Combined Reporting Issues List
for MTC Income and Franchise Tax Uniformity Subcommittee

Draft – For Discussion Purposes Only

1. Should a combined report be mandatory, or an anti-abuse tool? Discretionary with the taxing agency? "Permit or require?" Or "necessary to reflect income?"

2. Should the combined reporting group be treated as a single taxpayer for purposes of liability for tax, or should each specific entity doing business in a state be a taxpayer, with its own liability independently determined?

3. If the combined reporting group is a single liability taxpayer:

    a. How is nonbusiness income to be treated?

        i. Does the unitary group have a "group" domicile for purposes of nonbusiness intangible income?

        ii. Is it constitutionally appropriate under Allied Signal to make all members of the group jointly and severally liable for the nonbusiness income of another one of its members?

    b. What happens if a group of affiliated corporations are engaged in two separate nonunitary businesses?

        i. Is there a constitutional problem treating all members as a single taxpayer?

        ii. If there is, what are the mechanics of apportioning nonunitary businesses, if one entity has two divisions, and each of the divisions are unitary with the separate businesses, and the divisions are not unitary with each other?

4. If each member of the combined reporting group has its own liability based on its "share" of the unitary group's business income:

    a. How is the income assigned to the respective members for purposes of taxation? (E.g., intrastate apportionment?)

        i. Should each member be responsible for payment of tax on income measured by that member's share of group income determined by an apportionment percentage composed of payroll, property and sales factors. For example, each member's sales factor is that member's in-state sales divided by the total sales of the group. (*Joyce* Method)

1. Pros: Consistent with the theory of taxation that each member is responsible for payment of tax attributable to its own numerator activity.

2. Cons: May not prevent "nexus carve-ups" where the group separately incorporates the taxable activity in the state and then alleges P.L. 86-272 protections with respect to the other inbound sales.

ii. Should there be two stages of apportionment:

1. The first stage multiplies the business income of the group by an apportionment percentage determined by reference to the payroll, property and sales factors of the group as a whole (without regard to exempt status any of the members), and

2. The second stage then takes the state source income in the first stage and then "intrastate apportions" that income between the taxable members, based on the taxpayer's respective numerator activity in the state. (*Finnigan* Method)

3. Pros: Avoids potential for "nexus carve-ups"

4. Cons: Arguably inconsistent with the theory of intrastate apportionment; some potential P.L. 86-272 issues about indirect taxation of exempt income.

b. If each taxpayer member is independently liable, should there be a means for simplifying the tax returns so that a "key" corporation can file a "group" return on behalf of all members, to avoid having to have all of the taxpayer members file individual returns and duplicating data by multiple combined reporting schedules?

5. How is total income subject to apportionment computed?

a. Does each member determine income under the Code as if it were unconnected to the other members, or is there a computation of income and expense as if all members of the group were a single taxpayer?

b. Does the group as a whole have to make the same accounting elections (e.g., R&D, IDCs, etc.)?

c. How are expenses allocated to business and nonbusiness income, particularly when several members of the group have nonbusiness income? Is there a problem assigning expense incurred by one member to the nonbusiness income of another member?

6. How are intercompany transactions (see Treas. Reg. §1.1502-13) handled?

    a. Should intercompany income be currently taxed?

    b. Should the income be "eliminated" and the basis in the asset transferred to the purchaser? Would this create too many federal/state differences?

    c. What happens if an asset is sold between affiliates that are not unitary, but the income is deferred for federal purposes?

    d. Should intercompany income be deferred for state purposes as in the federal system?

    e. What is a restoration event for state purposes? Does conversion of an asset to nonbusiness use constitute a restoration event?

    f. What apportionment percentage should be used when income is restored?

    g. What happens if a corporation receives a distribution with respect to stock in excess of tax basis (IRC §301(c)(3))?

    h. What is to prevent an entity with deferred income from simply leaving the state and not restoring income?

    i. Can income previously deferred before the taxpayer entered the state be taxed by the state when it is restored for federal purposes?

7. How should dividends paid between unitary members be treated?

    a. Like any other dividend?

    b. Eliminated?

    c. Eliminated to the extent paid from unitary income (but not from nonbusiness or separate trade or business income)?

8. How do you deal with taxpayers on different fiscal years?

9. How does combination work if a member enters the group or leaves the group at midyear?

10. Special Rules, Limitations and Carryovers.

a. How are net operating loss carryovers determined?

   i. Is there a unitary group carryover, or a post-apportioned carryover specific to each member?

   ii. If the group method is used, what happens to the carryover if some of the members leave the group? Is the loss allocated based on the separate accounting contribution of the member creating the loss, or is there some other allocation of loss?

   iii. What happens if a member joins the group with an NOL? Is the NOL limited to that member or can it be shared with other new members?

b. How are charitable expenses treated: as business, or proportionately business and nonbusiness, etc.?

   i. How is the charitable expense carried forward—specific to the entity that incurs the cost, or some kind of group carryover?

   ii. What happens if the members of the group disaffiliate when a charitable carryover remains unused?

c. How do you deal with business and nonbusiness capital gains and losses (including section 1231 assets, involuntary conversion income)? Is it appropriate for one member's nonbusiness capital gain to "free up" the business capital losses of the group?

11. How are tax credits to be handled?

    a. Is the credit available only to the specific legal entity that incurred a creditable cost, or all of to the taxpayer members of the group? If the latter, how is the credit allocated?

    b. How are credits to be carried forward if members leave or enter the group?

    c. Is appropriate that tax attributable the nonbusiness income of one of the members to be available to apply a credit attributable to the business income of the group?

12. How is partnership income treated in the context of a unitary group?

    a. What happens if the partnership is itself an apportioning entity?

    b. What if the partnership is unitary with a member of the group?

    c. What if the partnership itself has both business and nonbusiness income?

   d. What if a partner is unitary with a second tier partnership but not the first tier partnership?

13. How is income of unitary financial institutions or insurance companies treated where those entities are not subject to the corporate income or franchise tax?

14. How should holding companies be treated?

    a. What is a holding company?

        i. A company that holds stock in another member(s), but has no operations?

        ii. A company that holds stock in another member(s), but has central management activity (i.e., a management holding company)

        iii. A company that holds intangibles and derives income therefrom, but has no other active operations (intangible holding companies)?

    b. How should intermediate holding companies be treated (i.e., a holding company between two unitary members).

    c. How should a parent holding company that holds only members of a single unitary group be treated?

    d. How should a parent holding company be treated if it holds corporations that represent two distinct unitary businesses?

    e. How should acquisition debt of a holding company be treated (e.g., leveraged buy-out)?

    f. How are dividends that pass to or from or through a holding company treated?

15. Should combination be worldwide, water's edge or something in between?

    a. How does combination work under a water's-edge system?

        i. Should U.S. source income (under federal tax law) of an otherwise excluded foreign entity be included in a combined report?

        ii. How does combined reporting work if a foreign entity has two divisions: a U.S. trade or business and a foreign trade or business.

    b. How does combination work under a worldwide system?

i. What can be done to have constitutionally acceptable "rough approximations" of income and factors?

ii. How can a foreign entity take advantage of tax laws that are preferential compared to book income?