



**Report of the Hearing Officer  
Regarding the Proposed “Finnigan Method” Model Statute for Combined Reporting  
July 13, 2020**

Table of Contents

I.	Introduction and Summary of Project.	Page 2
II.	The Relationship of the Proposed Finnigan Model to the Existing Joyce Model, and the Commission’s Current Policy Position on the Preferred Methodology.	Page 3
III.	Procedural History of the Proposed Finnigan Model Statute.	Page 4
IV.	Apportionment of Unitary Business Income on a Combined Filing Basis under Joyce and Finnigan, Compared.	Page 6
V.	The Legal Debate over the Joyce Versus the Finnigan Methodologies.	Page 7
VI.	The Impact of the Legal Debate Over the Joyce and Finnigan Methodologies on the MTC’s Adoption of the 2006 Joyce Model.	Page 8
	1. <i>In the Matter of the Appeal of Joyce, Inc.</i> , 1966 WL 1411 (1966)	Page 9
	2. <i>In Re Appeal of Finnigan</i> , 88–SBE–022, 1988 WL 152336, and Finnigan II	Page 9
	3. <i>Appeal of Huff Corporation</i> , 99-SBE-005, 1999 WL 386938. (1999).	Page 10
	4. California Codifies the Finnigan Rule.	Page 11
	5. After Careful Study, the Multistate Tax Commission Adopts the Joyce Model Combined Reporting Statute; Uncertainties about the Constitutionality of the Finnigan Methodology Are a Driving Factor in that Decision.	Page 11
VII.	Description of Key Components of the Proposed Finnigan Model.	Page 13
VIII.	Response to Public Comment on the Proposed Finnigan Model.	Page 14
	a. Proposed Addition of a Consolidated Filing Option.	Page 15
	b. Proposed Elimination or Simplification of the Capitol Loss Provisions.	Page 17
IX.	Recommendation.	Page 19
Exhibit A	Proposed “Finnigan Method” Model Statute for Combined Reporting	
Exhibit B	Notice of Hearing	
Exhibit C	Submission on the Proposed Finnigan/Combined Filing Model Alternative	
Exhibit D	COST Comments on Proposed Finnigan/Combined Filing Alternative Model	
Exhibit E	Response to Written Comments of COST – With Respect to Capital Gains and Losses	

## I. Introduction

Combined filing states use one of two main approaches to apportion a unitary group's taxable income—"Joyce" or "Finnigan"—named after two California administrative tax decisions from 1966 and 1978-1980, respectively.<sup>1</sup> It is sometimes said that the difference between these two approaches is that under Finnigan, the entire combined filing group of unitary corporations is essentially treated as a single taxpayer for apportionment purposes, while under Joyce, each corporate member of the combined group is treated as a separate taxpayer. Although the variations among existing state statutes present a much more complicated picture of how each of these systems operate, the description is broadly accurate.

In 2006, the Multistate Tax Commission (MTC) adopted its *Model Statute for Combined Reporting* based explicitly on the Joyce methodology of apportioning the incomes of multijurisdictional unitary combined filers. The carefully considered and meticulously drafted model has proven to be an invaluable guide for states implementing mandatory combined reporting or applying combined reporting on an *ad hoc* basis to prevent distortions of income. Combined reporting is also an area where uniformity is of critical concern, because variations in how states set themselves to the task of implementation can lead to duplicative taxation or significant tax gaps.

At the time of the model's development, a significant majority of the states that allowed or required combined reporting followed the Joyce methodology, including California. Since that time, however, several states have chosen to adopt the Finnigan methodology, including California, Wisconsin, Massachusetts, New York and Maine. The states' shift to Finnigan-based combined filing did not trigger a commensurate effort by the MTC to develop a Finnigan-based model statute, leaving states on their own to develop what are by necessity complex, detailed, and comprehensive statutory systems for determining tax bases and apportioning the incomes of unitary business entities. In April 2018, a member of the public asked the Commission's Uniformity Committee to undertake a project to create a Finnigan-based combined reporting model statute, to fill this gap in the MTC's otherwise comprehensive body of model laws for business taxation. The Committee approved a motion to accept the project at that meeting and quickly formed a working group to draft an alternative to the 2006 Joyce model.

The members of the Uniformity Committee at that meeting expressed a strong preference to retain as many substantive provisions of the 2006 Joyce model as possible, including the imposition of a worldwide combined reporting system with an available election of water's edge combined filing.

It is fair to say that the intrepid group of volunteers who stepped forward that spring envisioned a brief project involving the substitution of a few words or phrases to convert the existing Joyce model into a Finnigan model. As the working group's weekly sessions progressed through the summer and fall of 2018 and into 2019, it became apparent that piecemeal amendment to the language of the Joyce model would be unworkable: the separate-entity apportionment and income calculation provisions were simply too deeply embedded in the model's structure to utilize a cut-and-paste approach.

---

<sup>1</sup> *In re the Appeal of Joyce, Inc.*, California State Board of Equalization (1966); and *In re the Appeal of Finnigan Corporation*, 88-SBE-022, 1988 WL 152336, and *Appeal of Finnigan Corporation*, SBE No. 85-623-LB (1990)(*Finnigan II*, on rehearing).

The need for a fresh start became even more apparent in November 2018, when the Uniformity Committee voted in favor of adopting what became known as the Utah approach to combined filing. Under Utah's system, the entire unitary group is essentially treated as a single taxpayer for most purposes, including sharing many tax attributes. The Utah approach was seen to offer some advantages over how other states such as California and Massachusetts approached Finnigan-based combined reporting, as those states' statutes provide for a proportional reallocation of factors (or income) among the separate corporate entities subject to tax within the jurisdiction. The Utah approach appeared to be a more straightforward means of reaching an identical apportionment result for the combined group.

The proposed model, attached as Exhibit A to this report, follows the Utah approach of treating the entire combined filing group as a single taxpayer, alleviating the necessity of reallocating income and factors among the members of the group, while also imposing some limitations on the sharing of certain tax attributes based on federal consolidated filing principles. It is the culmination of almost two years of study, deliberation and drafting effort by the members of the working group and the full Uniformity Committee.

## II. The Relationship of the Proposed Finnigan Model to the Existing Joyce Model, and the Commission's Current Policy Position on the Preferred Methodology.

Although the Uniformity Committee approved the project to develop a Finnigan model combined reporting statute in 2018, at no point has the committee considered the withdrawal or modification of the 2006 Joyce model statute. The Finnigan combined reporting model has always been envisioned as a stand-alone alternative to the existing model. The Executive Committee is thus presented with the unusual circumstance of considering approval of a model apportionment statute that is inconsistent with an existing model, a position seemingly at odds with the Multistate Tax Compact's goal of promoting "uniformity or compatibility" in state taxing systems. *Compact*, Art. I.<sup>2</sup>

The Uniformity Committee concluded that the direct and immediate advantages of having a detailed Finnigan model available for the states considering adoption of combined reporting outweighed the theoretical disadvantages stemming from encouraging states to choose between them. And as a practical matter, where approximately 25 states have already chosen one of the two methodologies, it seems unlikely that the MTC would be able to convince the states to settle on a single methodology for years to come.

The development of this alternative to the Joyce model should be not, therefore, be interpreted as either an endorsement of the Finnigan methodology or a rejection of the Joyce methodology. And in that regard, it should be noted that the Uniformity Committee on April 22, 2020 voted to eliminate the prior endorsement of the Joyce methodology in the proposed revised *Statement of Information Concerning Practices of the Multistate Tax Commission and Signatory States Under Public Law 86-272* ("*Statement of Information*"); if approved as currently drafted, the *Statement of Information* will not endorse either methodology.<sup>3</sup>

---

<sup>2</sup> <http://www.mtc.gov/The-Commission/Multistate-Tax-Compact>

<sup>3</sup> <http://www.mtc.gov/getattachment/Uniformity/Project-Teams/P-L-86-272-Statement-of-Information-Work-Group/Work-Group-proposal-compare-to-current-2001-Statement.pdf.aspx?lang=en-US>

In keeping with the Uniformity Committee's decision to provide an alternative to the Joyce model, this Report does not make a recommendation as to which methodology is preferable from a policy standpoint, from a revenue standpoint, or otherwise. It is the hearing officer's conclusion, however, that the Finnigan methodology as incorporated in this proposed model is legally defensible, is easily administrable, and will consistently produce a fair apportionment and allocation of the combined net income of a unitary group of corporations among taxing states.

By contrast, there are some situations where the Joyce methodology *may not* result in the fair apportionment of the net income of a unitary group. A mismatch of apportionment factors and the income generated within a taxing state may occur by virtue of the application of Uniform Division of Income for Tax Purposes Act's (UDITPA's) Section 16<sup>4</sup>, which incorporates the "throw-back rule" for sourcing sales of tangible personal property (TPP). Section 16 provides that when a seller is not subject to tax in the state where TPP is delivered to a buyer, such sales are sourced ("thrown back") to the state from where the TPP was shipped. Application of the throw-back rule to the separate entities comprising a Joyce method return may therefore result in a theoretical overstatement or understatement of a combined group's business presence in those states in which shipment or delivery occurs, depending on a variety of factors.

There is a more concerning problem with the Joyce methodology that has been long-recognized by the states: its vulnerability to deliberate tax planning schemes based on P.L. 86-272 (15 U.S.C. §§ 381-384) immunity.<sup>5</sup> The interaction of the federal statute with Section 16's apportionment rules creates the potential for "nowhere" sales in situations where TPP is: (a) shipped by selling entity located in a state that does not follow UDITPA's throw-back rule; (b) delivered to the buyer in a state in which the selling entity has nominally limited its in-state activity to solicitation. And because intercompany sales are eliminated under combined reporting rules, little effort is required to concentrate a combined group's sales factor into a single entity designed to enjoy P.L. 86-272's immunity in the combined group's principal markets.

The universal adoption of Section 16's throwback sourcing rules would negate most efforts to rely on P.L. 86-272 immunity to reduce tax liability by structuring business operations to distort apportionment calculations.<sup>6</sup> Currently, however, only 22 states with business taxes measured by income or receipts have a throwback rule, while 24 states do not.<sup>7</sup> In comparison, such a scheme would be ineffective in a Finnigan state, since the selling entity's sales would continue to be sourced to the destination state.<sup>8</sup>

---

<sup>4</sup> Incorporated into the Multistate Tax Compact as Art. IV, Sec. 16.

<sup>5</sup> See *MTC Income & Franchise Tax Uniformity Subcommittee Work Group Recommendations Regarding Application of the Joyce Apportionment Formula*, p. 1, attached as Appendix F to the "Finnigan Briefing Book", dated June 8, 2018. <http://www.mtc.gov/getattachment/Uniformity/Uniformity-Committee/2018/Agenda-7-2018/Finnigan-Briefing-Book.pdf.aspx?lang=en-US>.

<sup>6</sup> Presumably, states could invoke UDITPA's equitable apportionment provision, Section 18, to recalculate the group's apportionment factors to achieve a better representation of business presence in such a circumstance.

<sup>7</sup> *Bloomberg Tax (BNA)*, State Corporate Income Tax Chart Builder (last visited 7/5/20).

<sup>8</sup> Based on pro-forma returns, the Maryland Comptroller has estimated that adoption of mandatory combined reporting utilizing the Finnigan methodology would result in significantly higher average tax revenues in that state than the Joyce methodology. The potential impact of "nowhere sales" under Joyce may or may not contribute to the difference. [https://www.taxadmin.org/assets/docs/Meetings/11rev\\_est/schaufefe.pdf](https://www.taxadmin.org/assets/docs/Meetings/11rev_est/schaufefe.pdf).

### III. Procedural History of the Proposed Finnigan Model Statute.

A working group was formed in April 2018 to begin work on the new model; it has been chaired throughout by Phil Skinner, Deputy Attorney General for the State of Idaho.<sup>9</sup> The working group held scores of weekly or bi-weekly public meetings over the next two years devoted to studying existing statutes, to consideration of alternative approaches, and to parsing the language of numerous drafts. These meetings were held via internet-based conferencing platforms and telephone. In addition, the working group presented drafts and policy options to the full Uniformity Committee at several in-person meetings. (The working group's progress in working through issues and considering various drafts of what became the current proposed model can be viewed on the Commission's project webpage, <http://www.mtc.gov/Uniformity/Project-Teams/Model-Option-for-Combined-Filing>.)

The current proposed model was presented to the Uniformity Committee on April 22, 2020 at which time the committee voted unanimously to approve the proposed model for referral to the Executive Committee.

On April 23, 2020, the Executive Committee unanimously approved the proposed model for public hearing.

The public hearing was duly noticed through the Commission's Public Notice mailing lists on April 30, 2020 and posted on the Commission's website, [www.mtc.gov](http://www.mtc.gov). The Notice is attached as Exhibit B.

Due to the outbreak of COVID-19 in the spring of 2020, the public hearing was held remotely, on June 9, 2020, by video-conferencing and telephone. The meeting was well-attended by approximately 60 state representatives and members of the public. MTC Uniformity Counsel, Helen Hecht, described the basic functioning and some of the technical aspects of the proposed model, and further highlighted some of the more significant policy choices embedded in the model's structure.

A memorandum submitting the draft for hearing and outlining the background of the project and certain key aspects of the proposed model was posted on the Commission's project page on June 1, 2020 and is attached hereto as Exhibit C.<sup>10</sup>

There were no public comments made during the hearing. A single written comment was received from the Council On State Taxation (COST) just prior to the meeting, attached as Exhibit D.<sup>11</sup> The written comment from COST raised two separate issues, discussed in Part VIII, below. The hearing officer announced during the hearing that the time for public comment would be extended for 10 days, until June 19, 2020. No additional comments were received. The hearing officer also asked MTC staff to respond in writing to one of the two issues raised by COST's public comment. That response is attached as Exhibit E.

---

<sup>9</sup> The MTC is indebted to Mr. Skinner and the other state representatives who worked on this project for their patient efforts, insight and commitment.

<sup>10</sup> [http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Model-Option-for-Combined-Filing/Submission-of-Finnigan-Alternative-to-Public-Hearing-with-Model-attached-\(FINAL\).pdf.aspx?lang=en-US](http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Model-Option-for-Combined-Filing/Submission-of-Finnigan-Alternative-to-Public-Hearing-with-Model-attached-(FINAL).pdf.aspx?lang=en-US)

<sup>11</sup> <http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Model-Option-for-Combined-Filing/06092020-COST-Ltr-re-MTC-Finnigan-Model-Attach.pdf.aspx?lang=en-US>.

#### IV. Apportionment of Unitary Business Income on a Combined Filing Basis under Joyce and Finnigan, Compared.

The essential difference between the Joyce and Finnigan approaches is the way in which the receipts (sales) factor numerator for the combined filing group is computed. Under both approaches, the receipts factor denominator includes all receipts of all the group members. Under Joyce, however, the receipts factor numerator excludes the in-state sales of members that, on a separate-entity basis, would lack nexus or would be deemed protected by P.L. 86-272.<sup>12</sup> In contrast, under Finnigan the receipts factor numerator will include in-state sales of all members, including those members that may lack nexus or that would be considered protected by P.L. 86-272 if filing as separate entities.

As described previously, UDITPA's throwback rule plays a significant role in apportionment calculations under Joyce, but it would rarely be triggered in states following the Finnigan methodology. The purpose of the throwback rule is to ensure full apportionment of the multistate taxpayer's income to prevent that taxpayer from obtaining a competitive advantage over a taxpayer that confines its operations to a single state.

Under the Joyce methodology, where the members of a combined filing group are treated as separate entities in applying UDITPA's apportionment rules, sales by a seller of TPP will be thrown back to the shipping state if that member is protected by P.L. 86-272, or the state lacks nexus under the jurisdictional limitations of the U.S. Constitution's due process and commerce clauses.<sup>13</sup> This is true even if other members of the same group comprising a unitary business are subject to tax in the destination state. By the same token, an out of state taxpayer delivering TTP into a state will be required to source its sales to the state from whence the TPP originated if the taxpayer is not subject to tax in that state on a separate-entity basis, even though other members of the unitary business enterprise are subject to tax in the destination state. The interplay of Joyce, P.L. 86-272 immunity and throwback rules can accordingly lead to some incongruous sourcing results for taxpayers engaged in selling TPP, imposing additional liability on some taxpayers and rewarding others, while often failing to reflect the extent of business activity in either the shipping state or destination state.

The Finnigan methodology essentially treats all members of a unitary combined filing group as a single entity for apportionment purposes. The sales factor numerator for taxpayers filing a combined return include all receipts from sales of TPP delivered into the state and all service receipts and receipts from intangible property sourced to the state if any member of the unitary filing group is subject to tax in that state. The throw-back rule is essentially non-operational. If any member of the unitary combined filing group is subject to tax in the destination state, all receipts from the sale of TPP, services and intangible property utilization are included in that state's numerator, while no receipts are thrown back to the shipping state.

---

<sup>12</sup> Under the MTC's *General Allocation and Apportionment Model Regulation*, a taxpayer is "subject to tax" in a state if the state has jurisdiction to impose an income tax over the taxpayer and the taxpayer is not immune from taxation under P.L. 86-272.

<sup>13</sup> A state's voluntary jurisdictional limitations, such as a factor-based nexus threshold, or a state's decision not to impose an income tax at all, does not affect the determination of whether a taxpayer is "subject to tax" in that state.

The Finnigan approach thus has the salutary effect of aligning the sales factor numerators of the taxpayer in every state with the overall calculation of taxable income generated by the unitary combined group. In other words, under the Finnigan methodology, in states employing a single sales factor, the sales factor numerator in each state will reflect the taxpayer's business presence in that state. In comparison, under the Joyce methodology, the sales factor numerator may be adjusted under the throw-back rules to achieve the goal of full apportionment of the tax base, favoring some states and disfavoring others. And as previously discussed, in the absence of a throwback rule in the shipping state, the Joyce methodology creates the potential for nowhere income, since the sales factor numerators will not necessarily add up to the sales factor denominator.

#### V. The Legal Debate Over the Joyce Versus the Finnigan Methodologies.

For almost half a century, there has been a fairly vigorous debate in academic circles and in the courts as to whether the Finnigan model or Joyce model of income apportionment is the most appropriate (or necessary) one for states to follow. Some description of that controversy may be helpful in order to place this model into context and to explain why certain drafting and policy choices were made.

The heart of the legal controversy is this: does the Finnigan approach result in the impermissible taxation of entities that lack nexus with the state or that are protected from state income taxation by P.L. 86-272?

The debate is sometimes framed as presenting the question of whether the Finnigan methodology is merely a rule of apportionment, or whether it constitutes an assertion of jurisdiction over protected or non-nexus entities. Because the U.S. Supreme Court has never opined on the constitutionality of the Finnigan methodology (despite having been given two opportunities to do so),<sup>14</sup> it may not be possible to provide a definitive resolution to the historic legal controversy in this or any other report. The weight of legal authority, however, supports the conclusion that the state and federal courts would uphold the Finnigan methodology of apportionment if it is challenged again.

Arguably the most significant case to consider the issue is *Disney Enterprises v. Tax Appeals Tribunal of the State of New York*, 888 N.E.2d 1029 (N.Y. 2008). In *Disney*, the New York Court of Appeals concluded that the state's Finnigan rule did not constitute an impermissible tax on Buena Vista Pictures, Inc. (a retailer of video cassettes claiming the protections of P.L. 86-272) by including the New York sales of that entity in the combined return's sales factor numerator. The court concluded that the Finnigan method presented a mere question of fair apportionment, and was not a "tax" on the entity itself. The court wrote: "we agree with the Appellate Division that by 'including Video's New York sales receipts in the numerator of the business allocation percentage, the Department is not imposing a tax upon Video. It is attempting to best measure the combined group's taxable in-state activities.'" 888 N.E.2d at 1033.<sup>15</sup>

The court went on to hold that the application of the Finnigan apportionment method did not run afoul of P.L. 86-272 because under the unitary business principle, the "taxpayer" was essentially the unitary group as a whole, not its component members, citing *Airborne Navigation Corporation v. Arizona*

---

<sup>14</sup> See *Deluxe Corp. v. Franchise Tax Bd.*, No. 991237 (Cal. Super. Ct. - San Francisco May 28, 1999); *Deluxe Corp. v. California Franchise Tax Board*, U.S., No. 01-603, *cert. denied*, 1/7/02; *Citicorp North America, Inc. v. Franchise Tax Bd.*, 83 Cal.App.4th 1403, 100 Cal.Rptr.2d 509 (App. 1st Dist. 2000)(*cert. denied*, No. 00-1537, 6/29/01).

<sup>15</sup> In a concurring opinion, Justice Smith came down on the opposite side of the apportionment/imposition of tax argument, finding that inclusion of Buena Vista's sales in the numerator did indeed constitute a tax on that entity.

*Department of Revenue*, 1987 WL 50031 (Ariz. Bd. Tax. App. Feb. 5, 1987). The court found that P.L. 86-272 did not unambiguously define a protected “person” as a separate taxable entity from the remainder of the unitary business. The court relied on well-established caselaw that in the context of federal preemption of traditional areas of state authority, including taxation, Congress’ intent to preempt state authority must be clearly and unambiguously expressed. See, e.g., *Dept. of Rev. of Oregon v. ACF Industries, Inc.*, 510 U.S. 332 (1994).

The court also noted but did not reach the state’s argument that because Disney’s various subsidiaries were providing promotional services on behalf of Buena Vista Pictures, it would not have been entitled to claim the protections of the statute.

The *Disney* decision was later cited with approval in *Arizona Dept. of Rev. v. Central Newspapers, Inc.*, 218 P.3d 1083 (Az. App. 2009), in which the court upheld Arizona’s inclusion of a partnership’s Arizona sales numerator on a combined return despite the argument that the partnership had immunity from taxation under P.L. 86-272, holding that the state’s administrative rule defining the combined group as a single person was valid.

Together, the *Disney* and *Central Newspaper* cases stand for the proposition that a state may choose to define the unitary group as the “taxpayer” for purposes of apportionment, and by necessary implication, that taxpayer is the relevant “person” for purposes of evaluating immunity from taxation under P.L. 86-272.

The absence of any subsequent litigation may also reflect the reality that the opportunities for a clear legal challenge to the Finnigan methodology are diminished by changes in modern business practices<sup>16</sup> and modern conceptions of taxing jurisdiction.<sup>17</sup> The very nature of a unitary business enterprise, which requires a synergy and exchange of value between the various components of the business, will usually supply the basis for a finding that the activities of particular corporate entities within the taxing jurisdiction served to further the business interests of (nominally) non-nexus or protected businesses.

And as described in more detail below, the proposed model eliminates the necessity of determining whether activities are performed “on behalf of” the nominally protected seller because it defines all members of the unitary business as a single entity (“person” or “taxpayer”) for tax imposition purposes.

#### VI. The Impact of the Legal Debate Over the Joyce and Finnigan Methodologies on the MTC’s Adoption of the 2006 Joyce Model.

Almost all of the early cases concerning the propriety or necessity of Joyce or Finnigan arose out of California, the birthplace of unitary combined filing. As explained below, the California State Board of Equalization (SBE) initially adopted Joyce out of concern that inclusion of corporations in the state’s combined filing system might run afoul of P.L. 86-272, if individual corporations that were immune from taxation under that federal statute were included in the combined return. The SBE later adopted the

---

<sup>16</sup> See, e.g., the MTC proposed *Statement of Information*, Art IV, Section C, outlining protected and unprotected activities carried out via the Internet. <http://www.mtc.gov/getattachment/Uniformity/Project-Teams/P-L-86-272-Statement-of-Information-Work-Group/Work-Group-proposal-compare-to-current-2001-Statement.pdf.aspx?lang=en-US>

<sup>17</sup> See especially, *Wayfair v. South Dakota*, 138 S.Ct. 2080 (2018)(abrogating the “physical presence” commerce clause nexus standard established in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

Finnigan approach as being more consistent with the unitary business principle in the context of combined reporting. The SBE then reluctantly returned the state to the Joyce methodology in the interest of furthering uniformity among the states employing combined filing and UDITPA. Those landmark cases are briefly described below.

1. *In the Matter of the Appeal of Joyce, Inc.*, 1966 WL 1411 (1966)

In 1966, the SBE had its first confrontation with the interaction of P.L. 86-272, UDITPA's apportionment formula and California's laws mandating combined filing. The taxpayer in that case, Joyce, manufactured and sold women's shoes. It employed two salespeople and had "certain leasehold improvements" in the state, but sales orders were approved out of state and merchandise was shipped from out of the state. Joyce was also incorporated in California, and on that basis, the SBE held that Joyce was not protected from taxation by California on the basis of P.L. 86-272 immunity.

The SBE held that Joyce was engaged in a unitary business with three other out of state businesses, all of whom were immune from taxation by California under P.L. 86-272. California assessed tax on Joyce based on the combined incomes of all four entities, which was then apportioned to the state using the state's three-factor apportionment formula. The sales factor numerator included the in-state sales of Joyce's subsidiary U.S. Shoe, Inc., an out of state manufacturer selling into California.

The SBE noted that California's combined filing statute did not include authority to tax out of state entities, but instead, the statute provided for the use of formulary apportionment to calculate the income of entities subject to tax within the state. Including the sales of U.S. Shoe in the sales factor numerator had the effect of improperly taxing U.S. Shoe's income, the SBE ruled. The SBE concluded:

Inasmuch as U. S. Shoe, in addition to appellant, solicited orders in California, a portion of the unitary income attributable to sources within this state constituted income of U. S. Shoe which was not includible in the measure of tax. The apportionment of the California income between appellant and U. S. Shoe was not made by respondent.

We conclude that respondent must allocate to appellant and include in the measure of tax only a reasonable portion of the unitary net income which respondent has determined is attributable to California sources. This allocation should be made on the basis of appellant's property, payroll and sales within California, in a manner designed to reasonably reflect the contribution of those factors to the total unitary net income.

Based on that decision, California's tax authorities applied what became known as the Joyce rule, including the in-bound sales of combined entities that were immune from taxation under P.L. 86-272 in the denominator but not the numerator of the combined filing group. (Another means of accomplishing the division of income mandated by the SBE would have been to entirely exclude the separately reported income and apportionment factors of the non-taxable entity from the combined filing group.)

2. *In Re Appeal of Finnigan*, 88-SBE-022, 1988 WL 152336, and *Finnigan II*

In *Finnigan I* (1988), the SBE considered the definition of "taxpayer" in the context of California's throw-back rule when applied to the operation of a combined filing group's sales factor. Finnigan Corporation was a California corporation that sold scientific instruments throughout the country. A unitary subsidiary, DISC Corporation, sold a different line of instruments throughout the country, but was not

considered to be “subject to tax” in any other state. The Franchise Tax Board’s assessment of Finnigan included the sales of DISC thrown back to California, since DISC was not taxable in other states as a separate entity. Finnigan complained that California was defining “taxpayer” inconsistently, and since the group was taxable in other states, DISC’s sales should not have been thrown back to California. The SBE agreed, citing *Edison California Stores, Inc. v. McColgan*, 183 P.2d 16 (1947), for the proposition that a “the same rules should apply” for divisions and separately incorporated entities when apportioning income.

In the rehearing of the *Appeal of Finnigan (Finnigan II)*, 85A–623–DB, 1990 WL 15164 (1990), the SBE addressed the Joyce rule directly, noting that rule had been subject to “particularly pointed scholarly criticism.”<sup>18</sup> The SBE explained that its original *Joyce* decision was rendered during a time of uncertainty about the effects of P.L. 86-272 and uncertainty about the leeway given to the states to employ combined reporting, a concern that was eliminated with the decision in *Container Corp. v. Franchise Tax Board*, 463 U.S. 189 (1983). The SBE wrote:

Joyce established an unsound rule of apportionment out of fear that the courts would give an expansive interpretation to Public Law No. 86–272 and thereby seriously restrict the application of unitary apportionment principles to multicorporate businesses. Intervening years have shown, however, that this fear was unfounded.

The SBE continued that the Joyce rule “contravenes fundamental unitary theory” by defeating the purpose of the sales factor, that is, reflecting the market for the taxpayer’s sales, and elevating form over substance by “yielding a different apportionment result” depending on whether the taxpayer operates as a single entity or multiple legal entities. The SBE emphasized that it was applying a rule of apportionment, and was not suggesting that it was creating a tax jurisdictional rule.

3. *Appeal of Huff Corporation*, 99-SBE-005, 1999 WL 386938. (1999).

The SBE’s role in the Joyce/Finnigan debate did not end with Finnigan, however. In 1999, the SBE considered the matter anew in the context of a refund claim filed by a unitary group of corporations challenging California’s inclusion of sales in the sales factor numerator of five out of seven state consumer products retailers that were protected by the application of P.L. 86-272. The SBE overruled its decision in *Finnigan I* and *II* and reverted to the Joyce rule. The SBE noted its overriding motivation for reverting to Joyce was not because Joyce represented the superior rule for apportionment; to the contrary, the SBE reaffirmed that Finnigan represented the better approach to apportioning income. Instead, the SBE “wistfully”<sup>19</sup> noted that the other UDITPA combined filing states had not followed its lead in moving to Finnigan, but rather had continued to use the Joyce methodology, leaving California as essentially an outlier. The SBE held that fostering uniformity among the states was of critical concern because of the likelihood that businesses would otherwise be subjected to duplicative taxation. The SBE noted that the MTC had endorsed the Joyce methodology (likely referring to the MTC’s *Statement of*

<sup>18</sup> The SBE cited J. Hellerstein and W. Hellerstein, 1988 Cumulative Supplement to J. Hellerstein, *State Taxation I: Corporate Income and Franchise Taxes* (1983), ¶ 9.17 [1][b] [iii]; Corrigan, “Finnigan’s Wake or Joyce’s? The Application of the Unitary Principle to Combined Groups,” 1 J.Cal.Tax. 5 (1989).

<sup>19</sup> Hellerstein, Hellerstein & Swain, *State Taxation*, ¶ 9.18[1][h][i] (Thompson Reuters 3<sup>rd</sup>. Ed. 2001 (2020 supp)).

*Practices Concerning P.L. 86-272*) and that in a 1997 *Multistate Tax Commission Review*, it was noted that 15 states had indicated their support of the Joyce methodology.<sup>20</sup>

4. California Codifies the Finnigan Rule.

In 2010, the California legislature codified the Finnigan rule, effective for tax years beginning 1/1/11. Cal. Rev. & Tax Code § 25135. California joined 11 other states in adopting the Finnigan approach to income apportionment. Section 25135 of California's Code is addressed solely to calculating the sales (receipts) factor for unitary entities. It provides that the sales factor numerator will include all sales of tangible personal property delivered to customers in the state if any member of a unitary combined filing group is subject to tax there, and further providing that the sales factor numerator will not be increased by "throw-back" sales of tangible personal property shipped from the state to customers in another state if any member of the unitary combined group is subject to tax in that destination state.

5. After Careful Study, the Multistate Tax Commission Adopts the Joyce Model Combined Reporting Statute; Uncertainties about the Constitutionality of the Finnigan Methodology Are a driving Factor in that Decision.

In June of 2003, the MTC's Uniformity Committee commenced work on a proposed model combined reporting statute at the request of the MTC's Executive Committee. A large part of the committee's work focused on developing a definition of a unitary business that was then incorporated into the MTC's Model *General Allocation and Apportionment Statute*. But a secondary focus of the Committee's study and deliberation was the choice between Joyce and Finnigan.

We are fortunate to have the benefit of a very comprehensive hearing officer's report and a robust public record of the Uniformity Committee's deliberations that provide us with significant insight into the reasons for the Commission's eventual endorsement of the Joyce methodology.

In 2004, a subcommittee formed to draft a new combined reporting model presented their Joyce-based proposal to the full Uniformity Committee. The committee did not approve it, asking the subcommittee to consider a new model based on the Finnigan approach. The Uniformity Committee's primary concern was the potential under Joyce for "nowhere income" resulting from tax planning schemes, discussed *infra*. The subcommittee's investigation of the matter resulted in a memo that recommended the

---

<sup>20</sup> There is more than a little irony in the SBE's decision to reject the Finnigan approach in this particular case, despite its continued belief that it represented the better system of apportionment. The decision was largely driven by the MTC's endorsement of the Joyce approach in its *Statement of Information Concerning Practices of the Multistate Tax Commission and Signatory States Under P.L. 86-272*. Huffey Corporation was engaged in the manufacture and sales of bicycles and other sports consumer equipment, yet the activities of one or both of its non-sales subsidiaries operating within the state would almost certainly have caused Huffey Corporation to lose its immunity under the guidelines established in the Commission's *Statement of Information*. In footnote 5 of the decision, the activities of those subsidiaries were described as follows: "Washington Inventory Service provided inventory services to retail businesses, including counting, stock replacement, reporting, ordering and related services. Huffey Service First, Inc. provided assembly and maintenance services for consumer products including, but not limited to, bicycles."

retention of its original Joyce-based draft model.<sup>21</sup> A memo listing the “pros and cons” for the Finnigan method bears review. The listed advantages of adopting the Finnigan rule included:

- *Under Finnigan, the business income ultimately apportioned to a state is the same whether an enterprise is conducted in divisional or multicorporate form.*
- *It prevents tax planning techniques for isolating sales in non-nexus affiliates.*
- *It helps reduce “no-where” income.*
- *It reflects the contribution of the market state in the production of income, in addition to manufacturing/production, regardless of whether the legal entity making the sales has nexus in a state.*

The subcommittee’s list of the “con’s” in following the Finnigan approach are particularly instructive. Some of the principal objections are listed below:

- *It is unclear whether the rule is constitutional. The California Court of Appeals has upheld the constitutionality of the Finnigan rule, but it is not clear whether this rule would be found constitutional in other jurisdictions.*
- *There is a question of whether the Finnigan rule contravenes Public Law 86-272. Because the word “person” used in P.L. 86-272 is likely to be interpreted as referring to each separate legal entity as opposed to the unitary group (see section 1 of title 1 of the United States Code), application of Finnigan may be unsupportable as an attempt by a state to contravene 86-272 and do indirectly what it cannot do directly.*
- *It may create more litigation. Because it is a more novel method than the Joyce rule, it is likely to produce litigation for a state that adopts the rule. It was the subject of much litigation in California.*
- *For states that have a throwback rule, it could be detrimental from a revenue perspective because they might not be able to throw back sales to their state if they adopt the Finnigan approach. In enacting the Finnigan rule, states should consider how it might affect their throwback rules.*
- *It may be inconsistent with the tax treatment required under other combined reporting provisions, such as those applicable to NOLs and credits.*
- *It may be inconsistent with the treatment of the separate group members as separate legal entities and as individual taxpayers.*
- *It may be a departure from the theory of intrastate apportionment that each member’s factors produce state source income in proportion to each member’s share of the factors of the group as a whole.*
- *It may be inconsistent with separate entity tax liability. Once tax is imposed upon a unitary member, the liability is that of the specific member. If the tax is unpaid, collection of that liability is limited to that particular member’s assets. If a unitary group were considered as a*

---

<sup>21</sup> See *MTC Income & Franchise Tax Uniformity Subcommittee Work Group Recommendations Regarding Application of the Joyce Apportionment Formula*, attached as Appendix F to the “Finnigan Briefing Book”, dated June 8, 2018. <http://www.mtc.gov/getattachment/Uniformity/Uniformity-Committee/2018/Agenda-7-2018/Finnigan-Briefing-Book.pdf.aspx?lang=en-US>

*single taxable entity, that would imply that assets of any member, located in any state or country, could be reached to satisfy an unpaid state tax deficiency of any member.*

The subcommittee's concerns with the constitutionality of the Finnigan approach were surely legitimate in 2004, but subsequent developments have significantly changed the equation.<sup>22</sup> Most significantly, the *Wayfair* decision has essentially eliminated a taxpayer's ability to claim a lack of nexus if it has systematic and substantial sales in the taxing state.

The subcommittee's concerns with the potential conflict with P.L. 86-272 also did not materialize; the California Court of Appeals had rejected similar arguments in *Deluxe Corp. v. Franchise Tax Board*, and with the later decisions in *Disney* and *Central Newspapers*, the propriety of the Finnigan method now appears to be firmly established.

Concern over revenue losses arising from the elimination of throw-back sales sourcing is a problematic basis for a policy decision. Section 16's throw-back provision is a remedy to prevent tax losses that would otherwise arise from "nowhere sales" due to a destination state's lack of taxing authority. It is not consistent with the theory of market-based sourcing as a measure of business presence within a state.

The subcommittee's concern that Finnigan would interfere with states' existing policies on NOLs and other tax attributes was unwarranted. States can and do choose to treat tax attributes independently from the choice of either Joyce or Finnigan apportionment rules. (The currently proposed Finnigan model generally allows sharing of tax attributes, subject to some restrictions.)

The Finnigan method does not compel states to ignore the separate legal existence of members of the combined group; few states have done so. (The currently proposed model does treat the group as a single taxpayer or person, but states can de-conform from the relevant definitions and still employ the remainder of the model statute.)

The remaining concerns listed in the memo were of minor significance then and remain so now.

Looking back on the memo and similar records of their deliberations 16 years later, it appears that the Uniformity Committee's rejection of the Finnigan methodology in favor of the Joyce approach could only have been based on the fear that it would be successfully challenged in state courts. Had that occurred, the goal of encouraging combined reporting to counter income-shifting might have been set back for years to come. (Presumably, the remedy in such a challenge would have been less drastic than eliminating the combined filing regime entirely.)

## VII. Description of Key Components of the Proposed Finnigan Model.

The essential components of the proposed Finnigan model are described in some detail in a memorandum dated June 1, 2020, prepared in conjunction with the public hearing in this matter, and are also described in a memorandum to the Uniform Committee dated March 23, 2020. Rather than repeat the content of those memoranda, only a few salient points bear emphasis here.

First, the model's structure is based, to the extent possible, on the structure established in the 2006 model, in keeping with the Uniformity Committee's initial instruction to the working group. The use of

---

<sup>22</sup> It bears noting that the subcommittee charged with creating the model statute included some of the most experienced and able state tax practitioners and legal scholars in the country.

worldwide combined reporting as the primary description of the scope of included entities remains. So too, the scope of the entities encompassed by the water's edge election provisions is unchanged. And the taxing agency retains authority to include additional entities within the combined group to prevent abuse or to more clearly reflect income (Section 2.B.).

Second, the Uniformity Committee's choice of the Utah approach as a template for treating the unitary group as an essentially indivisible whole is seen throughout the document, but the model goes beyond Utah's statute in explicitly defining the unitary group as a "person" (Section 1(g)) and by extension, as "the taxpayer" (Section 1(h)) for tax imposition purposes. These definitions will likely conflict with existing state definitions of those terms in other sections of the tax code, requiring some coordination and concordance. Defining the combined group as a "person" subject to tax is not necessary for operation of the model as a whole but brings the model statute unambiguously within legal principles established by the cases cited in section VI, above.

One of the policy controversies surrounding the choice of Joyce or Finnigan has been whether it is appropriate to allow sharing of income tax attributes among the separate members of the combined group. The treatment of net operating losses incurred before an entity joins the combined report appears to be the most contentious issue in many states. These controversies may be based on an erroneous understanding of the two systems, for neither apportionment system compels any particular treatment of such tax attributes.<sup>23</sup> In keeping with the Uniformity Committee's direction to follow the Utah approach, the proposed model follows analogous federal consolidated filing rules, which generally favor sharing of attributes subject to certain anti-abuse limitations. (Section 3.A.) States can, however, further limit the use of NOLs and capital losses, as will be discussed further below.

The model provides a method to calculate separate entity income where tax credits are limited to the entity generating them, recognizing that states generally do not allow such credits to be shared. (Section 3.A.viii.)

Some other provisions of the 2006 model were revisited and redrafted. The provisions for calculating an equivalent to federal taxable income for foreign corporations were simplified and clarified. (Section 3.A.i.(2)). New rules for apportioning partnership income to separate entities were established. (Section 3.B.iv.) And finally, a new provision was added clarifying that non-unitary entities with nexus in the state are required to file on a separate-return basis. (Section 4.C.)

#### VIII. Response to Public Comment on the Proposed Finnigan Model.

The Council On State Taxation (COST) submitted a public comment regarding the proposed model to the hearing officer on June 9, 2020, raising two issues. The first issue was a request that the proposed model include language allowing for the use of a "consolidated filing" option as an alternative to unitary combined filing. The second issue addressed concerns with perceived excessive compliance burdens that would be imposed on taxpayers due to the proposed model's requirement that capital gains and losses be recorded on a separate-entity basis and tracked separately for carryforward purposes, restricting the use of such losses in a manner consistent with federal consolidation filing rules. The hearing officer has considered both matters and concludes that the proposed model should not be

---

<sup>23</sup> Some Joyce states allow generous sharing of income tax attributes, while many Finnigan states restrict their utilization to the legal entity that generated it.

amended in response for the reasons set forth below. The hearing officer does recommend inclusion of two drafter's notes with the model to alert policy makers to the respective issues.

A. Proposed Addition of a Consolidated Filing Option.

COST proposes an amendment to the combined filing model to include an optional filing method based upon the federal consolidated filing group. The proposal was formally introduced by COST on October 4, 2019 in an e-mail to the working group's chair, Phil Skinner, although the matter had been discussed informally during prior meetings of the working group. The proposal was debated by the Uniformity Committee at its in-person meeting on November 6, 2019, in San Antonio, Texas. The committee rejected the proposal in a unanimous vote, but the Committee did instruct the Commission's legal staff to investigate the matter and prepare a whitepaper addressing state use of consolidated filing as an alternative to combined filing. Staff prepared a report for the Uniformity Committee dated February 2, 2020.<sup>24</sup>

The whitepaper summarized state practices regarding consolidated filing elections and found that such elections are commonly provided for by statute in most states. The elections have proven to be popular with taxpayers and have not created significant administrative or compliance burdens for revenue agencies. In addition, based on reports from state tax administrators and the MTC's audit supervisors, it appears that the consolidated elections are rarely if ever employed as a means of shifting income outside of the states' unitary combined filing tax base. Finally, the paper concluded that the consolidated filing options have not been associated with a significant reduction in tax revenues compared to unitary combined reporting.

In light of the whitepaper's findings, COST urges that the rejection of its proposal to include a consolidated filing election should be reconsidered. Despite the widespread acceptance of such elections among the states, the hearing officer concludes that it would not be advisable to include a consolidated election in the model. Instead, the hearing officer recommends inclusion of a drafters' note with the text of the model to: (a) alert policymakers to the potential benefits and drawbacks of such an election; and (b), to clarify that no negative inference should be drawn from the absence of such an election.

Before turning to the merits of COST's proposal, some clarification of what is meant by "consolidated filing election" is in order. Three types of consolidated (non-unitary group) filing elections were identified in the whitepaper:

1. Nexus Consolidated Filing. States that do not mandate unitary combined filing frequently allow an option for "nexus consolidated" filing, in which all corporations doing business in the state are allowed to file a pro-forma consolidated return. This option provides the substantial benefit to taxpayers of allowing a current year offset of income and losses among members of the nexus consolidated group. The filing group does not include non-nexus entities, and thus does nothing to address the problem of income shifting that combined filing is intended to prevent. The separate entity states' nexus consolidated return statutes vary considerably.

---

<sup>24</sup> <http://www.mtc.gov/getattachment/Uniformity/Project-Teams/Model-Option-for-Combined-Filing/consolidatedfilingwhitepaperamended.pdf.aspx?lang=en-US>

2. Federal Consolidated Group Filing Elections. A number of states mandating or allowing unitary combined filing provide an election to taxpayers to file returns including all corporations included on the taxpayer's federal consolidated return, without regard to whether those entities are engaged in a single unitary business. Under I.R.C. §§ 1501-1504, the federal consolidated group consists of corporations with at least 80% common ownership that elect to file on a consolidated basis, while excluding life insurance companies, REITs and regulated investment companies (RICs). As a practical matter, an election of the federal consolidated filing method will include all domestic C corporations with 80% common ownership, except for the excluded entities mentioned above and other entities exempt from state income taxation, *e.g.*, insurance companies paying premiums tax in the state.
3. Affiliated Group Elections. Several states allow an "affiliated group" election that varies from the federal consolidated group election in that all domestic C corporations with at least 50% common ownership are included in the return, and in some states, certain foreign corporations (such as those operating in tax havens) may be included.

This broad description of the three main types of elections offers a preview of some of the problems associated with including a consolidated filing election in the model. It would be necessary for the Uniformity Committee to study competing policies and procedures and suggest a single set of uniform rules where states have already established their own rules and neither the states nor taxpayers have expressed an interest in greater uniformity.

COST has proposed a consolidated election that would establish a 50% common ownership threshold for inclusion in the return (the affiliated group filing method), but presumably would not support inclusion of foreign entities doing business in the U.S. or incorporated in tax havens. States would also be asked to agree on inclusion or exclusion of life insurance companies, REITs and RICs otherwise excluded under I.R.C. § 1504, as well as potential state exclusions of premiums-paying property and casualty insurers and foreign operating companies (domestic 80/20's).

Of more significance, COST also posits that under its proposed vision of a consolidated filing election, UDITPA states would retain the distinction between business and non-business income.<sup>25</sup> In addition, taxpayers would presumably retain the ability to argue that particular flows of income items are not subject to apportionment under the due process and commerce clauses of the U.S. Constitution.

As set forth in the whitepaper, the principal benefit to allowing a consolidated or affiliated group filing election is the elimination of uncertainty over which entities should be included on a combined return under operation of the unitary business principle. This analysis can be fact intensive, and, at least at the edges, can appear subjective and unpredictable. Retaining the statutory distinction between business and non-business income and the constitutional limits on apportioning particular flows of income would simply negate the principal benefit of consolidated and affiliated filing elections. The majority of reported "unitary business" cases decided in the last four decades concern the apportionment of income flows, not the operational or "enterprise" unity of particular entities that might be subject to combination. See, *e.g.*, *MeadWestvaco Corp v. Illinois*, 553 U.S. 16 (2008)(capital gain on sale of

---

<sup>25</sup> For states following the 2015 amendments to Article IV of the Compact, these terms are "apportionable" and "non-apportionable" income, respectively.

division); *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992)(apportionment of dividends); *Mobil Oil v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980)(dividends and partnership distributions); *F.W. Woolworth Co. v. New Mexico*, 458 U.S. 354 (1982)(dividends). The same is true of business/non-business income determinations under UDITPA, as the business income definition in that statute is firmly grounded—albeit poorly drafted—in the unitary business principle. See *Hoechst-Celanese Corp. v. Franchise Tax Board*, 22 P.3d 324 (Ca. 2001). Disputes would arise as to whether a capital gain or partnership distribution—for which expenses have been historically deducted—arose out of the unitary business operations of an entity that may not even be part of the unitary business carried out within the taxing state.

The hearing officer believes that COST’s desire to retain distinctions between apportionable and non-apportionable income is simply incompatible with the consolidated filing election. Applying the unitary business principles established by Supreme Court precedent cited above to income generated by one or more members of a non-unitary group of business entities electing to file in the state would be an exercise in futility.

Currently, a small number of the states that allow consolidated or affiliated filing elections explicitly provide that the election constitutes an agreement that all income (and loss) reported on the federal consolidated return is subject to apportionment. That is, both the taxpayer and the state agree that the election constitutes a “waiver” of UDITPA’s business/non-business income distinction and constitutional limitations on state taxation. A far larger number of states do not address the issue in their statutes or regulations, and surprisingly, a few states explicitly provide for allocation of non-unitary income reported by the consolidated group.

The lack of agreement among the states on this critical issue and others (including, ironically, whether Finnigan or Joyce principles apply in calculating the sales apportionment numerator) leads the hearing officer to conclude that it would be inappropriate to include a consolidated filing election in the proposed model statute. The cause of increasing uniformity would not be furthered unless the Uniformity Committee also developed a model of what that election would entail, and states were prepared to follow the model’s policy choices.

#### B. Proposed Elimination or Simplification of the Proposed Model’s Capital Loss Provisions.

COST’s second comment voices the complaints by some of its members that the proposed requirement to separately track capital gains and losses on a separate-entity basis would be too burdensome given the small amount of tax liability that would be at issue. The hearing officer asked the MTC’s uniformity counsel, Helen Hecht, to respond to the comment. (The response is attached as Exhibit E.) As the response makes clear, the comments passed on by COST may reflect a misunderstanding of how the model treats those capital gains and losses.

The Uniformity Committee considered a number of different approaches to apportioning both capital gains and losses and net operating gains and losses.

One methodology under consideration was to restrict those tax attributes to the separate entities that reported them for federal purposes. That is the approach taken in the 2006 Joyce model combined reporting statute.

A second methodology considered, and the methodology ultimately chosen by the working group and approved by the full uniformity committee, was to treat those tax attributes as they would be treated for federal corporate income tax purposes under federal consolidated filing rules. Under those rules, current year net operating losses and capital losses incurred on a separate entity basis may be netted against operating income and capital gains, respectively, incurred by other members of the consolidated group. Capital gains of one entity can be offset by capital losses incurred by other entities within the consolidated group, with a limited carryforward period. It should also be noted that the calculation of net operating losses at the federal consolidated level is complicated by the interaction with capital gains and losses treatment. The federal consolidated rules (including SRLY and IRC Sec. 382) also provide for limitations on the amount of net operating losses and capital losses that can be brought into the federal consolidated group and the amount of loss that can be claimed by a member leaving the group. These rules have proven to be necessary to discourage abusive loss purchasing practices and to prevent double counting of losses.

Other methodologies for treating loss attributes were also considered, including a broad prohibition on allowing loss carryovers incurred by corporations previously filing as separate entities in prior years. (The prohibition on the use of separately-incurred losses would have a significant fiscal impact in some states considering a move to mandatory combined filing. Based on anecdotal reports, the potential loss of such tax attributes has been a stumbling block to convincing stakeholders to endorse combined reporting regimes in several states.) And finally, the working group considered but rejected the idea of separately tracking and limiting the use of non-business capital gains and losses to the entity that recorded those non-business amounts, although several Finnigan states currently have such a requirement.

There can be little argument that the intersection of federal consolidated filing rules, SRLY limitations and IRC § 382 present daunting tax accounting challenges. But the burdens of understanding and applying those rules—including tracking of losses on a separate-entity basis—are already imposed on all federal consolidated filers. The proposed model statute simply incorporates those rules for the purpose of establishing the state tax base of the combined group, and for purposes of calculating the state tax base for members entering and leaving the combined group, without creating separate state apportionment rules for these tax attributes. The Uniformity Committee's considered decision to piggyback on federal consolidation rules will reduce state tax compliance costs for taxpayers while simplifying state tax auditing. These beneficial effects of conformity should be especially widespread since the composition of the unitary combined group is often coextensive with the taxpayer's federal consolidated filing group.

And finally, conformity to federal consolidated filing rules should reduce effective tax rates since the federal rules allow for generous sharing of these tax attributes.

The MTC's uniformity counsel suggests that a drafter's note should be appended to the proposed model to advise that if the capital loss provisions are deemed too complicated and burdensome, such losses (and presumably net operating losses) should be terminated upon the occurrence of certain events, or limited to the entity recording the loss. The hearing officer agrees that a drafter's note to that effect would be appropriate.

IX. Recommendation:

The hearing officer recommends that the proposed Finnigan model combined reporting statute be approved for a By-Law 7 Survey of potentially affected states as currently drafted, with the minor addition of two drafter's notes, the first alerting policy-makers to the possibility of allowing a consolidated filing election, and the second to advise policy-makers on a suggested alternative treatment of capital loss attributes in the event the current treatment is deemed too complex and burdensome.

I look forward to answering any questions the Executive Committee may have on the proposed model and this Report.

Respectfully submitted,

Bruce Fort  
Hearing Officer and Senior Counsel, Multistate Tax Commission

7/13/20

## Exhibit A

### Proposed Model

The following draft model statute is intended to implement a single-entity style, Finnigan approach to combined corporate tax filing.

#### Section 1. Definitions.

**A.** “Combined group” means the group of all persons that must file a combined return as required by Section 2.A. or 2.B, including a group properly making a water’s edge election under Section 4.

**B.** “Combined return” means a tax return required to be filed for the combined group containing information as provided in [this Act] or required by the [Director].

**C.** “Corporation” means an organization of any kind treated as a corporation for tax purposes under the laws of this state, wherever located, which if it were doing business in this state would be a “taxpayer.”

**D.** “Internal Revenue Code” means Title 26 of the United States Code of [date] [and amendments thereto] without regard to application of federal treaties unless expressly made applicable to states of the United States.

**E.** “Partnership” means an organization of any kind treated as a partnership for tax purposes under the laws of this state.

**F.** “Person” means an individual, firm, partnership, general partner of a partnership, limited liability company, registered limited liability partnership, foreign limited liability partnership, association, corporation (whether or not the corporation is, or would be if doing business in this state, subject to [reference to state income tax act]), company, syndicate, estate, trust, business trust, trustee, trustee in bankruptcy, receiver, executor, administrator, assignee, or organization of any kind. For purposes of the [reference to state corporate income tax act] “person” also means

a combined group. *[DRAFTER'S NOTE: The state may have a definition of "person" that it wishes to reference here. What is important is that the model relies on the inclusion of the combined group in the definition of "person." See also the definition of "taxpayer" below.]*

**G.** "Tax haven" means a jurisdiction that, during the tax year in question has no or nominal effective tax on the relevant income and:

**i.** has laws or practices that prevent effective exchange of information for tax purposes with other governments on taxpayers benefiting from the tax regime;

**ii.** has tax regime that lacks transparency. A tax regime lacks transparency if the details of legislative, legal or administrative provisions are not open and apparent or are not consistently applied among similarly situated taxpayers, or if the information needed by tax authorities to determine a taxpayer's correct tax liability, such as accounting records and underlying documentation, is not adequately available;

**iii.** facilitates the establishment of foreign-owned entities without the need for a local substantive presence or prohibits these entities from having any commercial impact on the local economy;

**iv.** explicitly or implicitly excludes the jurisdiction's resident taxpayers from taking advantage of the tax regime's benefits or prohibits enterprises that benefit from the regime from operating in the jurisdiction's domestic market;  
or

**v.** has created a tax regime that is favorable for tax avoidance, based upon an overall assessment of relevant factors, including whether the

jurisdiction has a significant untaxed offshore financial or other services sector relative to its overall economy.

**H.** “Taxpayer” means a person subject to the tax imposed by [reference to state corporate income tax act].

*[DRAFTER’S NOTE: The tax imposition sections of the state code should be clear that tax is imposed on the combined group or corporations as part of a combined group.]*

**I.** “Unitary business” means a single economic enterprise 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. A unitary business includes that part of the business that meets the definition in this Section 1.I. and is conducted by a taxpayer through the taxpayer’s interest in a partnership, whether the interest in that partnership is held directly or indirectly through a series of partnerships or other pass-through entities.

*[DRAFTER’S NOTE: This definition follows the MTC Model General Allocation and Apportionment Regulations, Sec. IV.1.(b), defining a “unitary business.” Reg. Sec. IV.1.(b). includes a definition of a “commonly controlled group.” A state which treats ownership or control requirements separately from the unitary business requirement will need to make additional amendments to the statutory language. A state that does not wish to define unitary business in this manner should consider alternative language.]*

**J.** “United States” means the 50 states of the United States, the District of Columbia, and United States’ territories and possessions.

**Section 2.** Requirement to file a combined return; joint and several liability.

**A.** Except as provided in Section 4, all the corporations, wherever incorporated or domiciled, that are members of a unitary business shall file a combined return as a combined group. That return must include the income and apportionment factors, determined under Section 3, and other information required by the [Director] for all members of the combined group wherever located or doing business. The combined return must be filed under the name and federal employer identification number of the parent corporation if the parent is a member of the combined group. If there is no parent corporation, or if the parent is not a group member, the members of the combined group shall choose a member to file the return. The filing member must remain the same in subsequent years unless the filing member is no longer the parent corporation or is no longer a member of the combined group. The return must be signed by a responsible officer of the filing member on behalf of the combined group members. Members of the combined group are jointly and severally liable for the tax liability of the combined group included in the combined return.

**B.** The [Director], by regulation, may require that the combined return include the income and associated apportionment factors of persons that are not included pursuant to Section 2.A., but that are members of a unitary business, in order to reflect proper apportionment of income of the entire unitary business. Authority to require combination by regulation under this Section 2.B. includes authority to require combination of the income and associated apportionment factors of persons that are not subject to the [state income tax act], or would not be subject to the [state income tax act] if doing business in this state.

In addition, if the [Director] determines that the reported income or loss of a taxpayer engaged in a unitary business with a person not included pursuant to

Section 2.A., or pursuant to an election under Section 4, represents an avoidance or evasion of tax by such taxpayer, the [Director] may, on a case by case basis, require all or part of the income and associated apportionment factors of such person be included in the taxpayer's combined return.

With respect to inclusion of associated apportionment factors pursuant to this Section 2.B., the [Director] may require the exclusion of one or more of the factors, the inclusion of one or more additional factors that will fairly represent the taxpayer's business activity in this State, or the employment of any other method to effectuate a proper reflection of the total amount of income subject to apportionment and an equitable allocation and apportionment of the taxpayer's income.

**Section 3.** Determination of combined group income subject to tax.

**A.** The combined group calculates its state taxable net income as provided in this Section 3.A.

**i.** Determine the total combined group income or loss, before net operating loss deduction, as follows:

**(a)** Each member of the combined group determines its separate income or loss, before net operating loss deduction, as follows:

**(1)** For a member incorporated in the United States, or included in a consolidated federal corporate income tax return, the member's income or loss is the taxable income for the member under the Internal Revenue Code, on a separate entity basis, after making appropriate adjustments under [state tax code provisions for adjustments to taxable income].

**(2)** For any member not included in Section 3.A.i.(a)(1):

**(I)** The member's income or loss is determined from a profit and loss statement prepared for that member on a separate entity basis in the currency in which its books of account are regularly maintained, provided this profit and loss statement is subject to an independent audit, adjusted to conform it to the accounting principles generally accepted in the United States for the preparation of such statements and further modified to take into account any book-tax adjustments necessary to reflect federal and [state] tax law. Income or loss so computed includes all income wherever derived and is not limited to items of U.S. source income or effectively connected income within the meaning of the Internal Revenue Code. Items of income, expense, gain or loss and related apportionment factors that are denominated in a foreign currency must also be translated into U.S. dollars on a reasonable basis consistently applied year-to-year and entity-by-entity. Unrealized foreign currency gains and losses are not recognized. Income apportioned to this state is to be expressed in U.S. dollars.

**(II)** In lieu of the procedures set forth in Section 3.A.i.(a)(2)(I) or in any case where it is necessary to fairly and consistently reflect the income or loss and apportionment factors of foreign operations included in the unitary business, the [Director] may provide for other

procedures to reasonably approximate the income or loss and apportionment factors of members with foreign operations.

**(b)** Unless otherwise provided by this Act, or by regulation, income or loss of the members as determined under Section 3.A.i.(a) are combined, eliminating items of income, expense, gain and loss from transactions between members of the combined group, applying the consolidated filing rules under Internal Revenue Code and agency regulations as if the combined group was a consolidated filing group.

**(1)** Dividends paid by one member of the combined group to another member are excluded from that member's income to the extent those dividends are paid out of the earnings and profits of the unitary business included in the combined report in the current or an earlier year.

**(2)** A charitable expense incurred by a member of a combined group, to the extent allowable as a deduction pursuant to Internal Revenue Code Section 170, is subtracted first from the apportionable income of the combined group subject to the income limitations of that section applied to the entire apportionable income of the group, and any excess may be carried over as provided in Section 170, subject to limitations in that section.

**ii.** Determine combined group ordinary apportionable income or loss by eliminating from the amount determined in Section 3.A.i:

**(a)** The amount of any net capital gain resulting from application of the Internal Revenue Code, Subchapter P; and

**(b)** Any other income or loss, or item of income, expense, gain or loss, that is nonapportionable.

**iii.** Determine state share of combined group ordinary apportionable income or loss by multiplying the amount determined under Section 3.A.ii. times the combined group apportionment factor as determined under Section 3.B.

**iv.** Determine the combined group state net capital gain or loss from the application of the Internal Revenue Code, Subchapter P, and the amount of any state net capital loss carryover, as follows:

*[DRAFTER'S NOTE: If the state decouples from federal treatment of depreciation and tax basis and requires taxpayers to compute separate state amounts for capital gains, losses and/or loss carryovers, then insert language here referring to the section that instructs taxpayers how to report state-adjusted capital gains and losses.]*

**(a)** Each separate item of capital gain or loss for the combined group is determined [following Internal Revenue Code, Subchapter P or state provisions requiring the computation of state-adjusted capital gains and losses].

**(b)** Each separate item of apportionable capital gain or loss is then apportioned using the combined group's apportionment factor determined under Section 3.B., and each separate item of nonapportionable capital gain or loss is allocated under [reference to state allocation and apportionment statute].

**(c)** The capital gains or losses allocated or apportioned to this state are then netted consistent with the provisions of the Internal Revenue Code, Subchapter P.

**(d)** If the amount determined in Section 3.A.iv.(c) is a net capital gain, that gain is included in combined group taxable net income or loss before net operating loss deduction as computed under Section 3.A.vi.

**(e)** If the amount determined in Section 3.A.iv.(c) is a net capital loss, that loss may not be deducted from other income but may be carried over by the combined group and used to offset combined group capital gains, subject to [state law allowing a net capital loss carryover], but only to the extent that the amount or use of such capital loss carryover is not subject to limitations under any provision of the Internal Revenue Code or applicable federal regulations, or would not be subject to such limitations applied as if the combined group was the consolidated group.

**(f)** If the combined group capital loss carryover must be attributed to particular members of the group for purposes of determining limitations applicable to the amount or use of the capital loss under Section 3.A.iv.(e) above, then this will be done by multiplying the combined group net capital loss generated for any applicable year times a fraction the numerator of which is the separate entity net capital loss of the member for that year, if any, and the denominator of which is the total separate entity net capital losses for all the members of the combined group that had net capital losses for that year. A member's separate entity net capital loss carryover will be determined as follows:

**(I)** For each year in which the combined group recognized a net capital loss, multiply the combined group net apportionable gains and losses times the member's separate entity apportionment factor determined under Section 3.B, netting the resulting apportioned gains and losses as provided in this Section 3.A.iv; then adding any nonapportionable gains and subtracting any losses allocated to the state that were generated by that member.

**(II)** In no case may members of the combined group be attributed total capital losses under this Section 3.A.iv(f) in excess of the combined group net capital loss properly reported to this state in the tax year.

**(III)** In computing the net capital loss carryover for the member of the combined group, the separate entity capital losses for all members computed under this Section 3.A.iv.(f) will be deemed to be used to offset combined group capital gains in other years, as allowed under [federal or separate state law], on a pro-rata basis, starting with the earliest year.

**v.** Determine the amount of any combined group nonapportionable items of income, expense, gain or loss not allocated under Section 3.A.iv.(b) that are allocable to the state under [reference to state allocation and apportionment statute].

**vi.** Determine the combined group state net income or loss before net operating loss deduction by combining and netting the results from Section 3.A.iii., iv.(d), and v.

**vii.** Determine the combined group state taxable net income after any net operating loss deduction, by deducting from the amount of combined group state net income computed under Section 3.A.vi an allowable amount of the combined group's net operating loss carryover, determined under this Section 3.A.vii, as follows:

**(a)** The allowable amount of the combined group net operating loss carryover in any tax year is:

**(1)** The total of the combined group state losses determined under Section 3.A.vi for prior years to the extent such losses have not been used to offset the combined group's state net income and to the extent those losses are not otherwise limited by state law or this Section 3.A.vii; plus

**(2)** The net operating loss carryover of any members of the group created before the member became a part of the group, but only to the extent that the net operating loss carryover:

**(I)** represents net operating losses that were properly attributed to the member under Section 3.A.vii(b) below if the member was part of a separate combined group when the losses were created;

**(II)** represents net operating losses properly allocated or apportioned to this state in the year created;

**(III)** has not been used to offset income of any taxpayer;

**(IV)** would not be subject to limitations as to the amount or use applicable under any provision of the

Internal Revenue Code or federal regulations, or would not be subject to such limitations applied as if the combined group was the consolidated group; and

**(V)** is not otherwise not limited by state law; minus

**(3)** The net operating loss carryover of a member of the combined group attributed to that member under Section 3.A.vii.(c) below, that has not been used to offset income and is not otherwise limited by state law as of the date that member is no longer part of the combined group.

**(b)** If the combined group net operating loss carryover must be attributed to particular members of the group for purposes of determining limitations applicable to the amount or use of the net operating loss carryover under this Section 3.A.vii, then this will be done by multiplying the combined group net loss generated for any applicable year times a fraction the numerator of which is the separate entity net loss of the member for that year, if any, and the denominator of which is the total separate entity net losses for all the members of the combined group that had net losses for that year. A member's separate entity net loss will be determined as follows:

**(1)** The amount of combined group ordinary apportionable income determined under Section 3.A.ii multiplied times the member's separate entity apportionment factor as determined under Section 3.B; plus

**(2)** The amount of any combined group net gain determined under Section 3.A.iv. multiplied times the member's

separate entity apportionment factor as determined under Section 3.B; plus or minus

**(3)** The amount of any nonapportionable items of income, expense, gain or loss allocated to the state under Section 3.A.v. that were generated by the member; plus or minus

**(4)** Any adjustments to properly reflect the member's separate entity loss.

**(5)** In no case shall members be attributed total losses under this Section 3.A.vii.(b) in excess of the combined group loss properly reported to this state in the tax year.

**(6)** In computing the net operating loss carryover for the member of the combined group, the separate entity net operating losses for all members computed under this Section 3.A.iv.(f) will be deemed to be used to offset combined group net income in other years, as allowed under [federal or separate state law], on a pro-rata basis, starting with the earliest year.

**viii.** Application of state tax credits.

If the use of a tax credit provided in any other section of [this act] is limited to the [state] tax attributed to a member of a combined group, then the tax that may be offset by the credit is calculated as follows:

**(1)** The amount of combined group ordinary apportionable income determined under Section 3.A.ii multiplied times the member's separate entity apportionment factor as determined under Section 3.B; plus

**(2)** The amount of any combined group net gain determined under Section 3.A.iv. multiplied times the member's separate entity apportionment factor as determined under Section 3.B; plus or minus

**(3)** The amount of any nonapportionable items of income, expense, gain or loss allocated to the state under Section 3.A.v. that were generated by the member; plus or minus

**(4)** Any adjustments to properly reflect the member's separate entity loss; multiplied by

**(5)** The applicable tax rate.

**B. Allocation and apportionment.**

**i. Allocation and apportionment.**

Unless otherwise provided in this Act, [reference to state allocation and apportionment statute] determines how income or loss, or items making up income or loss, are allocated and apportioned to this state.

**ii. combined group apportionment factor.**

The combined group apportionment factor is a percentage determined under [reference to state allocation and apportionment statute] where the numerator of the factor[s] includes amounts sourced to the state for the combined group's unitary business, regardless of the separate entity to which those factors may be attributed, and the denominator of the factor[s] includes amounts associated with the combined group's unitary business wherever located.

**iii. Separate entity apportionment factor.**

The separate entity apportionment factor for a member of the combined group is a percentage determined under [reference to state allocation and apportionment statute] where the numerator of the factor[s] includes amounts sourced to the state for the member, and the denominator of the factor[s] includes amounts associated with the combined group's unitary business wherever located.

iv. If a member of the combined group holds a partnership interest from which it derives apportionable income, the share of the partnership's apportionment factor[s] to be included in the apportionment factor[s] of the group is determined by multiplying the partnership's factor[s] by a ratio the numerator of which is the amount of the partnership's apportionable income properly included in the member's income, whether received directly or indirectly, and including any guaranteed payments, and the denominator of which is the amount of the partnership's total apportionable income. If a member of the combined group directly or indirectly receives an allocation of a partnership tax item, such as an item of loss or expense, so that it is not possible to determine the member's share of apportionable income, the [Director] may provide rules for inclusion of particular partnership factors, or portions of factors, in the combined group's factors.

#### **Section 4. Water's -edge election; initiation and withdrawal.**

##### **A. Water's-s-edge election.**

Members of a unitary group that meet the requirements of Section 4.B. may elect to file as a combined group pursuant to a water's-edge election. Under such election, the combined group takes into account all or a portion of the income and

apportionment factors of only the following members, otherwise included in the combined group pursuant to Section 2, as described below:

**i.** the entire income and apportionment factors of a member incorporated in the United States or formed under the laws of any state, the District of Columbia, or any territory or possession of the United States;

**ii.** the entire income and apportionment factors of a member, regardless of the place incorporated or formed, if the average of its property, payroll, and receipts factors within the United States is 20 percent or more;

**iii.** the entire income and apportionment factors of a member which is a domestic international sales corporations as described in Internal Revenue Code Sections 991 to 994, inclusive; a foreign sales corporation as described in Internal Revenue Code Sections 921 to 927, inclusive; or a member which is an export trade corporation, as described in Internal Revenue Code Sections 970 to 971, inclusive;

**iv.** for a member not described in Section 4.A.i. to Section 4.A.iii., inclusive, include the portion of its income derived from or attributable to sources within the United States, as determined under the Internal Revenue Code without regard to federal treaties, and its apportionment factors related thereto;

**v.** for a member that is a “controlled foreign corporation,” as defined in Internal Revenue Code Section 957, include income to the extent of the income of that member that is defined in Section 952 of Subpart F of the Internal Revenue Code (“Subpart F income”) not excluding lower-tier subsidiaries’ distributions of such income which were previously taxed, determined without regard to federal treaties, and the apportionment factors related to that

income; any item of income received by a controlled foreign corporation is excluded if such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in Internal Revenue Code Section 11;

**vi.** for a member that earns more than 20 percent of its income, directly or indirectly, from intangible property or service related activities that are deductible against the apportionable income of other members of the combined group, include the related income and the apportionment factors; and

**vii.** the entire income and apportionment factors of a member that is doing business in a tax haven, where “doing business in a tax haven” is defined as being engaged in activity sufficient for that tax haven jurisdiction to impose a tax under United States constitutional standards. If the member’s business activity within a tax haven is entirely outside the scope of the laws, provisions and practices that cause the jurisdiction to meet the criteria established in Section 1.JI., the activity of the member shall be treated as not having been conducted in a tax haven.

**B. Initiation and withdrawal of election**

**i.** A water’s-edge election is effective only if made on a timely-filed, original return for a tax year by the members of the unitary business. The Director shall develop rules and regulations governing the impact, if any, on the scope or application of a water’s-edge election, including the procedures for election and termination or deemed election, resulting from a change in the composition of the unitary group, the combined group, the members, and any other similar change.

**ii.** Such election constitutes consent to the reasonable production of documents and taking of depositions in accordance with [state statute on discovery].

**iii.** In the discretion of the Director, a water's-edge election may be disregarded in part or in whole, and the income and apportionment factors of any member of the unitary group may be included in the combined report without regard to the provisions of this section, if any member of the unitary group fails to comply with any provision of [this act] or if a person otherwise not included in the water's-edge combined group was availed of with a substantial objective of avoiding state income tax.

**iv.** A water's-edge election is binding for and applicable to the tax year it is made and all tax years thereafter for a period of 10 years. It may be withdrawn or reinstated after withdrawal, prior to the expiration of the 10 year period, only upon written request for reasonable cause based on extraordinary hardship due to unforeseen changes in state tax statutes, law, or policy, and only with the written permission of the Director. If the Director grants a withdrawal of election, he or she shall impose reasonable conditions as necessary to prevent the evasion of tax or to clearly reflect income for the election period prior to or after the withdrawal. Upon the expiration of the 10 year period, the members of a combined group may withdraw from the water's edge election. Such withdrawal must be made in writing within one year of the expiration of the election, and is binding for a period of 10 years, subject to the same conditions as applied to the original election. If no withdrawal is properly made, the water's edge election will be in place for an additional 10 year period, subject to the same conditions as applied to the original election.

**C. Effect of water's edge election on excluded entities.**

The election under this Section 4 has no effect on whether entities that are excluded from the water's edge combined group may be separately liable for tax under [the state income tax act]. Entities subject to the state tax must separately file and pay tax in the state.

**Exhibit B**  
**Notice of Hearing**

**Helen Hecht**

---

**From:** Helen Hecht  
**Sent:** Thursday, April 30, 2020 5:01 PM  
**To:** Public HRG/MTG Notice-Public  
**Subject:** NOTICE - Public Hearing MTC Uniform Proposed Model - Combined Filing - Finnigan Approach  
**Attachments:** MTC Public Hearing - Proposed Combined Filing - Finnigan Model



Dear Members of the Public:

This is to notify you that the Multistate Tax Commission will be holding a public hearing on a proposed model statute for combined corporate income tax filing following the Finnigan approach (an alternative to the Commission's existing model).

The hearing on this proposed model will be held Tuesday, June 9, at 11:00 AM Eastern. Because of the Covid-19 emergency in the U.S., the public hearing will be held entirely by online video/phone conferencing. Log-in/dial-in information for the hearing is:

<https://global.gotomeeting.com/join/678180197>

**You can also dial in using your phone.**  
**United States: +1 (646) 749-3122**

**Access Code: 678-180-197**

The proposed model statute, along with the information memo submitted to the MTC's uniformity committee, is attached. You can also find this model on the project page, along with other information on the project on the Commission's website, here: <http://www.mtc.gov/Uniformity/Project-Teams/Model-Option-for-Combined-Filing>.

Bruce Fort, Senior Counsel for the Commission, will act as hearing officer in the public hearing. Anyone who wishes to participate in the public hearing and provide oral comments on, or ask questions about, the proposed model may do so. We also welcome the submission of written comments or questions prior to the hearing. You may submit written comments or questions to Loretta King, at [LKing@mtc.gov](mailto:LKing@mtc.gov).

If you any questions about the public hearing process or need assistance accessing information on the proposed model or other related information, you may direct those questions to me at 202-660-1951, or by email at [hhecht@mtc.gov](mailto:hhecht@mtc.gov).

Regards,

*Helen Hecht*, General Counsel  
**Multistate Tax Commission**  
444 North Capitol Street, Suite 425  
Washington, DC 20001  
[MTC.gov](http://MTC.gov)

## Exhibit C

### Submission on the Proposed Finnigan/Combined Filing Model Alternative

<b>To:</b>	Bruce Fort, Senior Counsel, Multistate Tax Commission Hearing Officer
<b>From:</b>	Helen Hecht, MTC, Uniformity Counsel
<b>Subject:</b>	Submission to Public Hearing on the Proposed <i>Finnigan</i> /Combined Filing Model Alternative
<b>Date:</b>	June 1, 2020

Pursuant to the Multistate Tax Commission Bylaw 7, the Commission's Executive Committee hereby submits the attached proposed *Finnigan*/Combined Filing Model Alternative ("proposed model") for public hearing to be held Tuesday, June 9, 2020, 11:00 A.M. Eastern.

#### **Purpose of the Proposed Model**

In 2006, the Commission adopted a Model Statute for Combined Reporting.<sup>1</sup> This 2006 model follows *Joyce* and the separate-entity approach. At its April 2018 meeting, the Commission's Uniformity Committee formed a work group to draft an alternative model following *Finnigan* and the single-entity approach.

#### **Background on *Joyce* versus *Finnigan***

Combined filing states use one of two main approaches to apportion a unitary group's taxable income—*Finnigan* or *Joyce*.<sup>2</sup> The essential difference between these two approaches is the way in which the receipts (sales) factor is computed. Under both approaches, the receipts factor denominator used to apportion group income will include all receipts of all the group members. Under *Joyce*, however, the receipts factor numerator will exclude the in-state sales of members that, on a separate-entity basis, lack nexus or are deemed protected by P.L. 86-272. In contrast, under *Finnigan*, the receipts factor numerator will include in-state sales of all members, whether those members lack nexus or are deemed protected by P.L. 86-272 on a separate-entity basis.<sup>3</sup> By the same token, states that follow *Joyce* and have a throwback rule will apply

---

<sup>1</sup> That model was revised in 2011. See on the MTC website, here:

[http://www.mtc.gov/uploadedFiles/Multistate\\_Tax\\_Commission/Uniformity/Uniformity\\_Projects/A\\_-\\_Z/Combined%20Reporting%20-%20FINAL%20version.pdf](http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Combined%20Reporting%20-%20FINAL%20version.pdf).

<sup>2</sup> For more on the differences between *Joyce* and *Finnigan* approaches, see the Briefing Book prepared for the Work Group, available on the MTC website project page, here: <http://www.mtc.gov/getdoc/4570fde6-763b-450f-85bf-cbbb6e30dc94/Model-Option-for-Combined-Filing.aspx>.

<sup>3</sup> Experts might describe the theoretical difference between *Finnigan* and *Joyce* differently. here is limited case law that might illuminate these differences, nor has the U.S. Supreme Court ever considered the issue of which theory is proper.

that rule on a member-by-member basis. Thus, a group member that lacks nexus and/or is deemed protected under P.L. 86-272 in the destination state will be required to throw back sales even if other members of the group have nexus in the destination state and are not protected under P.L. 86-272 in that state. States that follow *Finnigan* and have a throwback rule will apply that rule on a group basis. Thus, a group member will be required to throw back sales only if all the members of the group lack nexus and/or are deemed protected under P.L. 86-272 in the destination state.

States that follow *Joyce* traditionally treated group members as separate taxpayers—having separate tax attributes and filing separate returns. *Finnigan* states may also take some variation of this approach—referred to here as the “separate-entity approach.” But some *Joyce* states now allow sharing of certain tax attributes. And, some *Finnigan* states go farther and essentially treat the group itself as the taxpayer—referred to here as the “single-entity approach.”

### **Work Group’s Analysis**

Initially, the work group heard from states that follow the *Finnigan* approach. It then considered what changes to the 2006 model were necessary. In particular, the work group considered the treatment of important tax attributes—net operating loss carryovers, state tax credits, and capital loss carryovers. The work group recognized that if states allowed sharing of these tax attributes among members of the combined group, they would also need limits on that sharing as the members changed—and it therefore considered the limits imposed under federal income tax statutes and regulations. The work group also received a request from the Council on State Taxation to consider a consolidated filing election. The committee asked the work group to address this request by drafting a white paper on the issue to accompany the proposed model.

Drafts of the proposed model discussed by the work group and analysis of issues can be found on the project page on the MTC website, here: <http://www.mtc.gov/getdoc/4570fde6-763b-450f-85bf-cbbb6e30dc94/Model-Option-for-Combined-Filing.aspx>. The issues analyzed and the information produced includes:

- A Briefing Book, prepared for the work group prior to its first meeting;
- Descriptions of different states’ approaches to applying *Finnigan*;
- General analysis of the theories behind *Joyce* and *Finnigan*;
- Analysis of the treatment of NOLs by both *Joyce* and *Finnigan* states, including a white paper on the issue;
- Information on and discussion of federal limits on loss carryovers;
- Analysis of capital gain and loss treatment, including the treatment of apportionable and nonapportionable gains and losses; and
- A white paper on a state consolidated filing election.

### **Uniformity Committee and Executive Committee Action**

On April 22, 2020, the Uniformity Committee approved the proposed model for referral to the Executive Committee. On April 23, 2020, the Executive Committee approved the proposed model for public hearing.

### **Summary of the Proposed *Finnigan*/Combined Filing Model Alternative**

The proposed model, attached, reflects the deliberations and consensus of the work group on the issues discussed. It retains certain important provisions of the 2006 model, adopts elements necessary to implement the *Finnigan*, single-entity approach, and makes certain simplifications and clarifications.

Important aspects of the 2006 model retained include the following:

- The default worldwide combined filing group;
- The water's edge combined filing election;
- Tax haven provisions to address foreign income shifting;
- Offsetting of apportionable and nonapportionable capital gains and losses; and
- Anti-abuse provisions allowing state tax agencies to include income or factors of members of unitary business that are otherwise not included in the group.

Elements necessary to implement the *Finnigan* single-entity approach include:

- Defining "person" to include the combined group (so that the group would be the subject of the state tax—a "taxpayer");
- Requiring a single return for the combined group, calculating state taxable income for the group;
- Group members held jointly and severally liable for the tax owed by the group;
- Group members sharing net operating losses and capital losses, subject to federal-style limitations (e.g. IRC Sec. 382 and federal SRLY rules); and
- Provisions allowing state tax credits to be limited to individual group members, when required by state law.

Provisions of the 2006 model that are simplified or clarified include:

- Simplification of the method of determining income for foreign entity group members that do not file a federal tax return;
- Clarification of the treatment of partnership income and factors in the group return; and
- Clarification that entities that have a filing obligation, but are excluded from the combined group under the water's edge election, must file separate state returns.

**Exhibit D**  
**COST Comments on Proposed Finnigan/Combined Filing Alternative Model**



**Officers, 2019-2020**

Arthur J. Farham, Jr.  
Chair  
*Energy Services, LLC*

Robert J. Tuinstra, Jr.  
Vice Chair  
*Corteva Agriscience*

Michael F. Carchia  
Secretary & Treasurer  
*Capital One Services, LLC*

Amy Thomas Laub  
Immediate Past Chair  
*Nationwide Insurance Company*

Douglas L. Lindholm  
President  
*Council On State Taxation*

**Directors**

Madison J. Barnett  
*The Coca-Cola Company*

Barbara Barton Weiszhaar  
*HP Inc.*

Deborah R. Bierbaum  
*AT&T Services, Inc.*

C. Benjamin Bright  
*HCA Holdings, Inc.*

Paul A. Broman  
*BP America Inc.*

Tony J. Chirico  
*Medtronic, Inc.*

Susan Courson-Smith  
*Pfizer Inc.*

Karen DiNuzzo-Wright  
*Walmart Inc.*

Jamie S. Fenwick  
*Charter Communications*

Kurt A. Lamp  
*Amazon.Com*

J. Hugh McKinnon  
*Roytheon Company*

Mollie L. Miller  
*Presonus Medical Care  
North America*

John H. Paraskvas  
*Exxon Mobil Corporation*

Rebecca J. Paulsen  
*U.S. Bancorp*

Michael R. Raley  
*VF Corporation*

Patrick A. Shrake  
*Cargill, Incorporated*

Kyle Snedaker  
*Cosagra Brands, Inc.*

Archana Warner  
*Eaton Corporation*

Nikki E. Dobay  
Senior Tax Counsel  
(202) 484-5221  
[ndobay@cost.org](mailto:ndobay@cost.org)

June 9, 2020

Bruce Fort  
Sr. Counsel  
Multistate Tax Commission  
Hearing Officer

*Via E-Mail*

**Re: COST Comments on Proposed *Finnigan/Combined Filing Alternative Model***

Dear Hearing Officer Fort;

On behalf of the Council On State Taxation (COST), I am writing to suggest that consolidated group election language, similar to that proposed by COST in October 2019, be added to Section 4 of the proposed model. In addition, we would urge you to reconsider the requirement that capital gains and losses be separately tracked as those requirements are overly burdensome.

*The Proposed Model Should Include Consolidated Election Language*

Since the inception of this uniformity project, COST has actively engaged with this working group on its drafting efforts. On October 4, 2019 via email, COST proposed language to the working group that would allow a taxpayer to make a consolidated group election. (See attached Exhibit A.) The goal of the election language was to give a taxpayer the option to make an election for state purposes in accordance with the taxpayer's federal consolidated filing group for purposes of administrative ease. Specifically, a consolidated election often provides a level of certainty where the unitary relationship among affiliates may be in question. In addition, a consolidated filing election can often simplify compliance for a taxpayer helping to avoid the preparation of a pro forma federal return for a separate filing group.

Understanding the *Finnigan* model includes a 50 percent ownership threshold while the federal consolidated rules provides an 80 percent ownership threshold, COST has conceded that a taxpayer with affiliates below the 80 percent filing threshold would be required to file on a separate basis or as part of a second filing group. COST has not, however, conceded that a consolidated filing election would waive a taxpayer's ability to take a non-business/non-apportionable income position.

Based on COST's suggestion to include a consolidated filing election, a white paper was prepared by MTC staff on this issue. In the February 12, 2020 White Paper, the following conclusion was made in the Executive Summary:

The use of "consolidated" or "affiliated group" (as those terms are described below) filing elections is a well-accepted state tax policy tool that appears to provide significant benefits for taxpayers and administrators. States must still provide detailed guidance on a number of policy and tax accounting issues for taxpayers electing those filing options. In addition, based on the limited information available, these elections do not appear to facilitate additional income-shifting activity in states requiring water's-edge unitary combined filing.

One can assume some overall revenue reduction whenever an election is offered, since taxpayers will likely elect whatever methodology results in their lowest predicted tax liability. State administrators and auditors, however, have not reported significant differences in tax liability attributable to the election to file as a consolidated or affiliated group in lieu of unitary combined filing.

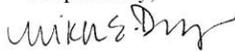
The White Paper went on to support this well-reasoned finding, which was in accord with COST's position. Considering the finding in the White Paper, COST would again suggest that the proposed consolidation election language as provided in Section 4 of Exhibit A be added to the proposed draft model.

*The Requirement to Separately Track Capital Gains/Losses is Overly Burdensome*

The proposed *Finnigan* model requires a taxpayer to separately track capital gains and losses. Based on feedback COST has received from its members, this requirement to separately track capital gains and losses is overly burdensome. Furthermore, when the potential state tax revenue at issue is considered, this requirement rises to the level of border line absurdity. Although COST has not been provided specific examples from members showing the overall burden, the general sentiment has been that the required level of tracking is overkill when compared to the ultimate amount of tax at issue with capital gains and losses. Thus, COST urges you to reconsider whether these tracking provisions are truly necessary.

In conclusion, COST supports the addition of specific consolidated election language and the elimination of the capital gains and losses tracking requirement in the proposed draft. We thank you for your time, and please do not hesitate to reach out if you have any questions or need further clarification.

Respectfully,



Nikki E. Dobay

cc: COST Board of Directors  
Douglas L. Lindholm, COST President & Executive Director

**Exhibit E**  
**Response to Written Comments of COST – With Respect to Capital Gains and Losses**

<b>To:</b>	Bruce Fort, Hearing Officer Proposed Alternative Combined Filing Model – Finnigan
<b>From:</b>	Helen Hecht – MTC Uniformity Counsel
<b>Subject:</b>	Response to Written Comments of the Council on State Taxation (COST) – With Respect to Capital Gains and Losses
<b>Date:</b>	June 18, 2020

Documents referenced in this memo (unless otherwise noted) are available on the combined filing project page, here: <http://www.mtc.gov/getdoc/4570fde6-763b-450f-85bf-cbbb6e30dc94/Model-Option-for-Combined-Filing.aspx>.

**COST Comments on Proposed Alternative Model Treatment of Capital Gains and Losses**

The Council on State Taxation (COST) submitted written comments the day of the public hearing. Those, comments included the following:

The proposed *Finnigan* model requires a taxpayer to separately track capital gains and losses. Based on feedback COST has received from its members, this requirement to separately track capital gains and losses is overly burdensome. Furthermore, when the potential state tax revenue at issue is considered, this requirement rises to the level of border line absurdity. Although COST has not been provided specific examples from members showing the overall burden, the general sentiment has been that the required level of tracking is overkill when compared to the ultimate amount of tax at issue with capital gains and losses. Thus, COST urges you to reconsider whether these tracking provisions are truly necessary.<sup>4</sup>

Subsequent to the hearing, you asked for a response to this comment.

For several months, the work group and the uniformity committee considered the state tax issues raised by capital gains and losses. At the direction of the work group, MTC staff also produced a number of memos and presentations addressing the subject.<sup>5</sup> This response draws upon information contained in those memos and presentations.

---

<sup>4</sup> See COST Comments on Proposed Finnigan/Combined Filing Alternative Model, June 9, 2020.

<sup>5</sup> See Corporate Tax Treatment of Capital Gains and Losses in a Combined Return - 1/15/2020; Memo to Work Group on Capital Gain and Loss – 12/17/19; Memo to Work Group on Capital Gain and Loss – 12/3/19; Memo to Work Group on Capital Gain and Loss – 1/18/19; Illustration of Capital Gain/Loss Alternatives – 11/2019; IRS 8949; 1120 Schedule D; Comparison: Combined Filing Models – Oct. 31, 2019; and Memo to Work Group on Capital Gain and Loss – 10/16/19.

## Response to COST's Written Comment on Capital Gains and Losses

### Introduction

COST comments that the model's requirement to "separately track capital gains and losses" is "absurdly" burdensome, but it is not clear exactly what requirement this comment is referring to. And while COST provided input on the treatment of capital gains and losses during the uniformity process, neither COST nor anyone else expressed concern as to the "absurdity" of any tracking requirements. Therefore, this response will first describe the work group's discussions of capital gains and losses and the shared use of loss carryovers. Next, it will describe three general types of requirements and the relative burdens of each type.

However, "tracking" is not a very accurate term (as this response will show). So, instead, this response uses more specific terms including "recordkeeping," "computing," "reporting," and "tracing," which more accurately reflect the nature of the various requirements.

Also, it is not accurate that the model imposes these requirements (with minor exceptions). Rather, the requirements are imposed by federal tax law, to which the model conforms (as does the tax law in a number of states).

### Work Group Discussions

The work group started with the 2006 Combined Filing Model (2006 model) which follows *Joyce* and the separate entity approach. Under that approach, each member computes its own in-state share of the group's taxable income or loss, as well as any net capital loss. Both NOL and capital loss carryovers are treated as separate member tax attributes and the group does not share in the use of those carryovers.<sup>6</sup> This strict limitation is enforced simply through the filing of separate tax returns—and therefore requires no other tracking.

The uniformity committee and the work group decided to take a single-entity approach to the alternative *Finnigan* model. Under this approach, the group's combined apportionable tax items (net income or loss and capital gains and losses) are generally apportioned using one combined apportionment factor. But even where this separate-entity approach is used, certain tax attributes, including both net operating loss (NOL) and capital loss carryovers, can be treated as separate entity attributes and sharing of their use can be restricted. (This is discussed further below.) The work group and the uniformity committee had lengthy discussions about whether NOL and capital loss carryovers should be group attributes, allowing members to share in their use. (This is the way in which loss carryovers are treated under federal consolidated filing rules.)

This sharing of loss carryovers was of serious concern to some work group and uniformity committee members. They worried that the single-entity approach combined with the sharing of loss carryovers would make it impossible to effectively limit the use of loss carryovers when necessary. This, in turn, might open the door to abusive practices such as "purchasing" losses (by acquiring companies solely for the purpose of using their losses) or double-counting losses (if the group's carryover amount is not

---

<sup>6</sup> See the Model Statute for Combined Filing (last amended August 17, 2006) Sec. 3.A.i.(g) and Sec. 3.C.ii(g). available here:

[http://www.mtc.gov/uploadedFiles/Multistate\\_Tax\\_Commission/Uniformity/Uniformity\\_Projects/A\\_-\\_Z/Combined%20Reporting%20-%20FINAL%20version.pdf](http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Combined%20Reporting%20-%20FINAL%20version.pdf).

reduced when a member leaves the group). These work group and committee members were also concerned that offsetting gains and losses among group members would prevent those gains and losses from being properly sourced, whether allocated or apportioned.

The work group and uniformity committee believed these concerns were well taken. Therefore, the work group considered various alternatives. One alternative is used by some *Finnigan* states. After the filing group's combined ordinary income or loss, and any net capital loss, are allocated and apportioned using a single-entity approach, the in-state shares of these group items are then assigned to members of the group. (This may be done pro-rata based on each members share of the particular tax item.) Under this approach, as under the 2006 model, members then file separate tax returns. And any loss carryovers (NOLs or capital losses) will be separate entity tax attributes from that point on, strictly limiting their use.

Another approach that was discussed briefly by the work group is to simply wipe out loss carryovers in the case of certain events. So, a corporation with a loss carryover will lose that carryover when the corporation has a change in ownership or joins a group. And if a corporation leaves a group, it will take no amount of loss carryover with it—so there can be no double-counting. This approach was not fully vetted by the work group but it appears to have the advantage of being simpler and not requiring any tracing of losses to particular members.

And finally, the work group considered the limitations imposed on the use of loss carryovers under federal tax law—including IRC §§ 382-384 and federal consolidated filing regulations, particularly the so-called SRLY rules—what this response will generally refer to as “federal-style limitations.” Under federal law, the capital loss carryover is a consolidated tax attribute. This means that federal law computes a group carryover amount and allows the use of that carryover to reduce the capital gains of any members of the group. But this is only where the group membership does not change. In that event, use of the capital loss carryover is limited to prevent the “purchasing” of capital loss carryovers, double-counting of capital loss deductions, and other potential abuses. And it must be noted that most states conform to §§ 382-384 and would likely need to conform to most SRLY rules as well, since it is those rules that also govern how group income and expense items are computed, as well as other issues necessary for combined filing.

There is no doubt that the federal-style limitations on the use of loss carryovers impose requirements for recordkeeping and tracing that are not imposed under the two alternative methods considered. But the federal-style limitations are also designed to limit the use of loss carryovers only in the event and to the extent necessary—striking a balance between preventing abuse while not penalizing corporations or groups for changes in ownership or membership. This, in turn, serves the underlying policy for allowing loss carryovers in the first place, which is to allow taxable income, reported annually, to more accurately reflect true economic income where the business cycle is often much longer than one year.

Further, experience with the federal rules has shown that they are generally effective at preventing abuse. Also, while federal-style limitations require recordkeeping and computations that may be somewhat more complex, the fact that the IRS has developed extensive rules governing these requirements provides built-in guidance for both states and taxpayers. Further, the work group's understanding was that COST preferred the federal-style limitations over the other two approaches considered by the work group.

In any case, ultimately, the work group decided to adopt federal-style limitations for both NOL and capital loss carryovers. The work group believed that these federal-style limitations could be implemented and complied with at the state level. Indeed, it was only this belief that likely persuaded some of the work group and committee members to agree to recommend the proposed model as drafted.

#### Federal Capital Gain and Loss Requirements to which the Draft Alternative Model Conforms

The model conforms not just to federal-style limitations on loss carryovers, but also to the federal treatment of capital gains and losses generally. Federal capital gain and loss requirements fall into three main categories. And since it is not clear exactly what tracking requirements COST's comment refers to, this response will briefly describe the three categories and discuss the need for those requirements.

The first category of requirements involves the recognition, valuation, characterization, and netting of capital gains and losses as well as the allocation or apportionment of those gains and losses in the year they are recognized for state purposes. Under federal law and filing requirements, members of a consolidated group must properly recognize, value, and characterize separate capital gains and losses under the appropriate IRC provisions. Those gains and losses are then netted.<sup>7</sup> As do most states, the model conforms to this federal treatment and follows this same general approach except that it does so on a post-apportionment or post-allocation basis. So separate nonapportionable (nonbusiness) gains and losses must be separated from other apportionable gains and losses. (The proposed alternative model makes this clear—see Sec. 3.A.iv.)

Note that some work group members commented that their state does not allow nonapportionable (nonbusiness) gains or losses that might be allocated to the state to be netted against apportionable (business) gains or losses that are apportioned to the state—under the theory that the nonapportionable losses are from an entirely different source and cannot be combined with apportionable losses. The work group also received some comments during the process from COST that its members preferred netting of allocated and apportioned gains and losses. In the end, the work group and uniformity committee decided that the model would allow netting of all gains and losses (provided they are properly sourced to the state).

It appears that COST's comment does not refer to this first category of requirements. These requirements are necessary to make sure that tax on capital gains and losses is properly reported in the year those gains and losses are recognized and have only an indirect impact on any "tracking" that might otherwise be required.

The second category of federal requirements involves the federal-style limits imposed on loss carryovers discussed briefly above. Again, these limits are typically triggered when a corporation has a change in ownership or enters or leaves a filing group. So, the calculation of the federal-style limits on the use of a group loss carryover generally involves determining the amount of the group's net losses, included in the carryover, that should be attributed to the particular member. It also involves determining how much of the amount attributed to that member may have been used, in order to arrive at the member's share of the carryover on the date that the limit imposed is triggered.

---

<sup>7</sup> See IRS Forms 8949, 4797, 6252, and Schedule K-1 (for corporate partners) where gains and losses must be captured and combined.

By explicitly confirming how a state, under the model, would apply these same federal limits in the context of combined filing group and the state-sourced capital loss carryover, the work group believed the model would effectively prevent the improper use of those carryovers in the same way federal limits work to prevent abuse. (See the proposed alternative model at Sec. 3.A.iv(e) and Sec. 3.A.iv.(f).) It should be noted that many states appear to conform to these federal provisions, but may not explicitly describe how they apply at the state level. Again, the federal requirements are generally implemented through recordkeeping and tracing rules with which taxpayers filing consolidated returns are, no doubt, familiar. The model does not provide specifically for some sort of tracking of capital gains and losses on a continuous basis—only that the taxpayer must properly compute limitations when necessary. (See Sec. 3.A.iv.(f) which provides: If the combined group capital loss carryover must be attributed to particular members of the group for purposes of determining limitations applicable to the amount or use of the capital loss under Section 3.A.iv(e) 15 above . . .) We are not aware of any reason to believe that taxpayers, generally, are unable to comply with these rules which have been in place at the federal level for many years.

It is possible that COST is referring to these requirements in its comment. However, it is not clear why COST members would view these limits as being overly burdensome with respect to the potential state tax related to capital gains and losses. Certainly, the MTC and many states can cite examples where capital gains and losses have resulted in significant state tax effects. But this is also not to say that the computations required might not be complex, especially given that, at the state level, the gains and losses must be netted and the loss carryover computed on a post-allocation and apportionment basis. Still, if it is true that this complexity outweighs the potential tax at stake in most cases, the answer is not simply to get rid of any tracking of capital gains and losses, as the conclusion below will make clear.

Finally, third category of requirements is made necessary by federal law which allows the use of capital loss carryovers only to offset capital gains and which also imposes time-limits on the use of those carryovers. As discussed by the work group and uniformity committee, some states do not follow this particular federal treatment, but instead allow the net capital loss in a particular year to be used to offset ordinary income in that year (if any) or to increase a net operating loss, effectively using up the net capital loss or making it a part of the taxpayer's NOL carryover from that year. Any NOL carryover, including net capital losses, may then be used to offset ordinary income in other tax years, subject to state law limitations. The work group did not adopt this approach, but instead conformed generally to the federal provisions—making it necessary to track NOL carryovers and capital loss carryovers separately.

Assuming that this is the type of tracking to which COST's comment refers, it is not clear that adopting the alternative approach would greatly reduce compliance burdens. Under the model, NOL carryovers are subject to the same federal style limitations that capital loss carryovers are subject to. And, the limitations on the use of NOL carryovers impose similar requirements for recordkeeping to allow tracing and the computation of limits whenever certain events occur (membership or ownership changes). Indeed, comingling state capital loss carryovers and NOL carryovers would potentially require taxpayers to maintain different or additional information for state purposes than what is already maintained for federal purposes.

## Conclusion

COST's comment appears to convey the opinions of only a few of its members. Also, COST refers to relative burdens, which it calls "overkill when compared to the ultimate amount of tax at issue with capital gains and losses." Obviously, when the effect is expected to be minimal and, therefore, any limitations would be immaterial for state tax purposes, we trust that taxpayers will at least have sufficient records to demonstrate this fact. But if it were true, overall, that the capital gains and losses do not have a significant effect on state taxes generally, then the appropriate change to the model would not be to discard the federal-style limitations. Rather, it would be to adopt the simpler version of limits that the work group discussed which effectively prevent *any* carryover of losses into our out of a group, or after a change of ownership.

But perhaps more troubling, as noted above, some work group and uniformity committee members were concerned with the feasibility of tracking and properly limiting the shared use of loss carryovers, particularly NOL carryovers. If the federal-style requirements limiting capital loss carryovers are, in fact, "absurdly" burdensome when applied at the state level, this would raise questions as to the feasibility of applying these very same requirements to NOL carryovers, which are, undoubtedly, a significant state tax issue. Information indicating that the requirements would not be feasible to apply could well have affected the work group's discussions and even its ultimate decision. Again, the solution would not be to abandon any limitations. Rather, it would be to adopt the simpler version the work group discussed which would disallow any use of loss carryovers after certain events.

Therefore, while the focus of COST's comments is unclear, I recommend that, at a minimum, the model contain a drafter's note making states aware of this issue and noting that if a state concludes the federal-style limitations on the sharing of loss carryovers are too burdensome, it should consider adopting the simpler, while stricter, limits on those carryovers in order to prevent potential abuse.