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June 9, 2020

Bruce Fort
Sr. Counsel
Multistate Tax Commission
Hearing Officer

Via E-Mail

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

Dear Hearing Officer Fort;

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

The Proposed Model Should Include Consolidated Election Language

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

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

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

> The use of "consolidated" or "affiliated group" (as those terms are described below) filing elections is a well-accepted state tax policy tool that appears to provide significant benefits for taxpayers and administrators. States must still provide detailed guidance on a number of policy and tax accounting issues for taxpayers electing those filing options. In addition, based on the limited information available, these elections do not appear to facilitate additional income-shifting activity in states requiring water's-edge unitary combined filing.
> One can assume some overall revenue reduction whenever an election is offered, since taxpayers will likely elect whatever methodology results in their lowest predicted tax liability. State administrators and auditors, however, have not reported significant differences in tax liability attributable to the election to file as a consolidated or affiliated group in lieu of unitary combined filing.

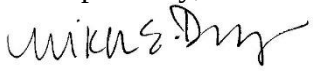
The White Paper went on to support this well-reasoned finding, which was in accord with COST's position. Considering the finding in the White Pater, COST would again suggest that the proposed consolidation election language as provided in Section 4 of Exhibit A be added to the proposed draft model.

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

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

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

Respectfully,



Nikki E. Dobay

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

Exhibit A

Multistate Tax Commission

Proposed Draft Model Statute for Combined Reporting

As of August 21, 2019

Section 1. Definitions.

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

A. "Taxpayer" means a person subject to the tax imposed by [state corporate income tax act]. [DRAFTER'S NOTE: The tax imposition sections of the state code should be clear that tax is imposed on corporations as part of a group.]

B. "Corporation" means a corporation as defined by the laws of this state, or organization of any kind treated as a corporation for tax purposes under the laws of this state, wherever located, which if it were doing business in this state would be a "taxpayer." The business conducted by a partnership that is directly or indirectly held by a corporation is the business of the corporation to the extent of the corporation's distributive share of the partnership income, inclusive of guaranteed payments to the extent prescribed by regulation.

C. "Partnership" means a general or limited partnership, or organization of any kind treated as a partnership for tax purposes under the laws of this state.

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

E. "Unitary business" means 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. [Drafter's note: This portion of the definition is drafted to follow MTC Reg. IV.1.(b)., defining a "unitary business." A state that does not wish to define unitary business in this manner should consider alternative language. In addition, this MTC Regulation defining unitary business includes a requirement of common ownership or control. A state which treats ownership or control requirements separately from the unitary business requirement will need to make additional amendments to the statutory language.] Business conducted by a partnership is treated as conducted by its partners, whether directly held or indirectly held through a series of partnerships, to the extent of the partner's distributive share of the partnership's income, regardless of the percentage of the partner's ownership interest or the percentage of its distributive or any other share of partnership income.

A business conducted directly or indirectly by one corporation is unitary with that portion of a business conducted by another corporation through its direct or indirect interest in a partnership if the conditions of the first sentence of this section 1.F. are satisfied, to wit: there is a synergy, and exchange and flow of value between the two parts of the business and the two corporations are members of the same commonly controlled group.

F. "Combined group" means the group of all persons that must file a combined return as required by Section 2.A. or 2.B, including a group properly making an election under Section 4.

G. "Combined return" means a tax return for the combined group containing information as provided in [this Act] or required by the [Director].

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Exhibit A

~~G.~~H. "Consolidated group" means the group of entities properly filing a federal consolidated return under the Internal Revenue Code for the taxable year.

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~~H.~~I. "United States" means the 50 states of the United States, the District of Columbia, and United States' territories and possessions.

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

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

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

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

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

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

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

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

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

In addition, if the [Director] determines that the reported income or loss of a taxpayer engaged in a unitary business with a person not included pursuant to Section 2.A. represents an avoidance or evasion of tax by such taxpayer, the [Director] may, on a case by case basis, require all or part of the income and associated apportionment factors of such person be included in the taxpayer's combined return.

With respect to inclusion of associated apportionment factors pursuant to this Section 2.B., the [Director] may

require the exclusion of one or more of the factors, the inclusion of one or more additional factors that will fairly represent the taxpayer's business activity in this State, or the employment of any other method to effectuate a proper reflection of the total amount of income subject to apportionment and an equitable allocation and apportionment of the taxpayer's income.

Section 3. Determination of taxable income or loss for a combined group.

A. Components of income subject to tax in this state; application of tax credits and post-apportionment deductions.

i. The combined group shall calculate and pay tax based on the combined group taxable income or loss apportioned or allocated to this state, which includes:

(a) apportionable income apportioned to this State, determined under this Section 3.

(b) income sourced to this state from the sale or exchange of capital assets and from involuntary conversions, as determined under Section 3.C.ii.(g), below;

(c) nonapportionable income or loss allocable to this State, determined under [cite to State allocation and apportionment provisions];

(d) income or loss allocated or apportioned in an earlier year, required to be taken into account as state source income during the income year, other than a net operating loss, and

(e) a deduction for the group net operating loss carryover or carryback subject to the provisions of Section 3.A.iii. and limits imposed by [cite to other NOL limitation provisions].

ii. If the use of a tax credit or post-apportionment deduction provided in any other section of [this act] is limited to the [state] tax or [state] income attributed to a separate corporation, then, if the corporation files as part of a combined group, the limit imposed on the use of the credit or post-apportionment deduction is equal to the corporation's share of the combined group's [state] tax or [state] income calculated following the general provisions of Subsection A.i. above and regulations of the Director adopted for this purpose. The corporation's separate-entity apportionment percentage for this purpose is calculated as follows:

(a) the corporation's apportionment percentage determined under [cite apportionment provisions], including in the [property, payroll and receipts factor] numerators the corporation's separate [property, payroll and receipts, respectively] associated with the combined group's unitary business in this state, and including in the denominator the [property, payroll and receipts] of all members of the combined group, which property, payroll and receipts are associated with the combined group's unitary business wherever located; and

(b) the [property, payroll, and receipts] of a partnership is included in the determination of the partner's apportionment percentage in proportion to a ratio the numerator of which is the amount of the partner's distributive share of the partnership's unitary income included in the income of the combined group in accordance with Section 3.C.ii.(c). and the denominator of which is the amount of the partnership's total unitary income.

iii. The combined group may take a net operating loss deduction against income allocated or apportioned to this state in a tax year under this Subsection 3 to offset such income, in whole or in part, to the extent the group has an available net operating loss carryover in that year.

(A) (a) The combined group available net operating loss carryover in any tax year is:

(1) The total net operating losses of the combined group allocated or apportioned to the state in past

years to the extent such losses have not been used to offset income of the group or are not otherwise limited by state law; plus

(2) The net operating losses of a member of the group created before that member became a part of the group, but only to the extent such losses:

(I) would not be subject to limitations applicable to those losses under any provision of the Internal Revenue Code or applicable federal regulations if the member were joining a federal consolidated filing group;

(II) were properly allocated or apportioned to this state in the year created;

(III) were properly attributed to the member under Paragraph (1) if the member was part of a separate combined group when the losses were created;

(IV) have not been used to offset income of any taxpayer; and

(V) are not otherwise limited by state law; minus

(3) The net operating losses of a member of the combined group attributed to that member under Paragraph (1) or brought into the group under Subparagraph (b) above that have not been used to offset income and are not otherwise limited by state law, as of the date that member is no longer part of the combined group.

(b) For purposes of applying the provision of this Section 3.A.iii. the combined group must attribute losses apportioned or allocated to this state in any tax year to the members of the group as follows:

(1)**(I)** To each member of the group that had a loss under Subsections A(1) or (2), the portion of the group loss determined by multiplying that loss by a fraction, the numerator of which is the member's loss, and the denominator of which is the total loss of all the members that had losses; plus

(2)**(II)** To each member of the group that had a nonapportionable loss allocated to this state, but only to the extent that such loss contributed to the total combined group loss reported to the state in that year.

(3)**(III)** Losses attributed to combined group members are deemed to have been used to offset income through the deduction allowed in Section A.(i)(e) by applying a pro-rata reduction to the losses of all combined group members in each year, starting with the earliest year. In no case shall members be attributed total losses under this Paragraph (1) in excess of the loss reported to this state by the combined group in the tax year.

B. Determination of State share of apportionable income of combined group.

i. The State share of apportionable income of the combined group included in the combined group income required to be reported to this state under Section 3.A.i.(a) is the product of:

(a) the apportionable income of the combined group, determined under Section 3.A.i.(a), and

(b) an apportionment percentage determined pursuant to [cite state allocation and apportionment rules], including [property, payroll, and receipts] of the combined group sourced to this state pursuant to [cite state allocation and apportionment rules] and associated with the combined group's unitary business in this state in the numerator, and including [property, payroll, and receipts] of the combined group wherever located and associated with the combined group's unitary business in the denominator.

ii. In calculating the apportionment percentage in Section 3.B.i.(a), [property, payroll, and receipts] of a partnership are included in the determination in proportion to a ratio the numerator of which is the amount of the distributive share of the partnership's apportionable income included in the income of the combined group in

accordance with Section 3.C. and the denominator of which is the amount of the partnership's total apportionable income.

C. Determination of the apportionable income of the combined group.

The apportionable income of a combined group is determined as follows:

i. From the total income of the combined group, determined under Section 3.C.ii., subtract income, and add expense or loss, other than the apportionable income, expense or loss of the combined group.

ii. Except as otherwise provided, the total income of the combined group is the sum of the income of each member of the combined group determined under federal income tax laws, as adjusted for state purposes, as if the member were not consolidated for federal purposes. The income of each member of the combined group is determined as follows:

(a) For any member incorporated in the United States, or included in a consolidated federal corporate income tax return, the income to be included in the total income of the combined group is the taxable income for the corporation after making appropriate adjustments under [state tax code provisions for adjustments to taxable income].

(b) (1) For any member not included in Section 3.C.ii.(a), the income to be included in the total income of the combined group is determined as follows:

(A) A profit and loss statement shall be prepared for each foreign branch or corporation in the currency in which the books of account of the branch or corporation are regularly maintained.

(B) The profit and loss statement must be adjusted to conform it to the accounting principles generally accepted in the United States for the preparation of such statements except as modified by this regulation.

(C) The profit and loss statement must be adjusted to conform it to the tax accounting standards required by the [state tax code]

(D) Except as otherwise provided by regulation, the profit and loss statement of each member of the combined group, and the apportionment factors related thereto, whether United States or foreign, must be translated into the currency in which the parent company maintains its books and records.

(E) Income apportioned to this state must be expressed in United States dollars.

(2) In lieu of the procedures set forth in Section 3.C.ii.(b)(1), above, and subject to the determination of the Director that it reasonably approximates income as determined under [the State tax code], the combined group may determine the income for any member not included in Section 3.C.ii.(a) on the basis of the consolidated profit and loss statement which includes the member and which is prepared for filing with the Securities and Exchange Commission by related corporations. If the member is not required to file with the Securities and Exchange Commission, the Director may allow the use of the consolidated profit and loss statement prepared for reporting to shareholders and subject to review by an independent auditor. If above statements do not reasonably approximate income as determined under [the State tax code] the Director may accept those statements with appropriate adjustments to approximate that income.

(c) If a unitary business includes income from a partnership, the income to be included in the total income of the combined group is the direct and indirect distributive share of the partnership's unitary business income allocated to any member of the combined group.

(d) All dividends paid by one to another of the members of the combined group are excluded 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. This provision does not apply to dividends received from members of the unitary business which are not a part of the combined group.

(e) Except as otherwise provided by regulation, apportionable income from an intercompany transaction between members of the same combined group is deferred in a manner similar to 26 CFR 1.1502-13. Upon the occurrence of any of the following events, deferred apportionable income resulting from an intercompany transaction between members of a combined group is restored to the income of the seller, and shall be apportioned as if earned immediately before the event:

(1) the object of a deferred intercompany transaction is

(A) re-sold by the buyer to an entity that is not a member of the combined group,

(B) re-sold by the buyer to an entity that is a member of the combined group for use outside the unitary business in which the buyer and seller are engaged, or

(C) converted by the buyer to a use outside the unitary business in which the buyer and seller are engaged, or

(2) the buyer and seller are no longer members of the same combined group, regardless of whether the members remain part of the unitary business.

(f) A charitable expense incurred by a member of a combined group, to the extent allowable as a deduction pursuant to Internal Revenue Code Section 170, is subtracted first from the apportionable income of the combined group (subject to the income limitations of that section applied to the entire apportionable income of the group), and any remaining amount is then treated as a nonapportionable expense allocable to the member that incurred the expense (subject to the income limitations of that section applied to the nonapportionable income of that specific member). A portion of a charitable deduction disallowed under the foregoing rule, but allowed as a carryover deduction in a subsequent year, is treated as originally incurred in the subsequent year by the same member, and the rules of this section apply in the subsequent year in determining the allowable deduction in that year.

(g) Gain or loss from the sale or exchange of capital assets, property described by Internal Revenue Code Section 1231(a)(3), and property subject to an involuntary conversion, is removed from the total separate net income of each member of a combined group and is apportioned and allocated as follows:

(1) For each class of gain or loss (short term capital, long term capital, Internal Revenue Code Section 1231, and involuntary conversions) all members' apportionable gain and loss for the class is combined (without netting between such classes), and each class of net apportionable gain or loss separately apportioned by each member using the member's separate-entity apportionment percentage determined under Section 3.A.ii, above.

(2) Each member then nets its apportioned gain or loss for all classes, including apportioned gain and loss from other combined groups, against the member's nonapportionable gain and loss for all classes allocated to this State, using the rules of Internal Revenue Code Sections 1231 and 1222, without regard to any of the member's gains or losses from the sale or exchange of capital assets, Section 1231 property, and involuntary conversions which are nonapportionable items allocated to another state.

(3) Resulting state source income (or loss, if the loss is not subject to the limitations of Internal Revenue Code Section 1211) of a member produced by the application of the preceding subsections is then applied to all other state source income or loss of that member.

(4) Resulting state source loss of a member that is subject to the limitations of Section 1211 is carried forward [or carried back] by that member, and shall be treated as state source short-term capital loss incurred by that member for the year for which the carryover [or carryback] applies.

(h) Expense of one member of the combined group which is directly or indirectly attributable to the nonapportionable or exempt income of another member of the combined group shall be allocated to that other member as corresponding nonapportionable or exempt expense, as appropriate.

Section 4. E~~Water's-edge e~~lections; initiation and withdrawal.

A. Water's-edge election.

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

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

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

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

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

v. for a member that is a "controlled foreign corporation," as defined in Internal Revenue Code Section 957, include income to the extent of the income of that member that is defined in Section 952 of Subpart F of the Internal Revenue Code ("Subpart F income") not excluding lower-tier subsidiaries' distributions of such income which were previously taxed, determined without regard to federal treaties, and the apportionment factors related to that income; any item of income received by a controlled foreign corporation is excluded if such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in Internal Revenue Code Section 11;

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

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

B. Consolidated group election.

Exhibit A

A taxpayer may make an election to file a combined group return on a consolidated group basis. Under such election, the combined group takes into account all or a portion of the income and apportionment factors of all of the members of the taxpayer's consolidated group for federal purposes. Where a taxpayer makes a such an election, the term "combined group" used throughout this provision shall refer to the taxpayer's consolidated group.

C. Initiation and withdrawal of elections

i. An election under Section 4 ~~water's-edge election~~ is effective only if made on a timely-filed, original return for a tax year by the members of the unitary business for purposes of water's edge election or the members of the taxpayer's consolidated group for purposes of a consolidated group election. The Director shall develop rules and regulations governing the impact, if any, on the scope or application of ~~a water's-edge~~these elections, including the procedures for election and termination or deemed election, resulting from a change in the composition of the unitary group, the combined group, the members of the taxpayer's consolidated group, and any other similar change.

ii. Such elections constitute~~s~~ consent to the reasonable production of documents and taking of depositions in accordance with [state statute on discovery].

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

iv. An election under Section 4 ~~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, the members of a combined group may withdraw from the water's edge election and the members of the taxpayer's federal consolidated group may withdraw from a consolidated 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~~ an ~~water's edge~~ election will be in place for an additional 10 year period, subject to the same conditions as applied to the original election.

Commented [ND1]: Should this be "unitary" instead of combined? Seems like that is what is used above.