MULTISTATE TAX COMMISSION

Supplemental Report of the Hearing Officer Regarding the proposed Model Statute for Combined Reporting

June 3, 2005
[Amended June 21, 2005]

I. Introduction and Summary

This report is a supplement to the April 25, 2005 Hearing Officer's Report, which was presented to the Executive Committee at its April 27, 2005 meeting in Washington, D.C. At that meeting, the Executive Committee determined that before taking action on the proposed model uniform combined reporting statute and the Hearing Officer's proposed changes, it would like to receive comments from the Uniformity Committee, and additional comments from taxpayer representatives and MTC member states. In order to receive those comments, a teleconference meeting of the Uniformity Committee was held on May 13, 2005. This Supplemental Report provides a review of the comments made at that meeting. Six members of the public spoke during the public comment period to address issues regarding insurance companies, companies doing business in tax havens, and allowance of tax credits. Uniformity Committee members also commented on these issues. The Uniformity Committee as a whole concluded it concurs with the changes proposed by the Hearing Officer in the April 25 Report. The Hearing Officer recommends no additional changes.

II. Public Comments

A. Taxpayer Representative Comments

1. Potential for Inclusion of Insurance Companies in the Combined Group.

Diann Smith, Council on State Taxation (COST), spoke on behalf of American Council of Life Insurers, American Insurance Association and the Property Casualty Insurers Association of America (the Insurance Group). She reiterated the Insurance Group's concern that inclusion of insurance companies in a combined group with

corporate income taxpayers would raise a host of technical problems with respect to the determination of the income base, apportionment factor consistency and other issues. This concern was also expressed by Jim Hall (ACLI). (*See Also* Insurance Group written comments filed March 28, 2005, pp. 11-16). In addition, Ms. Smith and Mr. Hall commented that most insurance companies do not purposely engage in transactions intended to distort the apportionment of income, and thus combination could be limited to a case-by-case requirement in situations of abusive tax avoidance or evasion, such as those that have occurred with captive insurance companies. Both Ms. Smith and Mr. Robert Monteleon (Prudential) suggested that because most states have two separate taxing regimes for insurance companies and corporations subject to the income tax, at some point, there should be a dialog between departments of revenue and departments of insurance regarding the proposal.

In the opinion of the Hearing Officer, it is well accepted that inclusion in the combined group of unitary entities that are not corporate income taxpayers will raise technical questions. It is because of these questions that the proposed model statute does not require combination of these unitary entities outright. Instead, the statute allows for combination to be required by regulation, after technical matters have been carefully considered and addressed. Of course, if technical matters cannot be resolved, combination can not and will not be required, regardless of the allowance provided by statute. (This issue was also addressed in the Hearing Officer's Report of April 25. *See* pp. 8-10.) Therefore, the Hearing Officer does not recommend amendment to the proposal on this point.

Nor does the Hearing Officer recommend limiting combination to cases of evasion or abuse. Combination of insurance companies, like combination of any other taxpayers, is not merely a means for addressing tax evasion and abusive income shifting; it is, more fundamentally, the most efficient and theoretically sound method for identifying and apportioning the income of a single, unitary business – regardless of whether there is distortion, evasion or abuse. Ideally, combination of all unitary entities would be employed wherever possible. As drafted, the proposed model statute will allow for combination wherever technical issues can be addressed through regulation. The Hearing Officer believes this is a reasonable and preferable approach.

2. Inclusion of Companies Doing Business in Tax Havens in the Water's Edge Combined Group

Kendal Houghton, Southerland, Asbill & Brennan, cautioned that defining the "doing business" standard as a constitutional standard will be no easier to apply with respect to tax havens than with respect to states and that, because it is not uniformly interpreted among the states, it may lead to lack of uniformity. Ms. Houghton suggested the Commission use its factor presence nexus proposal to define "doing business."

Mr. Jeffrey Friedman, also with Southerland, Asbill & Brennan, stated his opinion that a combination rule which includes a corporation depending on whether or not the corporation does business in particular country is a violation of the foreign commerce

clause, and is not insulated by the fact that the rule results from an election that is at the taxpayer's option. Ms. Diann Smith, speaking on behalf of COST, recognized that there have been high-profile cases of abusive tax sheltering involving tax havens, but expressed agreement with Mr. Friedman. Ms. Smith noted the current proposal indicates a bias that corporations doing business in "tax haven" countries are doing something wrong and suggested that the bias should be removed.

The Hearing Officer appreciates Ms. Houghton's suggestion that the combined reporting proposal incorporate the Commission's factor presence nexus proposal for purposes of determining whether an entity is "doing business" in a tax haven. However, no state has yet adopted the Commission's factor presence nexus proposal. The Hearing Officer recommends that a state's standard be the same for determining whether an entity is doing business in the state or in a tax haven jurisdiction. Thus, the combined reporting model should retain the constitutional standard currently used by most states for determining nexus. While it is true that applying this standard to tax havens will be no easier than applying it to the state's own jurisdiction, by the same token it will be no more difficult either. Therefore, when and if a state moves to adopt the factor presence nexus standard, it should at the same time consider modifying its combined reporting rule with respect to doing business in tax havens. (*See also* Hearing Officer's Report of April 25, p. 14)

The question of whether the proposals retention of corporations doing business in tax havens in the water's edge election violates the foreign commerce clause was addressed in the original Hearing Officer's Report of April 25. (*See* Hearing Officer's Report of April 25, pp. 14-16). The Hearing Officer does not recommend additional changes to the proposal on this point.

3. Treatment of Credits and Net Operating Loss

Mr. Roy Crawford, of Heller Ehrman, commented that the proposal's limitation of a tax credit to the taxpayer that earned it (unless the credit statute specifically directs otherwise) should be modified. Mr. Crawford suggests that limiting tax credits to the liability of the taxpayer that earned the credit is a departure from the unitary concept, and that a credit should be apportioned across the entire unitary group where the activity that generated the credit is related to the unitary business and to apportionable income. Ms. Smith commented that COST received more comments on this issue than on any other and suggested that the default, instead of restricting the credit to the taxpayer member, should be application of the credit to the entire group. Ms. Smith also noted that this issue is being litigated in the *General Motors* case currently pending in the California Supreme Court and encouraged committee members to review the briefs filed in that case.

This issue was also addressed in the original Hearing Officer's Report of April 25. (*See* pp. 19-22, esp. pp. 20-21) In the opinion of the Hearing Officer, while combined reporting should reflect the principles of UDITPA and unitary theory, nothing in either UDITPA or unitary theory requires a credit earned by one taxpayer to be allowed against

the separate tax liabilities of the other taxpayer members of a combined group. UDITPA is a method for apportioning the income of a single, unitary business across the multiple taxpayers engaged in that business, so that the tax base of each of those members may be determined. Once that is accomplished, there is simply no basis for reaching past income apportionment to the "apportionment" of other tax provisions such as credits.

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. (And in such case it would also make sense that nexus for any part of that unitary business would provide nexus for the entire unitary business.) 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 "apportioned" and allowed to offset the separate tax liabilities of other taxpayer members. In fact, doing so could cause a credit to be apportioned to members of the combined group that are not income taxpayers in that state and thus portions of the credit earned in the state would be unavailable to offset state tax liability. The Hearing Officer does not recommend an amendment on this point.

4. Other

Ms. Smith, COST, expressed appreciation for certain changes recommended by the Hearing Officer in the original Report, such as the time limit on the election, and modifications to the treatment of U.S. affiliates.

B. Uniformity Committee Comments

Michael Brownell, California Franchise Tax Board, commented that the States are not all in agreement regarding combination of insurance companies. California has concerns with such combination, while other states are actively pursuing it. Mr. Brownell believes the proposal is a good compromise, and allows states to work out technical issues associated with combination of corporations that are not income taxpayers before requiring combination. Mr. Brownell also commented that the Franchise Tax Board would support the proposal's limitation of a tax credit to the individual taxpayer member that earned the credit. He noted that proposed treatment of credits does not conflict with the requirements or principles of either UDITPA or unitary theory in general. Mr. Brownell noted that the proposal's language regarding inclusion of entities doing business in tax havens has resolved most of the difficulties with which the Franchise Tax Board was originally concerned.

The Uniformity Committee as a whole then expressed concurrence with the Hearing Officer's recommendations as set forth in the original Hearing Officer's Report of April 25.[1]

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[1] Mr. Gene Walborn (MT) noted he concurred, but would like to discuss the proposal's treatment of insurance companies further with his Director.

III. Next Step – Executive Committee Consideration and Action

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. 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. 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.