More States Move To Combined Reporting Despite Biz Pushback

By Maria Koklanaris · August 21, 2018, 11:13 AM EDT

A growing number of states across the nation are moving toward the corporate income tax calculation method known as combined reporting in an attempt to remedy falling U.S. corporate tax revenues, despite claims by corporate interests that the regime is burdensome and hard to administer.

To the chagrin of many pro-business groups that hate the method, 27 states and the District of Columbia have now adopted combined reporting — it will go into effect in 2019 for Kentucky and New Jersey, the two most recent converts. A decade ago, only 16 states used the method, in which multistate corporations must add together, or combine, the profits of all subsidiaries and then report them to the state as if they were one entity, called a unitary business. The remaining states with a corporate income tax are “separate entity states.” In those, multistate corporations may report profits of each subsidiary one by one.

Michael Mazerov of the Center on Budget and Policy Priorities, a strong proponent of combined reporting, compares it to the global base erosion and profit shifting global initiative, saying part of the idea is to keep companies from shifting income between jurisdictions. He also said it was a response to another trend in computing corporate income tax, the creation of single sales factor apportionment regimes. As states give their own companies tax relief, they look to make some of that up by seeking tax revenue from companies outside the state.

“There’s certainly a slow trend toward combined reporting,” Mazerov said. “There’s been more and more attention to both interstate and international income shifting, and I think policymakers are waking up to that.”

The issue remains highly controversial. The Council on State Taxation, which represents the state taxation interests of large corporations, is strongly opposed, calling the system in a policy position statement “unpredictable and burdensome,” with a “significant risk that [it] will arbitrarily attribute
more income in a state than is justified by the level of a corporation’s real economic activity in the state.” Many state chambers of commerce agree. Opponents frequently testify before state legislatures that are considering bills to adopt combined reporting. They will also take to the courts if they deem it necessary.

“There’s frequent litigation related to combined reporting,” Mazerov said.

One notable example, Staples Inc. v. Comptroller of the Treasury, came down Aug. 13 from a Maryland appeals court.

In a matter that spanned nearly two decades, starting from the tax year 1999, the Court of Special Appeals in Maryland ultimately agreed with the tax court that Staples’ in-state subsidiaries were sufficiently intertwined with the parent company to constitute a unitary business. That business had nexus to Maryland, and thus must pay millions of dollars in back corporate income taxes to Maryland, the appeals court agreed.

That litigation would have been a moot point if Maryland were a combined reporting state. Under combined reporting Staples would have had to include the income from the subsidiaries by law. Some lawmakers have tried each year since at least 2010 to adopt combined reporting, but it has never succeeded. The Maryland Chamber of Commerce and COST always register strong opposition.

“This is the most convoluted thing I have ever seen in my life, absent Gore,” Stephanie Lipinski-Galland of Williams Mullen in Washington, D.C., said of the Staples decision. “If they had combined reporting, we wouldn’t be having this conversation.” She referred to Gore Enterprise Holdings v. Comptroller of the Treasury, a similar case and the main precedent the appeals court cited in Staples.

Absent legislation, Lipinski-Galland said, the court effectively created a combined reporting standard. Calling the group a unitary business is telling, she said.

“Unitary is a combined reporting principle,” Lipinski-Galland said. “They [the court] made a decision that if we find a unitary company, they can bring in [the income of] these other businesses.”

Unlike in Maryland, combined reporting proponents in Kentucky and New Jersey were successful this year in adopting combined reporting legislation. The two states are otherwise quite different — Kentucky is a conservative midsize state, while New Jersey is more liberal and has twice the population. Darien Shanske, a tax professor at the University of California, Davis School of Law, applauded them.

“Combined reporting always makes sense,” Shanske said. “Kentucky and New Jersey absolutely did the right thing.”

If Shanske had his way, states would go much further. In a white paper published Aug. 4, Shanske argued for each of them to return to worldwide combined reporting. In most states with combined reporting, the requirement stops at “the water’s edge,” which means corporations either need not add in income of foreign subsidiaries or may elect not to.

Shanske said the Tax Cuts and Jobs Act, which changed the United States’ worldwide system to a modified territorial one for taxation of foreign income, provided some impetus for him to write.

“The system gives multinational corporations even more incentives to profit-share,” Shanske said. He
said some elements in the TCJA, such as the tax on global intangible low-taxed income, or GILTI, and the base erosion anti-abuse tax, or BEAT, provide some remedy but “were drafted so quickly they were loaded with imperfections.” It would be much more efficient and less complicated for states to return to worldwide combined reporting, he said.

In Kentucky, legislators sought to expand the corporate tax base and cut the rate, said Mark Sommer of Frost Brown Todd LLC in Louisville. But their methods were a bit of a surprise, Sommer said.

“Mandatory combined reporting came out of the Republican-controlled House, without advance notice or hearing in committee, literally on the last day of the regular session,” Sommer said. “The business community is mixed on mandatory combined reporting. Some [are] more vocal than others. Some [are] more actively lobbying than others.”

In New Jersey, combined reporting was another step in a process to remake the corporate tax system there, said Cosimo Zavaglia of Morgan Lewis & Bockius LLP in New York.

“In the past they incorporated a fairly broad economic nexus standard as well as add-back rules” for expenses and deductions, Zavaglia said.

Still, he said, it will be a big change for taxpayers and even for the Division of Taxation, which will have to retrain employees and rewrite audit manuals. And it’s a risk, Zavaglia said.

“States that have adopted a combined reporting regime don’t necessarily meet or exceed corporate tax revenue projections in the years that follow,” he said. “Many times, the projections they have don’t come to fruition.”


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