



MULTISTATE TAX COMMISSION

MEMORANDUM

To: Tommy Hoyt, Chair, Uniformity Committee
From: Phil Skinner, Chair, Finnigan/Combined Filing Work Group
Helen Hecht, MTC, General Counsel and Bruce Fort, MTC, Senior Counsel
Subject: Request that the Uniformity Committee Consider Draft Model
Date: March 23, 2020

The Finnigan/Combined Filing Work Group asks the Uniformity Committee to consider the attached draft model alternative to the Commission's Model Statute for Combined Reporting.

Background on *Finnigan* versus *Joyce*

Combined filing states use one of two main approaches to apportioning the group's taxable income—*Finnigan* or *Joyce*.¹ The essential difference between these two approaches is how the receipts (sales) factor is computed. Under both approaches, the receipts factor denominator includes all receipts of all the group members. Under *Joyce*, however, instate sales of members lacking nexus or deemed protected by P.L. 86-272 are excluded from the receipts factor numerator. In contrast, under *Finnigan*, the receipts factor numerator includes the instate receipts of those members.²

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 tax attributes. And some *Finnigan* states go farther and treat the group itself as the taxpayer—referred to here as the “single-entity approach.”

¹ 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>.

² 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.



The Project

The Commission adopted a Model Statute for Combined Reporting in 2006.³ That 2006 model follows *Joyce* and the separate-entity approach. At its April 2018 meeting, the committee responded to a request to draft an alternative model following *Finnigan* by forming a work group and recommending the single-entity approach be used.

Work Group Activities

The work group met regularly by phone until March of this year. Initially, the work group heard from states that follow the *Finnigan* approach. The work group 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 group members, they would also need limits on that sharing as the combined group members changed. The work group 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.

For the last year, the work group has provided detailed status reports and analysis to the committee, seeking further direction. In general, the committee agreed that the work group should continue with the single-entity approach. The committee also asked the work group to produce a white paper on the consolidated filing election.

Drafts of the model discussed by the work group and analysis of various issues considered by the group 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 include:

- 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.

³ 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.



Proposed Finnigan/Combined Filing Model

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 to allow state tax agencies to include income or factors of members of the 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.

Proposed Draft

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

1 **Section 1. Definitions.**

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

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

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

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

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

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

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

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

6 **i.** has laws or practices that prevent effective exchange of information for
7 tax purposes with other governments on taxpayers benefiting from the tax re-
8 gime;

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

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

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

21 **v.** has created a tax regime that is favorable for tax avoidance, based upon
22 an overall assessment of relevant factors, including whether the jurisdiction has
23 a significant untaxed offshore financial or other services sector relative to its
24 overall economy.

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

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

5 **I.** “Unitary business” means a single economic enterprise made up either of sepa-
6 rate parts of a single business entity or of a commonly controlled group of business en-
7 tities that are sufficiently interdependent, integrated, and interrelated through their ac-
8 tivities so as to provide a synergy and mutual benefit that produces a sharing or ex-
9 change of value among them and a significant flow of value to the separate parts. A uni-
10 tary business includes that part of the business that meets the definition in this Section
11 1.I. and is conducted by a taxpayer through the taxpayer’s interest in a partnership,
12 whether the interest in that partnership is held directly or indirectly through a series of
13 partnerships or other pass-through entities.

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

20 **J.** “United States” means the 50 states of the United States, the District of Colum-
21 bia, and United States’ territories and possessions.

22
23 **Section 2.** Requirement to file a combined return; joint and several liability.

24 **A.** Except as provided in Section 4, all the corporations, wherever incorporated or
25 domiciled, that are members of a unitary business shall file a combined return as a

1 combined group. That return must include the income and apportionment factors, de-
2 termined under Section 3, and other information required by the [Director] for all mem-
3 bers of the combined group wherever located or doing business. The combined return
4 must be filed under the name and federal employer identification number of the parent
5 corporation if the parent is a member of the combined group. If there is no parent cor-
6 poration, or if the parent is not a group member, the members of the combined group
7 shall choose a member to file the return. The filing member must remain the same in
8 subsequent years unless the filing member is no longer the parent corporation or is no
9 longer a member of the combined group. The return must be signed by a responsible
10 officer of the filing member on behalf of the combined group members. Members of the
11 combined group are jointly and severally liable for the tax liability of the combined
12 group included in the combined return.

13 **B.** The [Director], by regulation, may require that the combined return include
14 the income and associated apportionment factors of persons that are not included pur-
15 suant to Section 2.A., but that are members of a unitary business, in order to reflect
16 proper apportionment of income of the entire unitary business. Authority to require
17 combination by regulation under this Section 2.B. includes authority to require combi-
18 nation of the income and associated apportionment factors of persons that are not sub-
19 ject to the [state income tax act], or would not be subject to the [state income tax act] if
20 doing business in this state.

21 In addition, if the [Director] determines that the reported income or loss of a tax-
22 payer engaged in a unitary business with a person not included pursuant to Section 2.A.,
23 or pursuant to an election under Section 4, represents an avoidance or evasion of tax by
24 such taxpayer, the [Director] may, on a case by case basis, require all or part of the

1 income and associated apportionment factors of such person be included in the tax-
2 payer's combined return.

3 With respect to inclusion of associated apportionment factors pursuant to this
4 Section 2.B., the [Director] may require the exclusion of one or more of the factors, the
5 inclusion of one or more additional factors that will fairly represent the taxpayer's busi-
6 ness activity in this State, or the employment of any other method to effectuate a proper
7 reflection of the total amount of income subject to apportionment and an equitable allo-
8 cation and apportionment of the taxpayer's income.

9

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

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

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

15 **(a)** Each member of the combined group determines its separate in-
16 come or loss, before net operating loss deduction, as follows:

17 **(1)** For a member incorporated in the United States, or in-
18 cluded in a consolidated federal corporate income tax return, the
19 member's income or loss is the taxable income for the member un-
20 der the Internal Revenue Code, on a separate entity basis, after mak-
21 ing appropriate adjustments under [state tax code provisions for ad-
22 justments to taxable income].

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

24 **(I)** The member's income or loss is determined from a
25 profit and loss statement prepared for that member on a

1 separate entity basis in the currency in which its books of ac-
2 count are regularly maintained, provided this profit and loss
3 statement is subject to an independent audit, adjusted to con-
4 form it to the accounting principles generally accepted in the
5 United States for the preparation of such statements and fur-
6 ther modified to take into account any book-tax adjustments
7 necessary to reflect federal and [state] tax law. Income or loss
8 so computed includes all income wherever derived and is not
9 limited to items of U.S. source income or effectively connected
10 income within the meaning of the Internal Revenue Code.
11 Items of income, expense, gain or loss and related apportion-
12 ment factors that are denominated in a foreign currency must
13 also be translated into U.S. dollars on a reasonable basis con-
14 sistentlly applied year-to-year and entity-by-entity. Unreal-
15 ized foreign currency gains and losses are not recognized. In-
16 come apportioned to this state is to be expressed in U.S. dol-
17 lars.

18 **(II)** In lieu of the procedures set forth in Section
19 3.A.i.(a)(2)(I) or in any case where it is necessary to fairly and
20 consistently reflect the income or loss and apportionment fac-
21 tors of foreign operations included in the unitary business,
22 the [Director] may provide for other procedures to reasona-
23 bly approximate the income or loss and apportionment fac-
24 tors of members with foreign operations.

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

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

12 **(2)** A charitable expense incurred by a member of a combined
13 group, to the extent allowable as a deduction pursuant to Internal
14 Revenue Code Section 170, is subtracted first from the apportiona-
15 ble income of the combined group subject to the income limitations
16 of that section applied to the entire apportionable income of the
17 group, and any excess may be carried over as provided in Section
18 170, subject to limitations in that section.

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

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

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

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

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

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

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

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

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

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

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

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

22 **(I)** For each year in which the combined group recognized a
23 net capital loss, multiply the combined group net apportionable
24 gains and losses times the member's separate entity apportionment
25 factor determined under Section 3.B, netting the resulting

1 apporportioned gains and losses as provided in this Section 3.A.iv; then
2 adding any nonapportionable gains and subtracting any losses allo-
3 cated to the state that were generated by that member.

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

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

14 **v.** Determine the amount of any combined group nonapportionable items
15 of income, expense, gain or loss not allocated under Section 3.A.iv.(b) that are al-
16 locable to the state under [reference to state allocation and apportionment stat-
17 ute].

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

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

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

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

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

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

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

17 **(III)** has not been used to offset income of any tax-
18 payer;

19 **(IV)** would not be subject to limitations as to the
20 amount or use applicable under any provision of the Internal
21 Revenue Code or federal regulations, or would not be subject
22 to such limitations applied as if the combined group was the
23 consolidated group; and

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

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

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

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

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

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

4 **(4)** Any adjustments to properly reflect the member's sepa-
5 rate entity loss.

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

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

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

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

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

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

1 apportionment factor as determined under Section 3.B; plus or mi-
2 nus

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

6 **(4)** Any adjustments to properly reflect the member's sepa-
7 rate entity loss; multiplied by

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

9 **B.** Allocation and apportionment.

10 **i.** Allocation and apportionment.

11 Unless otherwise provided in this Act, [reference to state allocation and ap-
12 portionment statute] determines how income or loss, or items making up income
13 or loss, are allocated and apportioned to this state.

14 **ii.** combined group apportionment factor.

15 The combined group apportionment factor is a percentage determined un-
16 der [reference to state allocation and apportionment statute] where the numera-
17 tor of the factor[s] includes amounts sourced to the state for the combined
18 group's unitary business, regardless of the separate entity to which those factors
19 may be attributed, and the denominator of the factor[s] includes amounts associ-
20 ated with the combined group's unitary business wherever located.

21 **iii.** Separate entity apportionment factor.

22 The separate entity apportionment factor for a member of the combined
23 group is a percentage determined under [reference to state allocation and appor-
24 tionment statute] where the numerator of the factor[s] includes amounts sourced
25 to the state for the member, and the denominator of the factor[s] includes

1 amounts associated with the combined group's unitary business wherever lo-
2 cated.

3 **iv.** If a member of the combined group holds a partnership interest from
4 which it derives apportionable income, the share of the partnership's appor-
5 tionment factor[s] to be included in the apportionment factor[s] of the group is deter-
6 mined by multiplying the partnership's factor[s] by a ratio the numerator of
7 which is the amount of the partnership's apportionable income properly included
8 in the member's income, whether received directly or indirectly, and including
9 any guaranteed payments, and the denominator of which is the amount of the
10 partnership's total apportionable income. If a member of the combined group di-
11 rectly or indirectly receives an allocation of a partnership tax item, such as an
12 item of loss or expense, so that it is not possible to determine the member's share
13 of apportionable income, the [Director] may provide rules for inclusion of partic-
14 ular partnership factors, or portions of factors, in the combined group's factors.

15
16 **Section 4.** Water's -edge election; initiation and withdrawal.

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

18 Members of a unitary group that meet the requirements of Section 4.B. may elect
19 to file as a combined group pursuant to a water's-edge election. Under such election, the
20 combined group takes into account all or a portion of the income and apportionment
21 factors of only the following members, otherwise included in the combined group pur-
22 suant to Section 2, as described below:

23 **i.** the entire income and apportionment factors of a member incorporated
24 in the United States or formed under the laws of any state, the District of Colum-
25 bia, or any territory or possession of the United States;

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

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

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

14 **v.** for a member that is a “controlled foreign corporation,” as defined in
15 Internal Revenue Code Section 957, include income to the extent of the income of
16 that member that is defined in Section 952 of Subpart F of the Internal Revenue
17 Code (“Subpart F income”) not excluding lower-tier subsidiaries’ distributions of
18 such income which were previously taxed, determined without regard to federal
19 treaties, and the apportionment factors related to that income; any item of income
20 received by a controlled foreign corporation is excluded if such income was sub-
21 ject to an effective rate of income tax imposed by a foreign country greater than
22 90 percent of the maximum rate of tax specified in Internal Revenue Code Section
23 11;

24 **vi.** for a member that earns more than 20 percent of its income, directly or
25 indirectly, from intangible property or service related activities that are

1 deductible against the apportionable income of other members of the combined
2 group, include the related income and the apportionment factors; and

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

10 **B. Initiation and withdrawal of election**

11 **i.** A water’s-edge election is effective only if made on a timely-filed, original
12 return for a tax year by the members of the unitary business. The Director shall
13 develop rules and regulations governing the impact, if any, on the scope or appli-
14 cation of a water’s-edge election, including the procedures for election and termi-
15 nation or deemed election, resulting from a change in the composition of the uni-
16 tary group, the combined group, the members, and any other similar change.

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

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

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

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

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