Issue Brief

Combined Reporting

Issue

On Feb. 4, 2020, Gov. Tom Wolf proposed mandatory unitary combined reporting (combined reporting) for the corporate net income (CNI) as part of his 2020-2021 fiscal year budget. The change would be effective for tax years beginning in Jan. 1, 2021 and would coincide with annual decreases in the tax rate from its current 9.99 percent to 5.99 percent in 2025 and thereafter. The issue of combined reporting surfaced as a legislative matter in Pennsylvania in 2004, when Gov. Ed Rendell appointed a business tax reform commission to study Pennsylvania’s economic competitiveness. Since then, combined reporting has been frequently introduced and debated. This issue brief is intended to be informational only, and does not espouse a position for or against such a change.

Discussion and Explanation

Overview of Current Reporting System

Pennsylvania is a separate-company filing state, requiring each corporation to report only its income or loss to the Department of Revenue. All corporations doing business in Pennsylvania file their own returns, regardless of the existence of a commonly controlled, consolidated, or affiliated group. Transactions between the company and its affiliates are generally respected, other than certain intercompany transactions involving intangible and related interest expenses.

Overview of Combined Reporting

Similar to consolidated financial statements or federal income tax reporting, combined reporting requires members of a commonly controlled group to participate in one return if a unitary relationship exists. Combined reporting is mandatory in 28 of the 46 state-level jurisdictions with an income tax. In 2018, Kentucky and New Jersey adopted combined reporting.

Only corporations in a commonly controlled group that are unitary are required to participate in this one return. There are statutory and judicial tests among the states to determine whether entities are unitary. In essence, if there is dependency and contribution among the corporations whereby they act as one unit in concert, a unitary relationship exists. Ownership percentages, centralized management, flow of value, and economies of scale are some of the key unitary factors.

Separate-company income and losses are added together, and intercompany income and expense transactions are eliminated to offset each other. Apportionment factors for all members of the unitary group are added together, and the sum is multiplied by the total of separate-company income and losses to determine the state taxable income.

Pros and Cons

Several tax scholars advocate for combined reporting as good tax policy. They assert that it provides a level playing field for all corporate taxpayers and reduces the taxpayers’ or the states’ ability to artificially shift income outside or inside taxing states. The inclusion of a tax rate reduction is sometimes considered in conjunction with a shift to combined reporting to keep the effects of change revenue-neutral.
Combined Reporting

While combined reporting may not be intended as a tax increase or a revenue raiser, there will be winners and losers.

- Example – Winner: Profitable entity with no unitary affiliates benefits from a rate reduction with no combined return requirement.

Due to the potential for taxpayer benefits and detriments, the fiscal impact of combined reporting is often difficult to estimate. Other tax policy considerations include the following: added complexity for groups that include entities subject to special apportionment (e.g., transportation) or different taxes (e.g., banks and insurance companies); tax return burden (increased complexity in preparing unitary combined returns, particularly among businesses that principally do business in Pennsylvania and other separate-return states); and more tax appeals (increased controversy over the issue of what is a “unitary business”).

The Tax Landscape Has Changed

Intangible holding and financing companies, often referred to as the Delaware Loophole, are much less prevalent as entity structures. Much of this stems from the expansion of combined reporting to additional states, state statutes disallowing expenses related to such companies, and more stringent financial accounting standards. Pennsylvania enacted a provision addressing corporate add-back of intangible expenses for the years beginning after Dec. 31, 2014 (Act 52 of 2013). These changes serve to mitigate some of the direct fiscal impacts of combined reporting to both taxpayers and the Department of Revenue.

Combined Reporting Details

Combined reporting rules are not always consistent between the states. There are many distinctions in the mechanics of combined reporting and the related tax returns. Some of the key areas of distinction are discussed below.

- **Worldwide or Water’s-Edge?**
  Will combined reporting be limited to domestic (or water’s-edge) entities, or also include foreign affiliates?

- **“Joyce” or “Finnigan”?**
  Will apportionment include sales to Pennsylvania customers made by members of the unitary group not otherwise subject to Pennsylvania taxation?

- **Treatment of Tax Attributes?**
  How will prior tax attributes, such as net operating losses and tax credits belonging to separate corporations, be reported and utilized in a combined return?

- **Department Readiness and Systems**
  How will the Department of Revenue train employees and modify systems to process and audit combined returns?

- **Financial Statement Reporting**
  Financial statements may be materially affected by a change to combined reporting. Will rules be implemented to mitigate any of these one-time impacts as other states have done?

1 *Joyce* and *Finnigan* are the names of California cases with opposite decisions.

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**Contact Us**

<table>
<thead>
<tr>
<th>Government Relations Office</th>
<th>Headquarters</th>
</tr>
</thead>
<tbody>
<tr>
<td>500 N. 3rd St., Suite 600A</td>
<td>Ten Penn Center</td>
</tr>
<tr>
<td>Harrisburg, PA 17101</td>
<td>1801 Market St., Suite 2400</td>
</tr>
<tr>
<td>(717) 232-1821</td>
<td>Philadelphia, PA 19103</td>
</tr>
<tr>
<td><a href="mailto:governmentrelations@picpa.org">governmentrelations@picpa.org</a></td>
<td>(215) 496-9272</td>
</tr>
</tbody>
</table>

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For more information, contact your CPA or PICPA at governmentrelations@picpa.org.