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LEGAL ALERT

April 14, 2011

Shades of Gray: District of Columbia Combined Reporting Unveiled

On April 1 (fittingly), the District of Columbia's new Mayor, Vincent G. Gray, unveiled his proposed budget, B19-0203 "Fiscal Year 2012 Budget Support Act of 2011" (Budget Bill), which includes the long-awaited/feared combined reporting provisions.[1] In a twist unique to the District, D.C. Act 18-255 "Fiscal Year 2010 Budget Support Act of 2009" instructed the Council of the District of Columbia to enact – but did not actually enact – mandatory unitary combined reporting for purposes of calculating the District's franchise tax. The combined reporting legislation contemplated by D.C. Act 18-255 was to be effective for tax years beginning after December 31, 2010, but the Council did not consider substantive combined reporting legislation until it was included in the Budget Bill. If the Budget Bill passes as-is, the District will formally adopt a combined reporting regime effective retroactively to tax years beginning after December 31, 2010.

Discussed below are the issues raised by the proposed combined reporting regime, including questions raised by the unique tax aspects of the District, such as its net income tax on unincorporated businesses.

Issues Raised by the Budget Bill's Provisions

Most but not all of the District's proposed combined reporting provisions are adopted from the Multistate Tax Commission's (MTC) Model Statute for Combined Reporting.

Definition of Unitary

The Budget Bill's definition of "unitary business" is taken directly from the definition found in the MTC's Model Statute.[2] This definition is an abridged version because the MTC intended a more robust definition to be included in an adopting state's regulations. Significantly, the District's proposed definition lacks any type of ownership requirement for inclusion in the unitary group.

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[1] Please visit http://www.stateandlocaltax.com/ for additional information on the Mayor's Fiscal Year 2012 Budget Bill.

[2] "Unitary business" is "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. For purposes of this chapter, and § 47-1810.02 of this chapter, any business conducted by a partnership shall be treated as conducted by its partners, whether directly held or indirectly held through a series of partnerships, to the extent of the partner's distributive share of the partnership's income, regardless of the percentage of the partner's ownership interest or its distributive or any other share of partnership income. A business conducted directly or indirectly by one corporation through its direct or indirect interest in a partnership is unitary with that portion of a business conducted by one or more other corporations through their direct or indirect interest in a partnership if there is 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 and the corporations are members of the same commonly controlled group." DC Code § 47-1801.04(62) (as amended by the Budget Bill at 63).

Sutherland Observation: Although uncertainty is the norm for many issues in the context of combined reporting, adoption of a more robust definition of "unitary business" would provide District taxpayers and the DC Office of Tax and Revenue substantially more clarity about which members of a commonly controlled group are included in the combined report. There is no reason for the District to provide merely a skeleton definition because the Budget Bill's drafter could draw on other states' definitions. This is a significant flaw in the proposed legislation because such uncertainty will also likely impede the abilities of taxpayers to compute changes required by FAS 109 for financial statement purposes.

Composition of Combined Group

Absent an affirmative election to file a worldwide combined report, the Budget Bill requires taxpayers to file on a water's-edge basis.[3] This provision is the exact opposite of the MTC Model in which worldwide combined reporting is the default.

Like many other states' recently adopted water's-edge rules, and following the MTC format, the District's proposed water's-edge calculation includes the income and apportionment factors of various non-U.S. entities. An important variation from the MTC Model occurs in the Budget Bill's treatment of income from foreign entities not otherwise included in the combined group. The MTC model includes all "income derived from or attributable to sources within the United States, as determined under the Internal Revenue Code without regard to federal treaties, and [the] apportionment factors related thereto." The Budget Bill narrows the type of such income to be included in the combined group's tax base to "business income which is effectively connected . . . under the provisions of the Internal Revenue Code, with the conduct of a trade or business within the United States and, for that reason, subject to federal income tax." Unfortunately, a drafting error seems to have omitted the inclusion of the related apportionment factors.

The Budget Bill, again following the MTC Model, also includes in the water's-edge combined group "any member that is doing business in a tax haven defined as being engaged in activity sufficient for that tax haven jurisdiction to impose tax under United States constitutional standards."[4]

Sutherland Observation: Merely "doing business" in a tax haven sufficient to meet Commerce Clause standards, as opposed to "domiciled" in a tax haven, creates numerous compliance issues for multinational taxpayers and arguably violates the Foreign Commerce Clause's requirement of "speaking with one voice," as articulated by the U.S. Supreme Court in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979). Indeed, it is unclear whether taxpayers doing business in a tax haven should adopt the Internal Revenue Code's permanent establishment standard or an undefined nexus standard to determine which foreign members should be included in the combined group.

An additional problem with this provision is that it adopts verbatim the MTC's current definition of tax haven, which is antiquated because it relies on the no longer relevant OECD tax haven country list. The MTC has almost completed amending its definition of tax haven and, if the District insists on retaining the provision, it should follow the MTC's lead.

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[3] DC Code § 47-1810.07(A) (as amended by the BSA at 74).

[4] DC Code § 47-1810.07(A)(7) (as amended by the BSA at 76-77).

Tax Calculation and Tax Attributes

The Budget Bill, like the MTC Model, generally adopts the *Joyce* approach (i.e., treating each separate combined group member, rather than the combined group, as the "taxpayer") rather than the *Finnigan* approach (i.e., treating the combined group as the taxpayer).[5] Using the *Joyce* approach, the Budget Bill requires that each member calculate its own franchise tax liability. This means that tax attributes, such as credits and net operating loss carryovers, are trapped at the individual entity level and cannot be used by the group as a whole. Oddly, the Budget Bill completely fails to address the two issues that gave rise to the original *Joyce* and *Finnigan* cases – calculating the numerator for non-nexus members and the application of throwback.

An additional provision of note is that the Budget Bill completely eliminates dividends between members of the combined group from the taxable income base. This is important from a revenue perspective because currently the District only allows dividends paid from wholly owned subsidiaries to be excluded from the recipient's taxable base.

Issues Not Addressed by the Budget Bill

Impact of Existing Addback Provisions

Supporters of combined reporting in the District assert that the regime will raise more than $20 million annually. This number seems wildly inflated, however. First, the 2009 emergency legislation that ostensibly adopted combined reporting also revised the District's expense disallowance ("addback") to include interest and intangible expenses paid to related parties.[6] Most of the additional revenue gained from the expanded addback statute will be a wash if the District adopts combined reporting. Furthermore, while adoption of the addback statute nearly always generates revenue for taxing jurisdictions, adoption of combined reporting has unknown impacts on revenues. Given the composition of the combined group and the associated tax attributes of each individual member, adoption of combined reporting may effectively eliminate the tax increase achieved by the expanded addback statute.

Whither the Unincorporated Business Tax?

The District imposes an entity-level tax not only on corporations, but also on pass-through entities such as partnerships and LLCs taxed as partnerships for federal income tax purposes. Under the current regime, a corporate partner calculates its DC franchise tax by excluding its distributive share of any income subject to tax at the partnership level.[7] It is not clear how income from a partnership that is not subject to DC's tax on unincorporated businesses is to be included in the calculation of a corporate partner's DC franchise tax. In fact, the District corporate franchise tax return and instructions do not even mention the exclusion of such income.

The Budget Bill's adoption of a combined reporting regime further exacerbates this uncertainty since the bill does not describe how an unincorporated business that is part of a unitary group subject to the District franchise tax will be taxed. The Budget Bill provides that "if a unitary business includes income from a

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[5] *See Appeal of Joyce*, Cal. State Bd. of Equaliz., Nov. 23, 1966, Dkt. No. 66-SBE-070, and *Appeal of Finnigan*, Cal. State Bd. of Equaliz., Aug. 25, 1988, Dkt. No. 88-SBE-022, on reh'g, Jan. 24, 1990.

[6] DC Code § 47-1803.03(d)(7).

[7] § 47-1803.02(a)(2)(D).

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partnership, the income to be included in the total income of the combined group shall be the member of the combined group's direct and indirect distributive share of the partnership's unitary business income."[8] A similar provision provides for inclusion of the partnership's apportionment factors. However, the legislation does not include the partnership as a member of the combined group for purposes of calculating the partnership's tax. Furthermore, if a unitary partnership is not treated as a member of the combined group but instead is subject to tax on a separate basis, questions arise regarding the deferral of gain and loss on transactions between the partnership and a member of the unitary group.

Sutherland Observation: The failure to revise the franchise tax law to account for the District's direct tax on unincorporated businesses is a significant problem with the proposed legislation. The structure of the combined reporting provisions implies that a partnership is not actually a member of the unitary group. Does this mean that the partnership continues to calculate its tax on a separate entity basis and that its corporate partners continue to exclude the income and apportionment factors subject to the District's unincorporated business tax from the tax calculation of the combined group? If so, this would seem to create constitutional problems because the income of a pass-through entity that is not doing business in the District would be included in the combined group's tax base, while income from a pass-through entity subject to the DC unincorporated business tax would be excluded.

What's Next?

Public hearings on the Budget Bill will continue through May 6; final passage of the Budget Bill is expected by June 7. If the Council approves the Budget Bill and its substantive combined reporting legislation, Congress will review the Budget Bill but is unlikely to make changes to the legislation. Council approval of the Budget Bill, as drafted, is not a foregone conclusion. While Councilmember Jack Evans (Chair of the Committee on Finance and Revenue) favors combined reporting in concept, he has publicly rejected Mayor Gray's Budget Bill due to its other tax increases.[9] With a stand-alone combined reporting proposal unlikely this year, the District's leadership will likely seek a compromise.

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If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

Michele Borens	202.383.0936	michele.borens@sutherland.com
Jeffrey A. Friedman	202.383.0718	jeff.friedman@sutherland.com
Stephen P. Kranz	202.383.0267	steve.kranz@sutherland.com
Marc A. Simonetti	212.389.5015	marc.simonetti@sutherland.com
Eric S. Tresh	404.853.8579	eric.tresh@sutherland.com
W. Scott Wright	404.853.8374	scott.wright@sutherland.com
Douglas Mo	202.383.0847	douglas.mo@sutherland.com
Jonathan A. Feldman	404.853.8189	jonathan.feldman@sutherland.com

[8] § 47-1810.05(B)((4).

[9] *See* Washingtoncitypaper.com, What's Wrong with Vince Gray?, http://www.washingtoncitypaper.com/blogs/looselips/2011/03/09/whats-wrong-with-vince-gray/ (last accessed Apr. 4, 2011); Press Release, Office of Councilmember Jack Evans, Evans Responds to Mayor Gray's FY 2012 Budget Proposal (Apr. 1, 2011) (on file with author).

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Pilar Mata	202.383.0116	pilar.mata@sutherland.com
Michele L. Pielsticker	916.498.3311	michele.pielsticker@sutherland.com
Diann L. Smith	202.383.0884	diann.smith@sutherland.com
Marlys A. Bergstrom	404.853.8177	marlys.bergstrom@sutherland.com
Andrew D. Appleby	212.389.5042	andrew.appleby@sutherland.com
Zachary T. Atkins	404.853.8312	zachary.atkins@sutherland.com
Madison J. Barnett	404.853.8191	madison.barnett@sutherland.com
Michael L. Colavito	202.383.0870	mike.colavito@sutherland.com
Miranda K. Davis	404.853.8242	miranda.davis@sutherland.com
Maria P. Eberle	212.389.5054	maria.eberle@sutherland.com
Seth A. Fersko	212.389.5049	seth.fersko@sutherland.com
Lisbeth A. Freeman	202.383.0251	beth.freeman@sutherland.com
Charles C. Kearns	202.383.0864	charlie.kearns@sutherland.com
Jessica L. Kerner	212.389.5009	jessica.kerner@sutherland.com
David A. Pope	212.389.5048	david.pope@sutherland.com
Melissa J. Smith	202.383.0840	melissa.smith@sutherland.com
Maria M. Todorova	404.853.8214	maria.todorova@sutherland.com
Mark W. Yopp	212.389.5028	mark.yopp@sutherland.com

For more information about Sutherland's SALT team and for coverage and commentary on state and local tax developments, visit Sutherland SALT Online at www.stateandlocaltax.com.