MULTISTATE TAX COMMISSION

Report of the Hearing Officer regarding the proposed Model Statute for Combined Reporting

April 25, 2005

Submitted by Shirley Sicilian
Hearing Officer

Table of Contents

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I. Introduction

On November 11, 2004, the Multistate Tax Commission (MTC) Executive Committee approved an MTC proposed model statute on combined reporting for public hearing. The appointed hearing officer has held two public hearings and received five sets of written comments on the proposed model statute. This Report provides a procedural summary of the proposed model statute, an explanation of its key substantive features, a review of the public testimony received, and the hearing officer's recommendations for addressing that public testimony.

II. Summary of Procedure

A. Development of the Proposal

In June of 2003, the MTC Executive Committee requested the Uniformity Committee consider whether it would be feasible, appropriate and of service to the states for the MTC to develop model laws for combined reporting. After a review of preliminary research[1], the Uniformity Committee reported in July, 2003, that development of such model laws was feasible; would be useful for MTC member states; and would promote MTC principles of uniformity, ease of administration and sound tax policy. The Committee noted that this conclusion was consistent with a recommendation contained in the MTC's Federalism at Risk Report, published in June of 2003, that states adopt combined reporting for jointly owned and operated companies in order to appropriately report and assign income where it is earned.[2] On July 30, 2003, the

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[1] See memorandum dated July 29, 2003 to Ted Spangler, Chair, and members of the Uniformity Committee from Shirley Sicilian titled *Executive Committee Request Regarding Combined Reporting*. The memorandum provided a general description of combined reporting, summarized its potential benefits, and identified key policy questions which would need to be addressed in developing a combined reporting rule.

[2] *Federalism at Risk, A Report by the Multistate Tax Commission*; p. 25 (June, 2003)

Executive Committee directed the Uniformity Committee, through its Income & Franchise Tax Subcommittee, develop model combined reporting statute and regulations.

The Income & Franchise Tax Uniformity Subcommittee organized the project into three phases: 1) education, 2) policy direction and 3) drafting. During the education phase, the Subcommittee established standard definitions for common terms used in discussing combined reporting, reviewed a number of MTC staff memorandums on the topic,[3] and heard a series of seminars on legal, mechanical and policy aspects of combined reporting.[4] In addition, the Subcommittee received several thought-provoking and constructive comments from the public at its March and July meetings, and during numerous teleconferences.[5]

The Subcommittee began the policy development phase by producing a list of combined reporting "pro's and con's." It then compiled a list of fifteen key policy issues to be addressed in the model statute or regulations.[6] During its March, 2004 meetings and three follow-up teleconferences, the Subcommittee provided direction on each of these fifteen policy issues for staff to follow in preparing a first draft of a combined reporting statute. In doing so, the Subcommittee took into consideration the recommendations of the MTC State Tax Compliance Initiative Steering Committee regarding adoption of combined reporting as a solution to corporate income tax compliance concerns.[7]

The Subcommittee reviewed and discussed the first draft statute at its July, 2004 meeting in Mystic, Connecticut. At that meeting, a small group of Subcommittee members volunteered to research the issue of whether corporations that are not income taxpayers should be included in the combined group, and report their findings to the

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[3]The Committee reviewed three memorandums from MTC staff member Shirley Sicilian: 1) dated October 6, 2003 to members of the Income & Franchise Tax Uniformity Subcommittee titled *Combined Reporting – State Statutes and Two Cases re Inclusion of Non-Income Taxpayers in the Unitary Group*; 2) dated December 15, 2003 to members of the Income & Franchise Tax Uniformity Subcommittee titled *Combined Reporting: 1) definition of common terms, and 2) interaction with* Joyce *and* Finnigan *rules;* and 3) dated February 10, 2004 to Jennifer Hayes, chair, and members of the Income & Franchise Tax Uniformity Subcommittee titled *Combined Reporting: More on Definitions of Common Terms.*

[4] The seminars were given by Michael Brownell, Senior Staff Attorney with the California Franchise Tax Board. Mr. Brownell addressed the following topics: March 14, 2004 –Overview of California's Approach to Combined Reporting and Some Alternatives; April 27, 2004 – Charitable Expenses & Holding Companies; May 25, 2004 – Intercompany Transactions; June 30, 2004 – Treatment of Partnerships.

[5] Professor Richard Pomp, Mr. Arthur Rosen, Ms. Diann Smith, Mr. Robert Montellione, and others provided helpful participation and comments.

[6] Mr. Brownell was the primary author of the combined reporting policy issues list.

[7] *Corporate Income Tax Sheltering Work Group Report*; Prepared for the State Tax Compliance Initiative Steering Committee; pp 15-16, 24-29 (June 17, 2004).

Subcommittee.[8] A second draft statute, which incorporated Subcommittee members' amendments from the July meeting, as well as recommendations of the small research group, was reviewed by teleconference on October 1, 2004. A group of insurance industry representatives met with members of the small research group on October 13, 2004 and provided insight and comments which led to further changes to the draft statute. The proposed model statute currently before the Executive Committee was posted to the MTC website on October 29, 2004.

On November 8, 2004 the Income & Franchise Tax Uniformity Subcommittee discussed the draft and voted to adopt it as a proposed model statute with a favorable recommendation to the Uniformity Committee.[9] On November 9, 2004, the Uniformity Committee considered the recommendation of the Subcommittee and voted to recommend the proposal favorably to the Executive Committee. On November 11, 2004 the Executive Committee approved the proposal for public hearings.

B. Public Hearings

Public Hearings were held January 4, 2005 in Oakland, California and March 29, 2005 in Washington, D.C., following more than 30 days notice in each case. Oral public comments were received at both hearings. In addition, six sets of written comments were received prior to the closure of the public comment period on April 1, 2005. The written comments are attached as Exhibits:

Exhibit A	McDermott, Will & Emery (MW&E) – Kimberley Reeder and Margaret Wilson
Exhibit B	Southerland, Asbill & Brennan (SAB) – Kendall L. Houghton and Jeffrey A. Friedman
Exhibit C	Council On State Taxation, American Council of Life Insurers, American Insurance Association and the Property Casualty Insurers Association of America (Insurance Group)
Exhibit D	United Services Automobile Association (USAA) – Amy Cannefax
Exhibit E	Heller Ehrman (HE) – Roy E. Crawford
Exhibit F	Organization for International Investment (OFII)

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[8] Members of the small research group included Ted Spangler (ID); Wood Miller (MO); Mary Loftsgard and Robert Wirtz (ND); Janielle Lipscomb (OR); Robynn Wilson (AK); Michael Brownell and Larry Bobiles (CA).

[9] The Income & Franchise Tax Uniformity Subcommittee also appointed a small work group to consider whether it should recommend an amendment to the model statute to incorporate *Finnigan* style calculation of apportionment numerators as opposed to the *Joyce* approach currently contained in the model. On March 17, 2005, the small group recommended to the Subcommittee that the model statute should retain the *Joyce* rule. The small group noted that states adopting the model statute may also wish to separately consider a throw-back rule. The Subcommittee accepted the small work group's reconfirmation of the *Joyce* approach and voted to take no further action.

C. Next Steps – Executive Committee Consideration and Action.

This Report summarizes and makes recommendations for addressing the comments received through the public hearing process. For some comments, no change is recommended; while for others, alternative statutory language is proposed. The Executive Committee has several options. The proposed statute may be approved and passed on to the full Commission, amended and passed on to the Commission, disapproved entirely, or referred back to an earlier step in the process. If the Executive Committee chooses to pass any version of the proposal on to the Commission, it first authorizes (pursuant to MTC Bylaw 7) a polling of the affected Commission Member States to ensure that a majority of the affected States would consider adoption of the draft proposal. (This survey does not determine if the affected States will adopt the proposal—only whether the affected States will consider adoption of the proposal.) If the majority of the affected Commission Member States so indicate, the matter is referred to the full Commission for possible adoption as a recommended model uniform statute.[10] Once a model uniform statute has been adopted by the Commission, the Income & Franchise Tax Uniformity Subcommittee anticipates it will begin development of regulations to complement and expand on the principles reflected in that final version.

III. Summary of Substantive Provisions

The proposed model statute requires combination of all unitary entities that are subject to the state corporate income tax or that would be subject to the state corporate income tax if they were doing business in the state. Business conducted by any corporation through a partnership is treated as conducted directly by that corporation, to the extent of the corporation's distributive share of the partnership income. This is true whether the partnership is a general partnership, a limited partnership, an LLC or other entity treated as a partnership, or an S corporation. Other commonly-controlled, unitary entities, not otherwise subject to required combination because they are not income tax payers, may also be required to be included in the combined group by regulation if doing so would better reflect the proper apportionment of income of entire unitary businesses, or on a case-by-case basis if there is tax evasion.

Combination of eligible entities is required on a world-wide basis, unless taxpayers choose to make a water's-edge election. A water's-edge election limits the combined group to eligible domestic corporations, foreign corporations with U.S. source income, and corporations doing business in tax-haven countries.

The combined report required under this proposed model statute does not disregard the separate identities of the taxpayer members of the combined group. Each taxpayer member is responsible for tax based on its apportioned share of the business income of the combined group, together with that member's own allocated (nonbusiness)

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[10] Of course, all recommendations of the Commission are advisory to the States. For a recommendation to become effective in any State, that State must affirmatively adopt the proposal.

income, and its apportioned share of business income from any other combined group of which the taxpayer is a member. Business income of the combined group is calculated as the sum of all members' individually determined net business incomes. Dividends paid by one to another member of the combined group are eliminated from income, and no special treatment is provided for included foreign source income.

Because individual group members are recognized as separate taxpayers, as a general rule, a deduction or credit may be taken only by the specific taxpayer that earned it, and not against the total combined income or liability of the group. Likewise, the amount of total combined business income apportioned to a state is calculated as a function of each taxpayer's own factors in that state (the *Joyce* method), as opposed to the factors for the entire group as a whole in that state (the *Finnigan* method).

The statute does provide one exception to this general rule preserving the separate identity of the taxpayer. A charitable contribution deduction is allowed to be taken first against the business income of the combined group (subject to federal income limitations as applied to the entire business income of the group), and any remaining amount may then be treated as a nonbusiness expense allocable to the member that incurred the expense (subject to the federal income limitations applied to the nonbusiness income of that taxpayer member).

IV. Public Comment and Hearing Officer Recommendations

A. Criteria for Combination.

1. Unitary Business Requirement

Two commenters suggested it is not perfectly clear under the proposed statute that unity is required for combination. (MW&E p. 4-5; SAB oral comments) Both indicated their concern arises from the proposed language allowing the Director to adopt a regulation requiring combination "of any persons that are not included pursuant to [the mandatory combination provision], *but that are members of a unitary business*, in order to reflect proper apportionment of income of entire unitary businesses." (Emphasis added.) One of the two commenter suggested this language could possibly allow combination of unrelated taxpayers. (MW&E p. 4) The Hearing Officer believes this language clearly requires combination of only unitary entities. And, because the MTC's regulatory definition of unity requires common ownership and control, it would not allow combination of unrelated taxpayers. However, some states do treat the "common ownership and control" requirement as separate from the unity requirement. Thus, we recommend an explanatory note be added on this point to ensure clarity.

Several commenters expressed concerns with the proposed model's definition of "unitary business." The model defines a unitary business as:

> a single economic enterprise that is made up either of separate parts of a single business entity or of a commonly controlled group of business entities that are

sufficiently interdependent, integrated and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts.

Section 1.F.

One commenter suggested this definition "provides little guidance by which taxpayers may determine whether they are indeed engaging in a unitary business." (MW&E p. 3; see also p. 4) We agree this proposed statutory definition is brief. Our intent is that the statute be supplemented by regulation. Indeed, this statutory language was drafted to dovetail precisely with the MTC's existing model uniform regulation defining a "unitary business."[11] The adopted MTC regulation begins with the identical language, and then expands on that definition at length. Because the statutory definition is derived from existing, adopted regulatory language, it would not, as one commenter warned, set a "new definitional standard." (SAB p. 1-2) In the Hearing Officer's opinion, the nine page MTC regulation associated with this proposed statutory language fully addresses commenters' concerns because it does thoroughly incorporate "the broad parameters of the unitary business principle [that] have been articulated by the U.S. Supreme Court in [its] long-standing opinions." (MW&E p. 2)

One commenter noted the definition of "unitary business" does not include any mention of "what constitutes a 'commonly controlled group.'" (MW&E p. 4) This question, too, is addressed through the existing MTC regulation. Under the regulation, common ownership and control are required for unity, and are defined at length.

Three commenters suggested that even if the proposed combined reporting statute is intended to work together with our adopted regulation, that intent should be made clear in the model statute. (SAB p. 1-2; MW&E p. 4; COST oral comments) The Hearing Officer agrees. The scope of this project is to draft a uniform model combined reporting statute. The definition of "unitary business" has already been addressed through a previous MTC uniformity project and we do not intend to address that issue again through this project. The Hearing Officer recommends brackets be placed around the definition of unity in the model statute, and a note be added to clarify that this statutory definition is intended to work together with the MTC's model uniform regulation. If a state intends to define "unitary business" in a manner inconsistent with the MTC's adopted regulation, it will need to insert its own brief statutory definition and develop its own regulations to expand on that definition accordingly.

2. Relevance of Arm's Length Pricing

Under the proposed model statute, combination is required of all unitary corporate income taxpayers, rather than permitted upon the request of either the corporation or the department, or contingent upon some type of showing by either the corporation or the department. One commenter suggested the model be amended to allow separate reporting

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[11] See MTC General Allocation and Apportionment Regulations; Regulation IV.(b) Unitary Business (revised January 15, 2004) at http://www.mtc.gov/UNIFORM/ADOPTED.HTM

unless it can be shown that transactions between the entities are not at arm's length: "so long as related taxpayers charge each other the same amounts that they would charge to an unrelated business for the same transaction, no distortion or improper reflection of income would result." (MW&E p. 5) The commenter suggested that "[i]n fact, when related corporations do deal with one another on arm's length terms, combination may actually result in distortion." (MW&E p. 5) As a result, this commenter suggests the model require combined reporting "only when related corporations: (1) are engaged in a unitary business and (2) experience distortion attributable to a failure to conduct their intercompany transactions at arm's length." (MW&E p. 6)

In the opinion of the Hearing Officer, there is no rationale for conditioning combination on both a determination of unity and a finding of distortion through non-arm's length pricing. Combined reporting will attribute unitary business income in a manner conceptually superior to separate accounting whether or not the unitary entities are engaged in arm's length transactions. Indeed, under combined reporting, the income of a unitary business attributable to a state will not vary depending on whether a business chooses to operate as one corporation with numerous divisions or to incorporate those divisions into subsidiaries will not impact the amount of income produced by the business as a whole, subject to apportionment, and attributable to the state. By contrast, attempting to employ separate accounting where a business has chosen to incorporate its divisions is very difficult, if not, in truth, impossible. Separate accounting "…ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise."[12] The premise of combined reporting is that the synergies, interdependencies, and sharing of knowledge, know-how, and experiences that are typical features of a unitary business often cannot be properly captured by separate accounting.[13] With combined reporting, the enterprise-wide contributions to income that result from these features are not pigeon-holed into a few affiliates. Rather, they are apportioned across the entire enterprise, as they would be for a single corporation operating through divisions. In this way, the substance of the business activity conducted in the state controls the amount of income subject to apportionment, regardless of the organizational structure of the business entity or entities conducting those activities and regardless of any transactions that may take place between separately incorporated entities. Once unity has been determined, combination should occur, and there is simply no need to perform an additional test for arm's length pricing.

Nor does it make sense to "flip" the tests – so that a determination of unity is only required if there is a "gateway" finding of non-arm's length transactions. Adequately testing for arm's length pricing is extremely complex and time-consuming. Even if the test for arm's length pricing were no more burdensome than a test for unity, why subject taxpayers to two tests (first a test of arm's length pricing; and in cases where that test is

[12] *Container Corp. of America v. Franchise Tax Bd. Of California*, 463 U.S. 159, 165; 103 S.Ct. 2268, 2940 (1983).

[13] *Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana*; 61 Louisiana Law Review 699, 704, by Michael J. McIntyre, Paull Mines and Richard D. Pomp (2001).

not met, an additional test of unity) when it is only necessary to subject them to one (a test of unity)? In addition, required combined reporting of all eligible entities will help ensure the rule is applied uniformly, regardless of the impact on tax liability in individual cases. For these reasons, the Hearing Officer finds there is no need to modify the model statute to incorporate an additional test for arm's length pricing.

3. Entities Not Subject to a Corporate Income Tax.

Under the proposed model statute, only corporations subject to an income tax are specifically required to be combined. However, it is recognized that a single unitary business may be carried on by many types of business entities acting together, not just corporations and certainly not just corporations that are corporate income taxpayers. It is also recognized that it would be theoretically correct and, in many states, legally acceptable to statutorily require the inclusion of all such business entities in the combined group in order to properly apportion the income of the entire unitary business. In recognition of the theoretical basis for combination of all entities engaged in the unitary business, the model statute also authorizes combination of unitary non-corporate-income taxpayers to be required by regulation, provided such combination can be accomplished in a manner that will generally reflect a reasonable apportionment of income for those types of unitary entities. This theoretical consideration would not have been much of an issue until a few years ago - when the federal government began breaking down some of the barriers between different types of financial services industries.[14] One outcome of these changes is that industries such as banking and insurance companies, which are often not corporate income taxpayers, may now branch out and engage in a unitary business with other financial service industries that are subject to the corporate income tax.

Joint written comments on the potential for combination of non-corporate-income taxpayers were provided by the Council On State Taxation, American Council of Life Insurers, American Insurance Association and the Property Casualty Insurers Association of America (the Insurance Group). Similar comments were filed by United Services Automobile Association (USAA). These comments give a thorough review of the insurance company state tax system (including retaliatory taxes), benefits of this tax system for the states and the industry, and policy issues raised by the proposed model statute. (Exhibit C) Policy issues raised by the Insurance Group include complexities, implications and uncertainties for the insurance tax system if combination is viewed as indirectly subjecting insurance company income to a corporate income tax.

In fact, the *original* draft of the proposed model statute would have explicitly included all corporations, whether or not corporate income taxpayers, in the combined group. In addition to the theoretical basis for such inclusion, it was also recognized that including non-taxable entities in a combined group does *not* subject those entities, or their income, to a state's corporate income tax. For example, unitary entities that do not have nexus with the state, and cannot be taxed by the state, are routinely included in the combined group. Including these non-taxable entities in the combined group only includes those entities' income from the unitary business in the total pot of unitary

[14] See *e,g*, Riegle-Neal Act and Gramm-Leach-Bliley Acts of 1994 and 1999.

business income from which the taxable corporations' share is apportioned. The tax is then levied only on the taxable corporations' and their share of that income. The non-taxable corporations are not subject to the tax. Nor is any of the income from the unitary business that is attributable to those entities subject to tax.

This distinction was recognized in *State ex rel. Dept. of Revenue v. Penn Independent Corp*.[15], where the Oregon Tax Court found the apportionable income of a unitary group should include the income of an insurance corporation even though that corporation was not subject to Oregon's corporate income tax, but instead paid a gross premiums tax. The Tax Court noted "[i]t is important to remember that including the income of a nontaxable member of a unitary group does not subject that income to taxation by Oregon. It merely provides the base from which the taxable corporation's share is apportioned."[16] Indeed, the appropriateness of this holding has been recognized by Walter Hellerstein: "Although the result in this case is unusual, Judge Byers's thoughtful analysis of the theoretical justification for the result is plainly correct."[17]

However, after the original draft was issued, the Insurance Group raised its concerns. A small MTC subcommittee work group met with members of the Insurance Group to discuss these concerns. After discussion, the small work group agreed with the Industry Group that combination of entities which operate under significantly dissimilar financial and tax regimes can create mechanical issues which would need to be worked out, and that the resolution of those mechanical issues is likely to be different depending on the type of business entity or industry at issue. The small group agreed to balance the industry concerns against the correctness of combination and recommended to the Committee that the original draft be modified. The small group recommended that combination of dissimilar business entities could be attained through regulations which address the specific mechanical issues associated with combination for each of the different types of business entities. For example, combination of insurance companies may engender questions of how to establish "taxable income" for the insurance company that at the state level is subject only to a tax on gross premiums. Combination of non-income taxpayer financial institutions may raise issues surrounding the treatment of financial instruments in the calculation of the sales or property factors. In addition, different entities subject to different tax regimes in different states, *e.g.*, exempt organizations under IRC section 501(c)(3) may or may not be legally subject to combination in those states. A review of state legal authority for combination of each of the different entities may be required. For these reasons, the current version of the proposed model statute authorizes combination of other types of unitary entities to be required by regulation, so that appropriate rules can be developed to address each type of situation, rather than statutorily requiring combination in all situations. If the proposed

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[15] *State ex rel. Dept. of Revenue v. Penn Independent Corp*. 15 Or. Tax 68 (1999). http://www.publications.ojd.state.or.us/TC4321.htm.

16 Penn Independent, p. 74

17 Hellerstein, State Taxation: 2001 Cumulative Supplement No. 1, ¶ 8.11[3][e].

model rule is adopted, the Committee will consider drafting model regulations for combination of one or more different types of business entities.

The model statute does also allow for combination to be required by the director on a case-by-case basis, but only in situations involving tax avoidance or evasion. Although it may be clear in individual cases that combination would better reflect the income or loss of a particular taxpayer, or better reflect proper apportionment of income of a particular unitary business, the remedy allowed in these situations is through regulation, and not through authority to combine on an individual, case-by-case basis.

The Hearing Officer believes these modifications to the original draft, reflected now in the draft before the Executive Committee, represent a compromise that reasonably balances the concerns of the industry with the need to adequately take into account these important segments of a single unitary business, and therefore the Hearing Officer does not recommend further changes.

4. Partnerships

Under the model statute, business conducted by a corporate income taxpayer through a partnership is treated as conducted directly by that corporate taxpayer, to the extent of the corporation's distributive share of the partnership income. This is true whether the partnership is a general partnership, a limited partnership, an LLC or other entity treated as a partnership, or an S corporation. Because the corporation is considered to be engaged in the partnership business directly, as though through a division, the corporate partner's distributive share of the partnership income and factors will "flow up" for apportionment on the partner, as opposed to the partnership, level, irrespective of any threshold level of the partner's ownership interest, distributive share or any other measure of its stake in the partnership. Under this statutory "as if done directly" treatment, if a partnership has state source income, so will the partner. The principle is consistent with federal sourcing rules that treat a resident of a foreign country as having U.S. source income if the partnership or an S corporation of which the resident is a member has income from a U.S. source (IRC §875(1); §1366(b)). And it has been sustained in state court.[18]

One commenter suggested the model should explicitly specify whether it follows the "aggregate" or the "separate" theory and noted the myriad of issues that arise from the inclusion of partnership income in the combined report. (COST oral comments) The Hearing Officer believes the statute is adequately clear regarding the basic policy to be followed, but agrees that additional, more detailed guidance could be provided, and recommends the appropriate procedure for providing that guidance is through regulation.

5. Water's Edge Election

Whether or not, or the extent to which, foreign affiliates are included in the combined group is one of the most significant policy issues addressed in the proposed

[18] *Valentino v. Franchise Tax Board,* 87 Cal.App.4th 1284 (2001).

model statute. In principle, a combined group should include all affiliates participating in the group's unitary business, domestic and foreign. If combination includes only domestic corporations, then the apportionment of income associated with the foreign activity of a multinational unitary business can be manipulated through changes in the corporate structure. The income (or loss) and apportionment factors associated with the foreign activity could be excluded by conducting the activity as a foreign affiliate, or it could be included by conducting the activity as a foreign division of the domestic corporation. Many tax experts have noted this policy rationale supporting world-wide combined reporting.[19] Indeed, the U.S. Supreme Court has also recognized the rationale and upheld state imposition of world-wide combined reporting.[20]

Despite its conceptual superiority, the world-wide approach is extremely unpopular with multinational corporations and much of the international tax community.[21] Indeed, a number of hearing participants lent support to that supposition in both oral and written comments. (See e.g. MW&E p. 7-8; OFII p. 1) As a practical matter, a water's-edge combination is likely to be administratively simpler, for both the taxpayer and the state, and far less contentious. Thus, the proposed model statute requires world-wide combination, with a water's-edge election. (Section 5) This approach takes a policy position in support of world-wide combination, yet also realizes the practical benefits of administrative simplicity and conflict minimization that can be achieved through a water's-edge election. No commenters recommended a change to the basic approach requiring world-wide combination but allowing a water's edge election. However, several took issue with various specific aspects of the water's edge election, and these comments are addressed below.

(a) Members Doing Business in a Tax-Haven

Two commenters referred to the model's retention in the water's edge combined group of entities doing business in tax havens as a "back-door implementation of world-wide combination." (SAB p. 2; OFII p. 1) In the opinion of the Hearing Officer, the retention of tax haven companies in a water's edge election is justified in order to address documented wide-spread abusive international tax sheltering, and its limited application to only those countries identified as "tax havens" falls far short of a "quasi world-wide combination." Just as combined reporting is critical to addressing income shifting across

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[19] See *Use of Combined Reporting by Nation States*, by Michael J. McIntyre, Tax Notes International; p. 945 (Sept. 6, 2004). See also *Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana*; *Supra,* p. 732; citing to *Slicing the Shadow: A Proposal for Updating U.S., International Taxation,* by Reuven S. Avi-Yonah, 58 Tax Notes 1511 (March 15, 1993); *Design of a National Formulary Apportionment Tax System,* by Michael J. McIntyre, 84th Conf. on Tax'n, Nat'l Tax Ass'n 118 (Frederick D. Stocker ed. 1991); other citations omitted.

[20] *Container,* 463 U.S. 159, 103 S.Ct. 2983; *Barclays Bank PLC v. Franchise Tax Bd. Of California,* 512 U.S. 298, 114 S.Ct. 2268 (1994).

[21] *Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana*; *Supra,* p. 732.

states, it is also critical for addressing the serious problem of income shifting to foreign tax-haven jurisdictions. A July, 2003 study by the Multistate Tax Commission estimated the state revenue impact from corporations shifting income earned inside the U.S. to other nations.[22] Using conservative national estimates of international income shifting through transfer pricing, the study estimated state revenue losses of $5.3 billion for fiscal year 2001 alone.[23] World-wide combination addresses this issue by including all eligible unitary corporations, foreign as well as domestic, in the combined group. The proposed model's requirement that foreign corporations doing business in a tax haven jurisdiction be maintained as members of the combined group is necessary to avoid re-opening the foreign tax-haven opportunity through the water's-edge election. And, as further addressed below, the model's proscribed definition of tax-haven will reasonably limit the corporations to which the rule will apply.

(1) Definition of "Tax Haven"

- **Use of OECD Criteria**

The definition of "tax haven" in the proposed model statute is based on existing standards and criteria established by the Organization for Economic Co-operation and Development (OECD) in its 1998 report entitled Harmful Tax Competition: An Emerging Global Issue.[24] One commenter suggested the Section 1.I.i. should more specifically identify "to which list of OECD 'tax havens' it refers: there were 35 jurisdictions identified by the OECD in its 2000 Progress Report yet only seven jurisdictions identified in the 2004 Progress Report." (MW&E p. 10) Similarly, "there were 47 countries identified in the 2000 Progress Report of the [OECD] as having a potentially 'harmful preferential tax regime;" however, to date, none have been identified as having an actual "harmful preferential tax regime." The Hearing Officer believes it is intended that Section 1.I.i. refer only to jurisdictions and regimes that are actually on the

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[22] *Corporate Income Tax Sheltering and the Impact on State Corporate Income Tax Revenue;* A Report of the Multistate Tax Commission by Elliott Dubin; p. 4 (July, 2003).

[23] *Ibid*, p.5. The MTC study bases its estimate on estimated federal revenue losses attributable to international tax sheltering of $30 billion. This number is consistent with a 1990 estimate by the Subcommittee on Oversight of the House Ways and Means Committee, chaired at the time by Rep. J.J. Pickle. Estimates from other sources have been higher, exceeding $53 billion annually. See *An Estimate of 2001 Lost U.S. Federal Income Tax Revenues Due to Over-Invoiced Imports and Under-Invoiced Exports* by Simon J. Pak and John Zdanowicz, (October 31, 2002).

[24] *Harmful Tax Competition: An Emerging Global Issue*, OECD, 1998. http://www.oecd.org/dataoecd/33/1/1904184.pdf In 2001, the OECD deleted consideration of whether a jurisdiction has a significant untaxed offshore financial/other services sector relative to its overall economy as one of the criteria for distinguishing between "cooperative" and "uncooperative" tax havens. However, the consideration of significant untaxed offshore services remains one of the OECD criteria for the determination of whether a jurisdiction is a tax haven. Thus we have retained this consideration as one of several criteria to be examined in determining the existence of a tax haven under the model statute.

OECD lists during the year in question.[25] Thus, the language of Section 1.I.i. could be clarified as follows:

I. "Tax haven" means a jurisdiction that, during the tax year in question,:
i. ~~has been~~ is identified by the [OECD] as a tax haven or as having a harmful preferential tax regime …

- **Director Discretion**

The proposed model allows discretion on the part of the Director with respect to tax havens in two ways. First, the Director may classify a jurisdiction as a tax haven if he or she "determines [the jurisdiction] has created a tax regime which is favorable for tax avoidance, based upon an overall assessment of relevant factors, …." (Section 1.I.iii.) Second the Director "may treat an activity of the member as not having been conducted in a tax haven" if the activity is "entirely outside the scope of the laws, provisions and practices that cause the jurisdiction to meet the criteria established in [the definitional section.] (Section 5.A.vii.) Three commenters objected to the amount of discretion afforded the Director with respect to tax havens. (MW&E p. 10; SAB p. 3; COST oral comments) One commenter explained that "[t]he obvious effect of such discretion is the lack of uniformity across states that implement [the] proposed model statute." (SAB p. 5) The Hearing Officer acknowledges the importance of uniformity and believes amendments are possible which would reduce the amount of discretion afforded the Director without seriously compromising the effectiveness of the model provisions, as follows:

Changes to Section 1.I.:

I. "Tax haven" means a jurisdiction that:
…ii. exhibits the following characteristics established by the OECD in its 1998 report entitled Harmful Tax Competition: An Emerging Global Issue as indicative of a tax haven or as a jurisdiction having a harmful preferential tax regime, regardless of whether it is listed by the OECD as an un-cooperative tax haven:
(a) has no or nominal effective tax on the relevant income; and
(b) **(1)** has laws or practices that prevent effective exchange of information for tax purposes with other governments on taxpayers benefiting from the tax regime;

[25] It should be noted that Section 1.I.ii. could include jurisdictions that were once, but are no longer, on the OECD list of uncooperative tax havens. The OECD recognizes that removal of a jurisdiction or regime from its list does not mean that that jurisdiction or regime is no longer a tax haven under its definition, only that it has become a "cooperative tax haven" as opposed to an "uncooperative tax haven." As long as a "cooperative tax haven" is still a "tax haven," the jurisdiction will continue to meet the OECD definition in Section 1.I.ii. This is not inconsistent with the OECD's own caveat that a conclusion that a regime is not actually harmful does not in any way preclude the application of any domestic measure (such as CFC, FIF or any anti-abuse provisions) of a country to that or any other regime in *OECD's Project on Harmful Tax Practices: The 2004 Progress Report,* Part II ¶18.

(2) has tax regime which 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;

(3) 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; ~~**or**~~

(4) 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

~~**iii.**~~**(5)** ~~the director determines~~ has created a tax regime which is favorable for tax avoidance, based upon an overall assessment of relevant factors, including whether the jurisdiction has a significant untaxed offshore financial/other services sector relative to its overall economy.

Changes to Section 5.A.vii.:

> the entire income and apportionment factors of any member that is doing business in a tax haven. 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.I., ~~the Director may treat~~ the activity of the member shall be treated as not having been conducted in a tax haven.

(2) "Doing Business" in a Tax Haven

Four commenters remarked that inclusion in the water's edge election of any taxpayer "doing business" in a tax haven is overly broad. (MW&E p. 9; SAB p. 2-4; OFII p. 1-2; COST oral comments) One commenter suggested that it is presumably the "process of organizing" an entity in a tax haven jurisdiction that creates some tax benefit. (MW&E p. 9) One commenter noted that Montana and Alaska both include only those corporations that are "domiciled in" a tax haven.[26] (SAB p. 3) The Hearing Officer agrees that the "doing business" criteria is overly broad. However, in the opinion of the Hearing Officer, a rule limiting inclusion to taxpayers domiciled, particularly legally domiciled, in a tax haven may not be adequate for our purposes. A corporation incorporated in one country can have a commercial domicile in a haven and take advantage of the secrecy and low tax rate rules of the haven. The Hearing Officer recommends that the language be modified as follows:

> …the entire income and apportionment factors of any 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.

[26] Mont. Code §§15-31-322 and Alaska Code §43.20.073

Section 5.A.vii.

(3) Foreign Commerce Clause

Two commenters suggest the MTC's adherence to the OECD's criteria would violate the foreign commerce clause. (SAB p. 4; OFII p. 2) The foreign commerce clause restrictions established in *Japan Lines* are that state tax measures may not impose a risk of multiple taxation at the international level and may not prevent the federal government from "speaking with one voice" on international policy matters. The model does not violate either of these restrictions. First, the model is fundamentally an adoption of world-wide combination, which has been upheld by the U.S. Supreme Court. The water's edge election is just that – an election – and it is at the taxpayer's option. Nothing is "imposed" through an election allowing taxpayers to limit the inclusion of the foreign unitary affiliates which could otherwise constitutionally be required to be included in their combined report.

Second, the United States is a member of the OECD, the organization which has produced the definitions the model proposes to follow. That the model will incorporate and follow definitions adopted by an organization of which the federal government is a member will promote, not prevent the federal government's ability to "speak with one voice." A commenter suggested that the OECD's 1998 criteria have been "clearly rejected by the Federal government," and thus the MTC's reliance on these criteria would violate the foreign commerce clause. (SAB p. 4) As evidence of rejection, the commenter pointed to testimony provided in 2001 by Treasury Secretary Paul O'Neill to the Senate Committee on Governmental Affairs. (SAB p. 4)

In the opinion of the Hearing Officer, Sec. O'Neill's testimony has been misinterpreted. Indeed, Sec. O'Neill reported his concern with prior OECD provisions. But the conclusion of his testimony was that these concerns have been addressed. In fact, Sec. O'Neil stated:

> Our review of the OECD project has been guided by two fundamental principles. First, we must do everything that we can to enforce our own tax laws, including working to obtain needed information that is in the hands of other countries. Second, we will not interfere in the internal tax policy decisions of other countries. These principles led me to conclude that the United States should attempt to refocus the OECD initiative on its core element: the need for countries to be able to obtain specific information from other countries upon request in order to prevent noncompliance with their tax laws.
>
> I am happy to report that, together with other OECD member countries, we have made substantial progress in focusing the initiative on its core element of effective information exchange and in addressing aspects of the initiative that seemed unfair to non-OECD countries. … I would like to summarize three significant modifications to the OECD tax haven work, each of which I will describe in greater detail below. First, coordinated defensive measures would not apply to "uncooperative" tax haven jurisdictions any earlier than they would apply to similarly-situated OECD member countries. Second, the "no substantial

> activities" criterion will no longer be applied to determine whether or not a jurisdiction is considered to be an "uncooperative" jurisdiction. Third, the time for tax haven jurisdictions to make a commitment to transparency and information exchange has been extended from July 31st to November 30th.
>
> *The United States argued for each of these modifications within the OECD, and strongly supports them.*

Testimony of Sec. O'Neil, emphasis added

Sec. O'Neill clearly believes his concerns have been addressed and shows strong support for the OECD's provisions as modified. And, none of the modifications changed the OECD's 1998 criteria, incorporated in the proposed model, which are used to identify tax havens. Modifications to the date by which coordinated defensive measures will be taken against uncooperative tax havens (Sec. O'Neill's first point) and to the deadline for tax havens to make transparency commitments (Sec. O'Neill's third point) had no impact whatsoever on the OECD's 1998 criteria for identifying tax havens. Sec. O'Neill's second point merely eliminates a criterion for distinguishing between cooperative and non-cooperative tax havens, but does not eliminate or change any of the criteria established in 1998 for determining whether the jurisdiction is a tax haven in the first place. In the opinion of the Hearing Officer, the testimony presented by Sec. O'Neill, if anything, is strongly supportive of the OECD provisions as they now stand and are reflected in the proposed model.

(b) Subpart F Income

Under the proposed model, controlled foreign corporations (CFCs) are to be included in the water's edge election to the extent of their subpart F income. One Commenter suggested the section could be read to wholly include a CFC "if it earns even one dollar of Subpart F income." (MW&E p. 8-9) The Hearing Officer agrees and recommends the model language be amended as follows:

> [Members of the combined report under a water's edge election include] any member of a "controlled foreign corporation," as defined in [IRC] Section 957, to the extent <u>of </u>the income of that member <u>that</u> is defined in [Subpart F]….

Section 5.A.v.

The same commenter suggests a need for "an explicit acknowledgment in either [the Subpart F] section or the dividend elimination provision that the same item of Subpart F income will not be included in the income of multiple entities in a tiered CFC structure." (MW&E p. 9) The Hearing Officer believes such a clarification is unnecessary. If the CFC is non-unitary or otherwise excluded from the combined group, its Sub F income will not be included as such in the combined report, so dividends paid out of any of that CFC's income (including Sub F income) to any member of the combined group should be included as income of that member and should not be eliminated. On the other hand, if the CFC is unitary and included in the combined report, dividend elimination would clearly be required under Section 3.C.ii (d).

The commenter also suggests the "high tax" exception to the Sub F rule be clarified to indicate "whether it is possible for a taxpayer to treat income as Sub F income for federal purposes yet seek to take advantage of the high tax exception for state purposes." (MW&E p. 9) The Hearing Officer believes that an amendment clarifying high tax Sub F income is never included in a combined report would be sufficient to address this question. As long as the model excludes high tax income from the combined report, then even if the taxpayer elects not to exercise the high tax provision for federal purposes, the income will still be excluded from the combined report for state purposes. The Hearing Officer recommends the following amendment to Section 5.A.v. (water's edge election):

> [A]ny item of income received by a controlled foreign corporation ~~may~~ shall be excluded if ~~the taxpayer establishes to the satisfaction of the Director that~~ 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 [IRC] Section 11;

Section 5.A.v.

Clarification of this issue for purposes of a world-wide combined filing may be accomplished through regulation.

(c) Members Earning 20% of Income from Activities Deductible by Another Member

The proposed model would include in the water's edge combined report "any member that earns more than 20 percent of its income, directly or indirectly, from activities that are deductible against the business income of the other members of the combined group, to the extent of that income and the apportionment factors related thereto…" (Section 5.A.vi.) The purpose of this proposal is to address the potential for income shifting through intangible holding companies which would otherwise be excluded from the combined report under a water's edge election. One commenter expressed a concern that the provision is potentially over-broad. As an example, the commenter pointed out that a foreign parent manufacturer selling to a related party U.S. distributor could potentially see most of its income included in the water's edge group under this provision. (MW&E p. 9; COST oral comments) Another commenter sited this provision as overly burdensome because it would impose an "annual requirement to assess whether any foreign affiliate [meets the criteria]. (SAB p. 2)

In the opinion of the Hearing Officer, the breadth of this provision could be reduced without significantly jeopardizing its effectiveness as follows:

> any 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 business income of other members of the combined group, to the extent of that income and the apportionment factors related thereto;

Section 5.A.vi.

(d) Initiation and Withdrawal of Election

The availability of any election can have revenue implications as taxpayers would reasonably choose the methodology that produces the lower tax in each case. The model statute minimizes the potential for this type of impact by making the water's-edge election more of a long-term consideration. Under the proposal, the election is binding for all future tax years, and may be withdrawn or reinstituted after withdrawal only in restricted circumstances. One commenter voiced a concern that these circumstances are too restricted and recommended an election withdrawal option after a fixed period. (COST oral comments). In the interest of compromise, the Hearing Officer believes there would be no problem with a 10 year rolling option. A non-rolling option that defaults to the existing election, unless changed, for another 10 year period could also be acceptable. The Hearing Officer recommends the following amendment:

> 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 reinstituted 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, a taxpayer 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 shall be in place for an additional 10 year period, subject to the same conditions as applied to the original election.

Section 5.B.iv.

One commenter voiced a concern that the circumstances under which the Director may disregard the election are too broad. (See MW&E p. 10) The Hearing Officer agrees that the circumstances could be more fully described, but believes this would be more appropriately accomplished through regulation. The same commenter suggested that if the election is disregarded in part, in no circumstances should the Director's disregard of the election result in the payment of more tax than would have been paid on a world-wide combined basis. (MW&E p. 10-11) The Hearing Officer disagrees. It is possible that in any one year a world-wide combination would produce a significantly lower tax liability than a water's edge election. If a water's edge election is disregarded in part because, for example, the taxpayer has availed itself of an abusive tax shelter, the result should not be an even lower tax (through world wide combination) than would have otherwise resulted had the taxpayer not used the abusive tax shelter.

B. Method of Combination

1. Group Members as Individual Taxpayers vs. the Combined Group as a Single Taxpayer

As mentioned above, the combined report required under the proposed model statute does not disregard the separate identities of the taxpayer members of the combined group. The model is quite consistent in its treatment of the combined group as a set of individual entities rather than a single taxpayer: business income subject to apportionment is calculated as the sum of all members' individually determined net business income or loss; as a general rule, deductions and credits are taken only by the specific taxpayers that earned them; and, the amount of total combined business income apportioned to a state is calculated as a function of each taxpayer's own factors in that state (the *Joyce* method), as opposed to the factors for the entire group as a whole in that state (the *Finnigan* method).

An exception to this general rule is that charitable contribution deductions are allowed to be taken first against the group business income, and any remainder is then allocable to the specific taxpayer that earned the deduction. One commenter cited to this exception, plus a "sales factor throwback [recommendation] to be applied on the basis of *Finnigan,"* and the fact that "a taxpayer's share of business income apportionable to the state is calculated by reference to all business income of the individual members in combination," as indication that there is an "MTC preference in each discrete instance of drafting for the approach – "taxpayer" defined as the discrete entity/member of a unitary group v. "taxpayer" defined as the combined unitary group – that is likely to generate the greatest tax liability for the taxpayer." (SAB p. 6; also COST oral comments)

The Hearing Officer would disagree with the characterization of a throwback rule as a *Finnigan* style attribute. However, this point is irrelevant as the model statute takes no position on throwback.

The Hearing Officer would agree that a taxpayer's share of business income apportionable to the state is calculated by reference to all [net] business income of the individual members in combination. However, such combination is not the equivalent of treating the entire combined unitary group as a *single taxpayer*. It is simply the recognition of the entire combined unitary group as a *single business*. The proposed model then utilizes the combined report as a worksheet for properly apportioning the total income from that *single business* across the *individual taxpayer* members that are engaged in that single business.

So in fact, the only true exception to the general rule cited by the commenter is the charitable contribution deduction. Under the proposed statute, a charitable deduction is allowed to be taken first against the business income of the combined group (subject to federal income limitations as applied to the entire business income of the group), and any remaining amount may then be treated as a nonbusiness expense allocable to the member that incurred the expense (subject to the federal income limitations applied to the nonbusiness income of that taxpayer member).

The Hearing Officer agrees that consistency in whether each individual group member or the group as a whole is considered the taxpayer is a rationale goal. Although the proposed model is not perfectly consistent in its treatment of group members as individual taxpayers, the exceptions to the general rule are limited and reasonable. For example, perfect consistency would require us to abandon the model's treatment of the charitable deduction, which would result in "trapping" of these particular incentives at the parent level from which these contributions are often made. (One industry commenter specifically noted appreciation for the model's handling of charitable deductions [COST, oral comments]). An alternative model could be developed which perfectly consistently treats the entire group as a single taxpayer. Such a model would allow credits and deductions earned by any one entity to be usable by the entire group. In addition, under this "single taxpayer" model the state apportionment factor numerators would reflect the property, payroll and sales of the entire group as a single taxpayer, not just those entities considered to have nexus when viewed as if each were an individual taxpayer.

In the opinion of the Hearing Officer, the proposed model's approach of generally treating each member as an individual taxpayer, with a small number of exceptions where necessary and reasonable, is a sensible approach. The model's deviation from this approach in the case of charitable deductions in particular is an example of a limited, reasonable allowance and should be appreciated by taxpayer groups. Therefore, the Hearing Officer does not recommend a change to the model on this point. Additional comments on the treatment of apportionment factor numerators, credits and losses are discussed below.

(a) Apportionment Factor Numerators

As noted above, the proposed model follows the *Joyce* approach and determines apportionment factor numerators for each taxpayer member on an individual taxpayer basis. This approach is consistent with the MTC's Policy Statement on Information Concerning Practices of Multistate Tax Commission and Signatory States under Public Law 86-272, which was originally adopted in 1986. The policy choice was also recently reaffirmed by a small work group assigned to review the issue by the Income & Franchise Tax Subcommittee. No commenters objected to the model's use of the *Joyce* approach for determining the apportionment factor numerators. One commenter remarked that it "agree[s] wholeheartedly with the Model's use of a *Joyce* approach to determining the proper apportionment of the combined tax base on a taxpayer-by-taxpayer basis." (MW&E p. 7)

(b) Credits

As noted above, the proposed model also requires tax credits be allowed only on an individual taxpayer basis (unless the credit statute explicitly directs otherwise). Two commenters took the position that credits "should be applied to offset the income of the combined group." (MW&E p. 6; also COST oral comments) However, credits do not "offset *income*," they offset *tax liability*. If the proposed model were to treat the entire group as a single taxpayer with a single tax liability, then it might make some sense for credits to be applied against that single tax liability. But in a model such as the proposal before the Committee which treats each group member as an individual taxpayer with an individual tax liability, there is simply no rationale, absent statutory direction, for allowing a tax credit earned by one taxpayer member to offset the separate tax liabilities of other taxpayer members.

In addition, it is not at all clear to the Hearing Officer how credits could reasonably by apportioned and tracked from year to year if the commenters' position were adopted. For each credit earned by an individual taxpayer, a determination would need to be made as to whether the credit arose from an investment that was unitary business related and apportionable, or non-business related and not apportionable, or some of each. Taxpayers would need to separately track their use of credits and prioritize which credits were being applied first, in order to know whether a particular carryover credit were unitary business related and (possibly) available for use by the entire business in the second year, or not unitary business related and available for use only by that taxpayer in the second year. Some of both types of credit might carryover. Characterizing, apportioning and tracking the usage of different types of credits by multiple members of a unitary group, especially if the group members are changing from year to year, would certainly require a much more complex administration than that required under the approach recommended by the model.

For the above reasons, the Hearing Officer does not recommend a change to the proposed model on this point.

(c) Losses

As noted above, the proposed model also restricts net operating loss carryover deductions to the individual taxpayers that originally earned them. Two commenters believe this aspect of the proposed model is "inconsistent with the combined reporting concept. … If a group of corporations are required to combine their income in order to produce an accurate reflection of the income attributable to any one state, then the same logic ought to extend to the losses generated by that same group of corporations." (MW&E p. 6; COST oral comments) One commenter explained that "[i]f income is computed on a combined basis, it is logical that losses (and carryforwards) must also be computed and applied in a similar fashion."

In the opinion of the Hearing Officer, this position is only partly correct. The Hearing Officer agrees with the commenters that a net loss, like net income, is subject to apportionment among the members of the combined group. However, once apportioned, the net loss has been identified as attributable to a particular taxpayer member. It may be used to offset other types of income of that member - *e.g.*, the taxpayer's allocated non-business income, or business income arising from a different combined group. There is no rationale for allowing any remaining amounts of loss attributed to a particular taxpayer member to be *re-apportioned* among the entire group in the following year. Rather, the loss, once apportioned, should remain associated with the factors by which, and the individual taxpayer to which it was attributed in the year it was created. In addition, continued re-apportionment of NOL carryforwards would entail the same potentially significant administrative difficulties discussed with respect to apportionment of tax credits, above. Thus, the Hearing Officer does not recommend any changes to the model based on this point.

2. Deferred Intercompany transactions

The model provides that restorations of deferred company income resulting from an intercompany transaction between members of a combined group shall be apportioned as business income. One commenter suggested that a specific determination should be made in each case as to whether the restoration should be treated as business or non-business income. In the opinion of the Hearing Officer, this is not necessary because only business income should be deferred in the first instance, so all restorations should be restorations of business income. To ensure that that is the case, the Hearing Officer recommends the following amendment:

> Except as otherwise provided by regulation, <u>business</u> income from an intercompany transaction between members of the same combined group shall be deferred in a manner similar to 26 CRF 1.1502-13. Upon the occurrence of any of the following events, deferred <u>business</u> income resulting from an intercompany transaction between members of a combined group shall be restored to the income of the seller, and shall be apportioned as business income earned immediately before the event: …

Section 3.C.ii(e)

3. Elimination of Dividends

The proposed model provides that:

> All dividends paid by one to another of the members of the combined group shall, 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, be eliminated from the income of the recipient. This provision shall not apply to dividends received from members of the unitary business which are not a part of the combined group.

One commenter suggested amendments to this language to clarify the proper treatment of dividends paid by one to another member of the combined group out of pre-acquisition (or pre-unity) earnings and profits, and whether earnings and profits are determined for the purpose this provision on a separate return basis or on a "recomputed" basis as a share of combined business income. In the opinion of the Hearing Officer, this statutory language correctly states the intended rule in general terms. It is acknowledged that additional guidance would be helpful on these (and other) points, and the Hearing Officer recommends the appropriate method for providing such guidance would be through regulations.

4. Compliance Burdens

One commenter expressed a concern for "compliance burdens" generated by the proposed model statute. (SAB p. 2) However, most of these concerns are simply related to the need for a taxpayer to calibrate foreign affiliates income with the income that would be recognized under state law. This is necessary if the taxpayer does not make the water's edge election. And in some cases, may be necessary under the water's edge election. Additional guidance may be provided by regulation to minimize any burdens. Other examples of potential burden given by the commenter have been addressed above.

C. Implications of Adopting the Model Combined Reporting Statute

One commenter suggested that if a state adopts the proposed model combined reporting statute, it may repeal any throwback, throwout or add-back provisions. (MW&E p. 3) In the opinion of the Hearing Officer, this is incorrect with respect to throwback or throwout provisions, and is not necessarily the case with respect to add-back provisions. The purpose for the throwback rule is to avoid no-where income, and avoid discrimination against wholly instate businesses that can't cause nowhere income to "fall between the cracks." The policy of throwback is just as important and necessary to that objective in a combined reporting setting than in a single entity setting. Add-backs may still be appropriate for taxpayers that elect water's edge and create foreign intangible holding companies or for insurance companies if combination isn't available. That said, the Hearing Officer would note that these issues are beyond the scope of recommendations for changes to the model combined reporting statute.

Respectfully Submitted,

____
Shirley K. Sicilian

Hearing Officer

Exhibit A McDermott, Will & Emery (MW&E) – Kimberley Reeder and Margaret Wilson

Exhibit B Southerland, Asbill & Brennan (SAB) – Kendall L. Houghton and Jeffrey A. Friedman

Exhibit C Council On State Taxation, American Council of Life Insurers, American Insurance Association and the Property Casualty Insurers Association of America (Insurance Group)

Exhibit D United Services Automobile Association (USAA) – Amy Cannefax

Exhibit E Heller Ehrman (HE) – Roy E. Crawford

Exhibit F Organization for International Investment (OFII)

Exhibit G Model Statute with Hearing Officer's Proposed Changes