined reporting, including the revenue effects, the effect on a state's economic competitiveness, and compliance and administrative costs. The results of the study concluded that "switching from separate filing to combined reporting can decrease, increase or leave state tax collections unchanged depending upon the complex economic relationship among corporations included in a combined group." The report further concluded that because of that complexity, "the overall revenue effects of adopting combined reporting is very difficult to predict reliably."[8]

The Maryland Experiment

In 2007, Maryland, historically a separate reporting state, passed legislation that allowed the state to study combined reporting through the use of some mandatory information reporting requirements imposed on corporate groups.[9] Corporations have to file two corporate income tax returns in Maryland — a separate return and a combined "informational" return. In March 2009 initial results from the study were released. The study concluded that the effect of combined reporting on Maryland tax revenue could not be determined because of issues surrounding the integrity of the data that was reported. Further work was required. In October 2009 the comptroller of Maryland's Bureau of Revenue Estimates released its findings for the 2006 Maryland corporate information reports.[10] While the report determined that combined reporting (in 2006, at the peak of the economic boom) would have increased revenue, the authors acknowledged that this revenue estimate was only an initial estimate that does not reflect the effect of net operating loss carrybacks and other changes that could reduce tax.[11]

What Is the Real Deal?

Regardless of states' reasoning for advocating combined reporting, it is safe to say that the above studies call into question the premise that the adoption of combined reporting will lead to enhanced

[2] *See* Michael Mazerov, "Corporate Lobbyist's Case Against Combined Reporting in New Mexico: A Rebuttal," Dec. 1, 2009.

[3] William F. Fox, LeAnn Luna, Ann Boyd Davis, Rebekah McCarty, and Zhou Yang, "An Evaluation of Combined Reporting For Tennessee," *State Tax Notes*, Nov. 9, 2009, p. 397, *Doc 2009-16134*, or *2009 STT 214-1*.

[4] *Id*. at 415.

[5] *Id*.

[6] Robert Cline, "Understanding the Revenue Effects of Combined Reporting," *State Tax Notes*, June 23, 2008, p. 959, *Doc 2008-11925*, or *2008 STT 122-3*.

[7] *Id*.

[8] *Id*. at 980.

[9] Md. Code Ann. Tax-Gen. section 10-804.1. A pro forma combined return is required for tax years beginning after December 31, 2006, and before January 1, 2011.

[10] "Analysis of Tax Year 2006 Maryland Corporate Information Reports," Bureau of Revenue Estimates, Comptroller of Maryland (Oct. 1, 2009).

[11] *Id*. at 3.

corporate income tax collections. Further, the studies all recognize and highlight the nonrevenue implications of combined reporting on taxpayers and the Department of Revenue. The bottom line is:

Combined Reporting Is Not the Most Effective or Efficient Means to Combat Tax Planning

There is little question that combined reporting guards against "income shifting" among related parties. Combined reporting inhibits the ability of taxpayers to conduct tax planning within a unitary group. Instead of (or in addition to) combined reporting, a number of states have enacted expense disallowance provisions that are designed to prevent tax benefits associated with intercompany lending and licensing of intangibles.[12] While expense disallowance provisions often are overly broad, not reasonably applied, and affect intercompany transactions that are not tax-motivated, they are simpler to apply and present a far less radical tax change than the adoption of combined reporting.

Combined Reporting Produces Unpredictable Revenue Results

While much of the attention on combined reporting has focused on perceived revenue increases, the aforementioned studies have independently concluded that combined reporting, at best, is not a clear revenue raiser. In some states specific taxpayers may pay more tax under a combined reporting regime. However, that revenue increase is often offset by those taxpayers that will pay less tax. Further, there are certainly more effective and definite ways to increase tax revenue (for example, expense disallowence provisions).

Combined Reporting Produces Increased Compliance and Administrative Burdens and Does Not Create a Level Playing Field

While much of the focus on combined reporting has been on the tax revenue effect, there are several other factors that influence resistance to the adoption of combined reporting. The Cline report and other studies note that the primary reason taxpayers oppose combined reporting is the compliance burden. Although proponents might assert that combined reporting may be easier because most multistate taxpayers already file combined returns, each state's combined reporting mechanics are slightly different, as noted above. Combined reporting can be particularly burdensome for smaller businesses that may not have the resources to address the compliance issues associated with each state's combined reporting rules. Developing policies, procedures, and regulations addressing combined reporting issues is also administratively burdensome on state revenue departments.

Combined Reporting May Not Stimulate Economic Growth

There is no conclusive evidence that combined reporting stimulates economic growth. In fact, most new combined reporting regimes have not been in effect long enough for states to use any increased tax revenue to upgrade infrastructure and attract new business. Further, some taxpayers have acted in opposition and have withdrawn or decided not to enter states that have enacted combined reporting regimes. As a result, economic stimulation may actually suffer.

Conclusion

Regardless of what the proponents say about combined reporting, the outcome of the studies and revenue estimates speak for themselves — combined reporting does not clearly increase tax revenue. For now it appears uncertain whether the results from the Fox report, the Cline report, the Maryland experiment, or other studies will have any effect on state efforts this year to adopt combined reporting. Because the continuing economic recession will likely influence state behavior, it is possible that the national economy will have a greater effect on state tax revenue than will the state's choice of tax system. In this uncertain economic environment, corporate taxpayers want and need stability. As one tax administrator said:

> Companies expect to pay tax when they go into a state, but they like stability and predictability.[13] ✰

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Sutherland's SALT Practice is composed of 20 attorneys who focus on planning and controversy associated with income, franchise, sales and use, unclaimed property, and property tax matters. Sutherland's SALT Practice also monitors and comments on state tax legislative and policy efforts.

[12] For example, over 20 states have enacted related-party expense disallowance provisions since the late 1990s — including Alabama, Connecticut, Georgia, Maryland, Massachusetts, and Virginia.

[13] Reagan Farr, *The Tennessean* (Nov. 26, 2009).