Issue Brief

Combined Reporting

Issue

The issue of combined reporting surfaced as a legislative matter in Pennsylvania back in 2004 when Gov. Edward Rendell appointed a business tax reform commission to study Pennsylvania's economic competitiveness. Since then, myriad proposals to change the corporate filing method from the current separate company reporting system to a unitary basis have been introduced and debated. On Feb. 7, Gov. Tom Wolf called for legislation adopting mandatory unitary combined reporting effective for tax years beginning on or after Jan. 1, 2018, while phasing in corporate tax rate reductions beginning in 2019, ultimately reducing the corporate net income rate to 6.49 percent by 2022.

Discussion and Explanation

Overview of Current Reporting System

Pennsylvania is a separate-company filing state. Under this system, each corporation includes only its income on the state corporate net income tax return it files with the Department of Revenue. All separate corporations of a commonly controlled group doing business in the state file their own, individual returns. Many state departments of revenue believe that separate-company reporting enables corporations to shift income to affiliated corporations that do not file in Pennsylvania. The current tax rate is 9.99 percent.

Overview of Mandatory Unitary "Combined Reporting"

Similar to consolidated financial statements or federal income tax reporting, mandatory unitary combined reporting requires members of a commonly controlled group to participate in "one" return, hence the term "unitary." Such a system is mandatory. 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 who is unitary. In essence, if there is "dependency and contribution" among the corporations whereby they act as one unit in concert, like a symphony orchestra of separate musicians, a unitary relationship exists. Centralized management is one key factor.

All separate-company income and losses are added together. All intercompany income and expense transactions are "eliminated" (offset each other). All apportionment factors for determining the fraction of income taxed by Pennsylvania are added together, and the sum is multiplied by the sum total of separate-company income and losses.

Combined Reporting: Pros and Cons

Tax Policy Considerations: Academically speaking, combined reporting is considered good tax policy by several tax scholars. 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 the taxing state. The inclusion of a tax rate reduction is sometimes considered in conjunction with a shift to combined reporting to keep the effects of such change revenue-neutral.

Winners and Losers: While combined reporting is intended not to be a tax increase or a revenue raiser, there will be winners and losers.

- Example – Winner: Highly profitable Pennsylvania company with out-of-state subsidiaries having significant losses.
- Example – Loser: Pennsylvania loss-company with highly profitable out-of-state subsidiaries.

The Department of Revenue is equally susceptible to the winner and loser concept. That is, the state is at risk of losing revenue if taxpayer winners reduce their Pennsylvania taxes more than taxpayer losers. Without conducting a study, the ultimate outcome is an unknown.

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 such as New Jersey, Maryland, and Delaware); and more tax appeals (increased controversy over the issue of what is a "unitary business") leading to increases in a system that is already overburdened with pending tax appeals.

The Tax Landscape Has Changed

DHC is No Longer a Big Factor: Through combined reporting and "add-back" statutes, the states have closed the so-called Delaware holding company (DHC) loophole. A DHC is a passive investment holding company formed and domiciled in Delaware that pays no Delaware corporate income tax. Pennsylvania corporations can pay DHCs royalties or interest and reduce their Pennsylvania taxable income.

Accounting Standards (FIN 48): Current accounting standards do not permit many corporations to book a benefit with "uncertain tax positions." Because of add-back statutes, the state tax benefits that DHCs produce are uncertain; thus, "reserves" are required. DHCs are no longer enhancing the "bottom-line" of financial statements.

Add-Back Powers: Pennsylvania joined add-back states with the passage of Act 52 of 2013. The statute prohibits the deduction of royalties paid to an affiliate not taxed in its home jurisdiction. Interest deductions are also prohibited if the loan funding came from the royalty arrangement. However, transactions possessing a valid business purpose other than saving Pennsylvania corporate net income tax and with arm's-length pricing are permitted.

Devil Is in the Details

- *World-Wide or Water's Edge?*
  Will combined reporting be limited to domestic (or water's edge) entities, or also include foreign affiliates?
- *"Joyce" or "Finnigan"?*[1]
  Will the sales factor for apportioning income be combined or separate for determining such issues as "throw-back" sales and sales' numerator determination?
- *California or Illinois Combined Reporting Mechanics?*
  Will the mechanics involve calculating taxable income separately and then adding together (as in California); or will all income be combined and multiplied by the combined apportionment factor (as in Illinois)?
- *Pennsylvania Department of Revenue Readiness and Systems*
  Are Pennsylvania Department of Revenue employees trained and ready to process and audit combined returns?
- *Separate Accounting and Transfer Pricing Agreements*
  Will combined reporting provisions address these concepts? If so, will they be considered for establishing that a nonunitary relationship may exist between certain entities?
- *Financial Reporting Implications*
  Financial statement tax provisions may be materially affected.

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

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