



MULTISTATE TAX COMMISSION

To: Phil Skinner, Chair, Finnigan Combined Reporting Model Statute Working Group
From: Bruce Fort, Counsel, Multistate Tax Commission
Re: Analysis of Proposed “Finnigan Method” Combined Reporting Statute
Date: April 9, 2019

Some weeks ago, the Commission’s staff was asked to prepare an analysis of our most recent draft of the proposed Model Combined Reporting Statute Utilizing the Finnigan Methodology of Income Apportionment (the draft). The summary was requested so that the members of the Uniformity Committee would have a better understanding of some of the drafting and policy choices made by our Working Group. Below, we provide some background on the project and then provide a section-by-section analysis of the draft proposed model.

Background:

In 2006, the Commission adopted a Model Combined Reporting Statute (the 2006 Model) that was intended to be a “best practices” standard for separate-entity states contemplating moving to combined filing. The 2006 Model defines the unitary group to include all taxable corporations on a worldwide basis with an election for water’s-edge reporting. Both the default worldwide reporting provisions and the water’s edge provisions include several safeguards giving the tax administrator authority to vary the composition of the reporting group to combat inappropriate income-shifting and base erosion.

The 2006 Model also adopted the “Joyce” methodology of income apportionment, which provides that each corporate member of the reporting group will be treated as a separate taxable entity for income apportionment purposes. The decision of the Commission’s membership to utilize the Joyce methodology in the 2006 Model may be attributed to a desire to promote uniformity, as the Joyce methodology was at that time used by a substantial majority of the combined filing states.

The other recognized methodology for apportioning income is called the “Finnigan” method, which, broadly speaking, calls for calculating the apportionment factors of the members of the combined report as if they constituted a single taxable entity.

In the spring of 2018, the Commission’s Uniformity Committee received a request to develop an alternative model combined reporting statute based on the Finnigan method. The Uniformity Committee agreed to take up the proposal as a new uniformity project at its July 2018 in-person

meeting in Boston. A working group was formed shortly thereafter that has been meeting telephonically approximately twice month since that time.

The Differences Between Joyce and Finnigan, Explained:

The principal difference between the Joyce and Finnigan methodologies centers on calculation of the receipts (formerly “sales”) factor for the combined group. Under both the Joyce and the Finnigan methods, the denominator of the receipts factor includes all receipts of the combined group members. But under the Joyce method, the receipts factor numerator of each member is calculated on a stand-alone basis, disregarding the unitary relationship among other members of the combined group. Thus, the combined group’s numerator includes the receipts of only those entities with nexus in the taxing state whose activities exceed the protections of P.L. 86-272. Under the Finnigan method, the numerator of the combined group is calculated as though the members of the combined group are a single entity; thus, if one member of the combined group has nexus and activities that exceed P.L. 86-272 protections, the receipts factor numerator would include all receipts from all members of the combined report sourced to the state. The Finnigan method has the obvious virtue of using the same methodology for calculating both the numerator and denominator of the receipts factor for the combined group.¹

Although the Finnigan method is sometimes described as treating the entire combined filing group as a single taxpayer, it is important to note here that none of the states currently utilizing the Finnigan methodology completely disregards the separate legal status of the members of a combined report for all purposes. Utah may come closest to treating the combined reporting group as a single taxpayer, computing NOL’s on a combined basis and allowing the free sharing of tax credits, but it begins its calculations by using the pro-forma separate taxable income of each member of the combined return.

The Uniformity Landscape Facing the Working Group:

The working group discovered that there was little agreement among the thirteen states employing the Finnigan methodology in how the Finnigan choice was signaled or how the calculations should be made for apportioning income, nor was there substantial uniformity in how losses and credits were handled.² In a similar vein, the working group concluded that any state’s implementation of a combined reporting regime would require significant modifications to any model statute to incorporate existing state

¹ A secondary aspect of the Joyce/Finnigan dichotomy concerns the “throw-back” rule for calculating the receipts factor in Compact Art. IV.16.(b). Under the Joyce method, the receipts of a seller of TPP are more likely to be thrown back to the location of shipment, not destination, since the taxpayer may have structured itself to gain protection under P.L. 86-272. The impact of throw back makes it hard to predict the impact of the Joyce/Finnigan choice for a given taxpayer. But states are steadily moving away from utilizing throw back.

² The Finnigan states are Arizona, Connecticut, California, Kansas, Maine, Michigan, Montana, New York, North Carolina (where combination is required), Rhode Island, South Carolina (where required), Utah, and Wisconsin.

statutory systems, including definitional sections, and would require legislatures to consider a number of policy choices.

On the other hand, the working group concluded that for many states currently using the Joyce approach, a change to the Finnigan approach might be accomplished relatively easily if the only change in policy the state sought was correcting the imbalance between the calculation of the receipts factor numerator and denominator, as outlined above.

The Uniformity Committee's direction to the working group to develop a Finnigan combined reporting model did not include direction as to whether other aspects of the 2006 Model should be continued. As set forth above, that Model was intended to establish a series of best practices and incorporated a number of policy choices based on respecting the separate nature of each member of the combined group, so that as a matter of form as well as substance, income and liability for tax would be directly attributed to the taxpayers with nexus with the state (and not otherwise given immunity under P.L. 86-272.)

The working group accordingly did not consider itself bound to maintaining all of the 2006 Model that did not directly affect the change from Joyce to Finnigan, but the draft ultimately preserves the great majority of the 2006 Model's overall structure and all definitions. Some language in the 2006 Model was changed in the draft to correct some editing problems with the references to the Commission's unitary business definition. Additionally, the 2006 Model was updated to reflect the 2015 changes to Compact Article IV, including the substitution of "apportionable income" for "business income" and the change from "sales" to "receipts."

One policy choice embedded in the 2006 Model that the working group did address were the limitations on sharing of loss carryforwards, capital losses, credits and similar tax attributes that were arguably intended to reflect the Joyce conception of the nature of a combined return. Under that conception, that each member of the combined group stands apart except in the combination of apportionable income and the calculation of apportionment denominators. The working group accordingly asked the Uniformity Committee in November of 2018 to consider whether the new model should continue to reflect the "separateness" of the individual members of the group, or move towards the Utah approach that tended to treat the filing group as a unitary whole. Most of the Uniformity Committees members indicated that they wanted to the working group to work towards a model reflecting Utah's approach. So, the draft model does allow for some sharing of tax attributes among the members and does permit some sharing of loss carryforwards.

This approach is not inconsistent with how other Finnigan states treat the question of sharing tax attributes. Once again, neither the Finnigan nor the Joyce method actually deems the members of the combined group to be a single taxpayer for all purposes, and so it does not automatically follow that losses and attributes of the members of a combined group using the Finnigan approach need be shared. In fact, the working group discovered that both Joyce and Finnigan states have made these policy choices independently of the question of how to determine the receipts factor numerator.

The tax attributes sharing approach embodied in the draft is also consistent with the federal approach to net operating loss calculations. We have thus attempted to allow NOL sharing with some limitations intended to prevent abusive practices. While these policy decisions may lie outside the core assignment of converting the 2006 Model to a Finnigan approach, the working group felt it was necessary to address these issues in order to create a complete model that could be used by the states. But the working group did not intend that the draft should be read as an endorsement any particular policy.

Section by Section Analysis of Finnigan Method Draft:

Section 1: Definitions.

The definitional section of the current draft is closely similar to the definitional section of the 2006 Model, with a few minor changes. The definition of “unitary business” (Sec. 1.F) was amended to fix some editing and typographical errors in the original; no substantive changes were intended. The definition of “combined group” (Sec. 1G) was changed to reflect that the group can be considered as a single taxpayer under a state’s law, eliminating the reference to each taxpayer’s net business income or loss. A new definition of “combined report” (Sec. 1H) was added to reflect that a combined report is separate from the return filed by a taxpayer. This definition is written with the assumption that most states will continue to treat each taxable member of a combined group included on a report as a separate taxpayer.

Neither the 2006 Model nor the current draft define the term “net income.” The draft is written with the assumption that this term will be controlled by state definitions of “net income” and “federal taxable income” already incorporated in other state statutes pertaining to business income taxation. The model assumes the state’s definition will be based on federal taxable income before special deductions (line 28 of the 1120), since NOL’s are computed separately from the federal calculations. In addition, the draft uses the undefined term “base income” to refer to federal taxable income after state additions and subtractions, e.g., exclusion of income from U.S. obligations.

The 2006 Model’s definition of a tax haven (Sec. 1J), which was amended in 2010, remains unchanged.

Section 2: Requirement to file a combined report.

The 2006 Model provides a default to worldwide combined reporting with a procedure to elect water’s-edge reporting. The 2006 Model also provides for discretionary authority to include entities on a combined report, including entities that would not otherwise meet the definition of “taxpayer” under state law, via regulation, where necessary to reflect a proper apportionment of income. (Sec. 2.B). The 2006 Model further provides discretionary authority to include, on an *ad hoc* basis, the income and apportionment factors of any entity not included on the combined report if it is determined that such inclusion is necessary to prevent avoidance or evasion of tax liability.

The draft contains several changes to the titles, subtitles and various provisions in the body of Section 2 to reflect modern drafting conventions, but no substantive changes to the provisions of Section 2 were intended.

Section 3: Determination of taxable income or loss using combined report.

The principal changes to the 2006 Model are incorporated in Section 3 of the draft. The Model's first paragraph of Section 3—identifying the separate calculation of income and losses for each member of the combined report, and separate apportionment of that income and loss to each taxpayer included on the report—has been eliminated in the draft. This “explanatory” language in the 2006 Model signaled adoption of the Joyce methodology. New language has been added to the draft indicating an aggregate approach to determining apportionable income.

The three most important changes to the subsections of Section 3A addressed to particular aspects of income calculation reflect the Finnigan conception of treating the combined group as single unit: (a) the provisions for net operating loss calculations (Sec. 3A11(a)-(c)); (b) a change to the apportionment of capital gains and losses (Sec. 3A(7)), but eliminating the carryback of such losses; and (c) a provision allowing for sharing of state credits (Sec. 3A12). Other changes to the 2006 Model were made to eliminate references to business and non-business income, and to abbreviate and clarify certain provisions. These sections were not intended to be substantively different from the provisions of the 2006 Model addressed to income calculations for members included on the combined report.

The draft additionally includes one provision relating to income from limited partners in investment partnerships that has been adopted in some states, Section 3.A.(4)(B), below, that is not related to the change to the Finnigan methodology.

Section 3A(1) provides that the “base” income (federal net income subject to state adjustments) of a member filing on a federal consolidated basis will be calculated separately, as if the entity were not filing a federal consolidated return. This starting point is consistent with the 2006 Model.

Section 3A(2) provides a similar calculation for non-consolidated filers, consistent with the same provisions of the 2006 Model.

Section 3A(3) addresses calculation of base income for non-U.S. taxpayers (necessary for the calculation of tax for worldwide combined reporting, and for certain provisions of the water's edge election return). It is substantively unchanged from the 2006 Model.

Section 3A(4) addresses the treatment of unitary income derived from pass-through entities.

Subsection 3(4)(A) is substantively the same as the 2006 Model, but the draft contains a new subsection (B), providing that income of a limited partner derived from an investment partnership shall not be considered to be unitary income unless the general partner of the investment partnership and the limited partner have common ownership. This new provision has not received attention from the working group.

Section 3A(5)'s treatment of dividends varies slightly from the 2006 Model. It provides the basic rule that dividends paid between members of the combined group should be eliminated. At the recommendation of a sharp-eyed commentator, staff recommends that the provision be changed to

more closely parallel the 2006 Draft. Staff also recommends some additional language excepting taxable dividends paid by a Real Estate Investment Trust (REIT) from the elimination rule:

All dividends paid by one member of the combined group to another member of the combined group included on the same combined report 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 included as part of the same combined report, or dividends for which a dividends-paid-deduction has been claimed and allowed.

Section 3A(6) applies federal consolidation rules regarding deferrals, eliminations and exclusions among members of the consolidated group to the combined filing group. Its language varies slightly from the 2006 Model but is substantively the same. The 2006 Model incorporates federal consolidation principles but limits application of those principles to transactions and events involving apportionable business income, while the draft applies those principles to all intercompany transactions and activities. Staff does not believe the difference is material.

Section 3A(7) applies to charitable contributions, allowing those contributions to be claimed against the income of the combined group as a whole. This provision continues the 2006 Model's policy allowing sharing of this particular tax attribute (on the theory that such contributions are often made by a corporate parent that may not have sufficient taxable income to allow offset of the contribution). The draft eliminates the 2006 Model's provision regarding use of any excess contribution disallowed under IRC 170 as a non-business expense allocable to the member that made the contribution, as likely unnecessary and inconsistent with the Finnigan approach.

Section 3A(8) is addressed to capital gains and losses and allows a limited aggregation of losses by category and assignment among the unitary members consistent with the Finnigan approach, but the federal limitation on capital gain offset against ordinary income in IRC Section 1231 is continued on a group basis. In addition, the loss can only be carried forward, a limitation that may reduce computational complexity.

Section 3A(9) disallows all expenses related to non-apportionable income and non-taxable income in the calculation of the combined group's apportionable income, even where the expenses may have been incurred by a different member of the combined group than the member that recognized the non-apportionable gain or loss.

Section 3A(10) provides that the income and loss apportioned to the state shall be "adjusted by the total amount of income or loss allocated to this state pursuant to [state allocation rules]." This subsection was a later addition to the draft, which the working group intended as a clarification that non-apportionable and non-taxable income should continue to be calculated and allocated apart from the combined return liability. Staff recommends adding the following language from the 2006 Model to clarify that disallowed expenses related to non-apportionable income or non-

taxable income should be allocated on a separate-entity basis to the entity recognizing the income/loss:

Any expense of one member of the unitary group which is directly or indirectly attributable to the nonbusiness or exempt income of another member of the unitary group shall be allocated to that other member as corresponding nonbusiness or exempt expense, as appropriate.

Section 3A(11) provides rules for the calculation of net operating losses of entities newly joining the combined filing group, for losses incurred as a member of the combined group, and for treatment of losses incurred by a member that subsequently leaves the group. The net operating loss rules are the subject of a separate memorandum prepared by staff. The net operating calculations in (11)(a)-(c) are more specific and detailed than the net operating loss calculation rules in the 2006 Model, and are intended to conform to federal policies concerning consolidation and separate year loss limitations.

Section 4A(12) provides that a state tax credit is calculated at the separate-entity level but can be applied against the combined group's income. That is, a credit based on a set of criteria applicable to a particular taxpayer would not be calculated on the application of those criteria to the combined group as a whole (unless a state's statute specifically indicated that intent). The credit can be applied against the overall liability of the group while the entity that earned the credit remains a member of the group, but no carryover would be allowed once the entity leaves the combined group. Consistent with the Joyce methodology concept, the 2006 Model limited tax credits to the members earning such credit, with no provision allowing for offsetting of the entire combined group's income tax liability.

Section 3B: Calculation of Apportionment Factors for Combined Group:

Section 3B of the draft diverges from the 2006 Model's approach to income apportionment significantly enough that a line-by-line comparison would be difficult. While the 2006 Model emphasizes that the apportionment factor numerators for each taxpayer are computed on a separate-entity basis, the draft provides that both numerators and denominators of the apportionment formula are considered on a combined basis. Section 3B(1) establishes the Finnigan methodology by providing that all receipts of the combined group are attributable to the state if any member of the combined group is "taxable in the state." That term is a reference to Compact Art. IV, Section 2 and is defined by MTC's Model Regulation IV.3 as having conducted sufficient activities within a state to be subject to the state's taxing jurisdiction and to not being protected from income tax liability pursuant to P.L. 86-272. Section 3B(1) further provides that if any member of the group is taxable in another state, then all members of the group shall be deemed taxable in that state. That provision establishes that receipts from sales to a destination state will not be thrown back to the shipping state if any member of the combined group has exceeded the protections of 86-272 in that destination state.

Section 3B(4) provides that a single return, accompanied by the combined filing report, must be filed by the corporate parent if it is a member of the combined group or a designated member if

not. The designated member must remain the primary filer in subsequent years unless it leaves the group. The section further provides for joint and several liability for all members of the group.

The working group elected to eliminate the 2006 Model's provisions for a surety to file on behalf of all taxpayers, since a single return will be required.

Section 4: Water's Edge Election.

The draft retains all of the 2006 Model's water's edge provision will only minor changes to reflect that the combined group is being treated as the entity responsible for making an election, not each individual member of the group as the 2006 Model required. The draft currently allows individual taxpayers to initiate a petition for withdrawal from the water's edge election. Staff recommends that this language be changed to limit a withdrawal from the water's edge return to the combined group as a whole, to be consistent with the remainder of the draft's recognition of the combined group as a single taxpayer for most administrative purposes.

We hope this summary explanation is helpful. The latest draft is appended.

