STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS

DEPARTMENT OF REVENUE
DIVISION OF TAXATION

Report to the General Assembly on Combined Reporting of Corporate Income Tax

Overview:

House Bill 6300, Section 12, passed in the 2007 General Assembly required the Division of Taxation, with the assistance of the Office of Revenue Analysis, to prepare and submit to the General Assembly by December 1, 2008, a report concerning the policy and fiscal ramifications of changing the corporate tax and other business income taxes to a combined method of reporting.

Current Law:

The business corporation tax was first imposed in 1947 by G.L. 1938, Ch. 37. Before 1947, the corporate tax was more in the nature of a property tax on intangibles than an income tax. The tax is on the net income of corporations incorporated or doing business in the state. Net income is defined as the corporation's net income as determined under federal law plus:

(1) any interest not included in federal income,
(2) any specific exemptions,
(3) effective July 1, 2007, for a captive REIT, the amount of the dividends paid deduction allowed under the Internal Revenue Code for the taxable year,
(4) any Rhode Island business corporation tax, and
(5) applicable to tax years beginning on or after January 1, 2008, any deductions required to be added back to net income under R.I. Gen. Laws §44-11-11(f)[1], which include otherwise deductible interest expenses and costs and intangible expenses and costs directly or indirectly paid, accrued, or incurred to, one or more related members;

and minus:

(1) interest on any U.S. or otherwise exempt obligations and
(2) the federal net operating loss deduction

Rhode Island requires corporations to file tax reports on a separate company basis. Corporations that are part of an affiliated group for Federal purposes are required to file "separate company" Rhode Island returns even though their income may have been reported to the Federal Government in a consolidated return of affiliated corporations. Thus, the taxable income of the corporation is computed on a stand-alone separate company basis even though the corporation participates in a consolidated filing for Federal income tax purposes.

[1] 44-11-11(f) For purposes of computing its net income under this section, a corporation shall add back otherwise deductible interest expenses and costs and intangible expenses and costs directly or indirectly paid, accrued or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions with, one or more related members.

An affiliated group of corporations may elect to file a consolidated return for the taxable year provided that each member corporation:

(A) is not a Foreign Sales Corporation (FSC), Domestic International Sales Corporation (DISC), a Subchapter S corporation, or is not a corporation, and

(B) is subject to taxation under chapter 44-11 of the Rhode Island General Laws, and

(C) has the same fiscal period, and

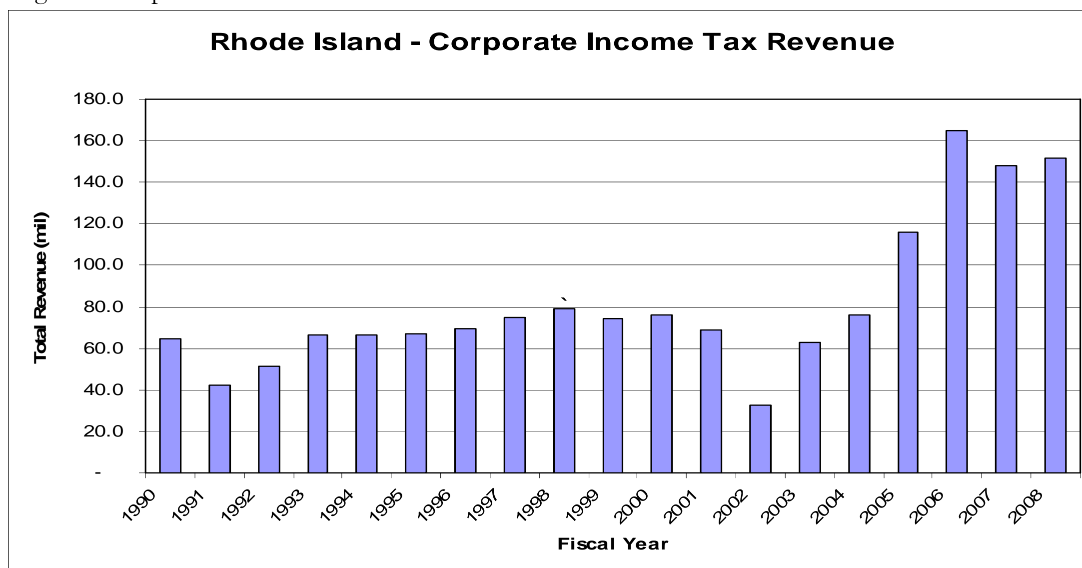
(D) was affiliated at any time during the taxable year, and

(E) consents to such filing and gives written notice thereof to the Tax Administrator no later than the 15th day of the third month following the close of the fiscal year, and joins in the filing of such consolidated return.

Revenue:

For fiscal year 2008 business corporation taxes accounted for 4.4% of Rhode Island's general fund revenue. During fiscal year 2008 the business corporation tax accounted for $151.4 million in revenue. A total of 44,250 businesses filed the business corporation tax, 41,986 (94.8%) paid only the minimum tax of $500. Figure 1 illustrates the revenue derived from business corporation tax since 1990:

Figure 1: Corporate Income Tax Revenue Fiscal Years 1990 - 2008



The November 2008 Revenue Estimating Conference estimated that fiscal year 2009 business corporation taxes will generate approximately $108.0 million.

History of Combined Reporting:

As far back as 1924 the United States Supreme Court has ruled that unitary (also known as combined) reporting is an appropriate way to tax corporations (*Bass, Ratcliff & Gretton Ltd v. State Tax Commission*, 266 U.S. 271). In *Edison California Stores v. McColgan*, 30 Cal. 2d. 472, 183 Pac. 2d 16 (1947) the court held that if the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary. The court ratified the use of the combined report concept by extending

the logic that required divisions to account as a single business to a commonly controlled multi-corporate group.

Currently 22 states have combined reporting requirements (see Figure 2). In 2004, Vermont became the first state in more than 20 years to adopt combined reporting (effective in tax year 2006).

Figure 2: State with Combined Reporting Requirements

State	Comments
Alaska	
Arizona	
California	First state to adopt combined reporting in 1937
Colorado	
Hawaii	
Idaho	
Illinois	
Kansas	
Maine	
Massachusetts	Effective for tax years beginning on or after January 1, 2009
Michigan	Effective for tax years beginning on or after January 1, 2008
Minnesota	
Mississippi	
Montana	
Nebraska	
New Hampshire	
New York	Effective for tax years beginning on or after January 1, 2007
North Dakota	
Texas	
Utah	
Vermont	Adopted combined reporting in 2004 effective for tax years beginning on or after January 1, 2006
West Virginia	

Overview of Combined Reporting:

Generally speaking, combined reporting requires a related group of businesses which have a flow of value among them to combine their income for tax purposes. The combined net income of the group is apportioned by measuring the activity of the group in a taxing jurisdiction based upon the combined apportionment factors of the group.

The goal of combined reporting is to accurately calculate the total net income of a related group by eliminating the distorting effects of transactions within the group. With combined reporting, corporations cannot structure transactions, such as transferring royalty and dividend income and interest expenses, between affiliates in various states to shift income and therefore avoid tax. As a result, this reduces corporate income tax planning based on shifting income to commonly owned corporate low tax or no tax states that are beyond the income tax reach of Rhode Island. It can also benefit businesses by recognizing the losses of money-losing members of the group.

In combined reporting, the unitary group is treated as a single entity. The combined reporting method may only be used where an affiliated group of corporations' activities constitute a unitary business. A unitary business is one in which there is a high degree of interrelationship and interdependence among the activities of the company or related companies.

Provided below are four examples to outline the affects of combined reporting.

Example #1: Single Corporation Operating in Rhode Island

ABC, Inc.
$10.0 million net taxable income

Apportionment Schedule			
	In Rhode Island	Total	Apportionment Factor
Sales	5,000,000	5,000,000	100%
Property	5,000,000	5,000,000	100%
Wages	5,000,000	5,000,000	100%
		Apportionment Formula	300/3
		Apportionment Percentage	100%

Background: ABC, Inc is a retail company 100% located in Rhode Island.

Tax Liability:

Tax Liability = $900,000

Taxable Income	10,000,000
Apportionment Percentage	100.00%
Rhode Island Tax Income	10,000,000
Rhode Island Tax Rate	9.0%
Rhode Island Tax Liability	900,000

Results: ABC, Inc would be required to pay $900,000 in Rhode Island corporate income tax.

Note: Since ABC, Inc is a single entity corporation; the tax liability of the corporation would remain the same if combined reporting was required in Rhode Island.

Example #2: Multi-State Corporate family with Retail Operations in Rhode Island

Parent:
ABC Holding Company, Inc.
$2.0 million net taxable income

	In Rhode Island	Total	Apportionment Factor
Sales	0	2,000,000	0%
Property	0	500,000	0%
Wages	0	500,000	0%
Apportionment Formula			0/3
Apportionment Percentage			0%

Sub A:
ABC, Inc.
$5.0 million net taxable income

	In Rhode Island	Total	Apportionment Factor
Sales	5,000,000	5,000,000	100%
Property	5,000,000	5,000,000	100%
Wages	5,000,000	5,000,000	100%
Apportionment Formula			300/3
Apportionment Percentage			100%

Sub B:
ABC Headquarters, Inc.
$3.0 million net taxable income

	In Rhode Island	Total	Apportionment Factor
Sales	0	3,000,000	0%
Property	0	500,000	0%
Wages	0	500,000	0%
Apportionment Formula			0/3
Apportionment Percentage			0%

Background:

Parent: ABC Holding Company, Inc. is a Delaware holding company that manages the corporation's patents. 100% of the income comes from fees charged to Sub A, ABC, Inc, for use of those patents. ABC Holding Company, Inc does not have any nexus in Rhode Island.

Sub A: ABC, Inc is a retail company 100% located in Rhode Island.

Sub B: ABC Headquarters, Inc, is a Nevada corporation that acts as the corporate headquarters. 100% of the income comes from fees charged to Sub A, ABC, Inc, for consulting fees. ABC Headquarters, Inc, does not have any nexus in Rhode Island. ABC Headquarters, Inc recognized positive net income this year of $3.0 million.

Tax Liability under current law:

Parent: ABC Holding Company, Inc. – Tax Liability = $0

Sub A: ABC, Inc.

Tax Liability = $630,000

Taxable Income	5,000,000
Intangible Add-Back[2]	2,000,000
Net Taxable Income	7,000,000
Apportionment Percentage	100.00%
Rhode Island Tax Income	7,000,000
Rhode Island Tax Rate	9.0%
Rhode Island Tax Liability	630,000

Sub B: ABC Headquarters, Inc. – Tax Liability = $0

Results: By creating two separate corporations outside of Rhode Island to manage the intangible assets and perform the headquarter functions, ABC, Inc. was able to lower their corporate income tax liability in Rhode Island by $270,000 (30%). It is important to note that, in this example, the General Assembly's action in the 2007 session to require the add back of costs associated with intangibles charges increased state tax collections by $180,000 relative to the taxes that would have been collected prior to the enactment of this provision.

[2] R.I.G.L. 44-11-11(f) requires a corporation in computing net taxable income to add back otherwise deductible interest expenses and costs and intangible expenses and costs directly or indirectly paid, accrued or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions with, one or more related members.

Example #3: Multi-State Corporate family with Retail Operations in Rhode Island with Combined Reporting Requirement.

Parent:
ABC Holding Company, Inc.
$2.0 million net taxable income

	In Rhode Island	Total	Apportionment Factor
Sales	0	2,000,000	0%
Property	0	500,000	0%
Wages	0	500,000	0%
Apportionment Formula			0/3
Apportionment Percentage			0%

Sub A:
ABC, Inc.
$5.0 million net taxable income

	In Rhode Island	Total	Apportionment Factor
Sales	5,000,000	5,000,000	100%
Property	5,000,000	5,000,000	100%
Wages	5,000,000	5,000,000	100%
Apportionment Formula			300/3
Apportionment Percentage			100%

Sub B:
ABC Headquarters, Inc.
$3.0 million net taxable income

	In Rhode Island	Total	Apportionment Factor
Sales	0	3,000,000	0%
Property	0	500,000	0%
Wages	0	500,000	0%
Apportionment Formula			0/3
Apportionment Percentage			0%

Background:

Parent: ABC Holding Company, Inc. is a Delaware holding company that manages the corporation's patents. 100% of the income comes from fees charged to Sub A, ABC, Inc, for use of those patents. ABC Holding Company, Inc does not have any nexus in Rhode Island.

Sub A: ABC, Inc is a retail company 100% located in Rhode Island.

Sub B: ABC Headquarters, Inc, is a Nevada corporation that acts as the corporate headquarters. 100% of the income comes from fees charged to Sub A, ABC, Inc, for consulting fees. ABC Headquarters, Inc, does not have any nexus in Rhode Island. ABC Headquarters, Inc recognized positive net income this year of $3.0 million.

Tax Liability under current law with Combined Reporting Requirement: ABC, Inc would be required to file a combined report with ABC Holding Company, Inc and ABC Headquarters, Inc in Rhode Island. Under the combined reporting requirements, income and expenses are required to be combined and the apportionment percentage is calculated based on all corporations filing combined.

Tax Liability = $649,980

	In Rhode Island	Total	Apportionment Factor
Sales	5,000,000	10,000,000	50%
Property	5,000,000	6,000,000	83.33%
Wages	5,000,000	6,000,000	83.33%
Apportionment Formula			216.66/3
Apportionment Percentage			72.22%

Taxable Income	10,000,000
Apportionment Percentage	72.22%
Rhode Island Tax Income	7,222,000
Rhode Island Tax Rate	9.0%
Rhode Island Tax Liability	649,980

Results: By requiring combined reporting ABC, Inc.'s tax liability in Rhode Island is not affected by the intercompany transactions. ABC Inc. would actually be required to pay $19,980 (3.2%) more in corporate income tax under a combined reporting requirement than under current law even with the costs of intangibles add-back provision.

Example #4: Multi-State Corporate family with Retail Operations in Rhode Island with Combined Reporting Requirement.

Parent:
ABC Holding Company, Inc.
$2.0 million net taxable income

	In Rhode Island	Total	Apportionment Factor
Sales	0	2,000,000	0%
Property	0	500,000	0%
Wages	0	500,000	0%
		Apportionment Formula	0/3
		Apportionment Percentage	0%

Sub A:
ABC, Inc.
$5.0 million net taxable income

	In Rhode Island	Total	Apportionment Factor
Sales	5,000,000	5,000,000	100%
Property	5,000,000	5,000,000	100%
Wages	5,000,000	5,000,000	100%
		Apportionment Formula	300/3
		Apportionment Percentage	100%

Sub B:
ABC Headquarters, Inc.
$(5.0) million net taxable loss

	In Rhode Island	Total	Apportionment Factor
Sales	0	3,000,000	0%
Property	0	500,000	0%
Wages	0	500,000	0%
		Apportionment Formula	0/3
		Apportionment Percentage	0%

Background:

Parent: ABC Holding Company, Inc. is a Delaware holding company that manages the corporation's patents. 100% of the income comes from fees charged to Sub A, ABC, Inc, for use of those patents. ABC Holding Company, Inc does not have any nexus in Rhode Island.

Sub A: ABC, Inc is a retail company 100% located in Rhode Island.

Sub B: ABC Headquarters, Inc, is a Nevada corporation that acts as the corporate headquarters. 100% of the income comes from fees charged to Sub A, ABC, Inc, for consulting fees. ABC Headquarters, Inc, does not have any nexus in Rhode Island. ABC Headquarters, Inc recognized a large loss this year due to the sale of a long-term asset ABC Headquarters, Inc's taxable loss for this tax year was $5 million.

Tax Liability under current law with Combined Reporting Requirement: ABC, Inc would be required to file a combined report with ABC Holding Company, Inc and ABC Headquarters, Inc in Rhode Island. Under the combined reporting requirements, income and expenses are required to be combined and the apportionment percentage is calculated based on all corporations filing combined.

Tax Liability = $129,996

	In Rhode Island	Everywhere	Apportionment Factor
Sales	5,000,000	10,000,000	50%
Property	5,000,000	6,000,000	83.33%
Wages	5,000,000	6,000,000	83.33%
		Apportionment Formula	216.66/3
		Apportionment Percentage	72.22%

Taxable Income	2,000,000
Apportionment Percentage	72.22%
Rhode Island Tax Income	1,444,400
Rhode Island Tax Rate	9.0%
Rhode Island Tax Liability	129,996

Results: By requiring combined reporting ABC, Inc.'s tax liability would be greatly reduced in Rhode Island due to the losses experienced by ABC Headquarters, Inc. ABC Inc. would be required to pay $500,004 less, –79.4%, in corporate income tax under a combined reporting requirement.

Pros and Cons of Combined Reporting:

Pros:

- Minimizes Tax Avoidance Planning – By requiring corporations and their subsidiaries to report all their profits together can minimize their ability to utilize tax planning or tax avoidance strategies. In a combined reporting state, all of the income and expenses of a company and its subsidiaries would be added together, so that passive investment companies and other tax avoidance loopholes would have no impact at all on the company's taxable income.
- Levels the playing field – Tax planning strategies are typically used by large multistate corporations who have the resources to design and implement these strategies. Small businesses, which do not have the opportunities or resources to engage in interstate income shifting.
- Better measurement of income within state – Requiring corporations and their subsidiaries to report using the combined reporting method better reflects the income activity of a combined group of corporations in a given state. Combined reporting limits the ability of corporations to shift income to lower tax states or those without a corporate income tax (such as Delaware and Nevada).
- Determines tax based on business activity in the state and not by the business's organizational structure. With reorganization corporations can change the tax situation in a given state. Under current law, Rhode Island treats taxpayers very differently depending on how they are organized. Combined reporting would combine operations of related companies into one profit and loss statement, therefore resolving the taxation issues with a multi-state corporate organization.

Cons:

- Business Climate Perception – Opponents of combined reporting argue against combined reporting have suggested that adopting combined reporting may have a negative impact on a state's business climate. Their claim is that many out-of-state companies may not locate into a combined reporting state because of the added tax burden to comply with the corporate tax laws.
- Administrative Burden for State and Taxpayers – Many practitioners and corporations feel that combined reporting places an undue burden on multistate corporations. The cost to administer a combined reporting structure is also increases due to the high number of audits necessary to determine if a multi-state corporation is required to file combined or separate.
- Potential Revenue Loss in First Few Years – There is a strong belief that more complex audits and appeals and increased litigation can be expected as a result of the unitary determination in states adopting combined reporting. This increased litigation could potentially lead to decreased revenue in the first few years of implementing combined reporting. The belief is that companies that would recognize a lower tax liability using combined reporting would willingly file and pay early. But the companies who would recognize a tax increase due to combined reporting would litigate and delay their tax payments, therefore creating a decline in the revenue from corporate income tax.

Revenue Estimates:

Assumptions & Methodology:

The Division of Taxation elected to use the State of New Hampshire to assist in analyzing the impact of combined reporting. The State of New Hampshire has been a combined reporting state for several decades. Given the history with combined reporting and the fact that New Hampshire is a New England state in close proximity with Rhode Island, the Division of Taxation felt New Hampshire would provide the most relevant data.

The Division of Taxation matched the top 200 corporate income tax filers in Rhode Island with New Hampshire's corporate tax filings to determine which entities filed combined in New Hampshire. New Hampshire reported that only 35 of the top 200 companies filing in Rhode Island filed a combined corporate income tax return. To expand the population, the Division of Taxation also identified 30 of the largest companies (based on gross receipts within Rhode Island) to create a sample population of 65 companies. The sample population consists of a diverse group of entities:

- 14 retail companies
- 18 financial/management services companies
- 14 manufacturing companies
- 8 wholesale distribution companies
- 11 other companies including those in the oil/gas, pharmaceutical, transportation and research and development industries

Using tax year 2006 returns, the Division of Taxation recalculated the corporate income tax using a combined method for the sample population. The sample population tax liability under the current Rhode Island corporate tax structure was $5.9 million. Under a combined reporting system where the rate and the apportionment percentage remained the same, the sample population's tax liability would be $14.4. Based on the analysis, 9.0% of the corporations saw a tax decrease, 27.5% of the corporations saw a tax increase and the remaining 63.5% of the corporations saw no change in their tax liability.

Although this sample population seems relatively small compared to the entire universe of companies that file under Rhode Island's business corporations tax, the Division of Taxation believes that this sample represents the majority of companies that would be affected by combined reporting. Many of the mid-size and small business entities filing business corporation tax would not be affected by combined reporting since they are single entity organizations.

A major portion of the tax increase could potentially be related to the add-back of intangible expenses. The 2007 General Assembly amended the business corporation tax law to require corporations to add-back otherwise deductible interest expenses and costs of intangible expenses accrued through transactions with related companies. The add-back provisions, which have been enacted, can expect to reduce the additional revenue recognized from implementing combined reporting. The Division of Taxation also estimates that the increase for the sample population would not be reflective on the remainder of the universe of business corporation tax filers.

Given the results of the analysis and the above assumptions, the Division of Taxation estimates that combined reporting would generate an additional 5% to 8% of business corporation tax revenue in the State of Rhode Island.

Recommendations:

- The Governor's Tax Policy Work Group is scheduled to issue a report which will address combined reporting for corporations. This report and the final report of the Tax Policy Work Group should collectively be taken into consideration by the General Assembly.
- If the General Assembly wishes to adopt combined reporting requirements in Rhode Island, it is recommended that the model statue issued by the Multi-State Tax Commission be used as a starting point (see Appendix A).
- If the General Assembly wishes to adopt combined reporting requirements in Rhode Island, it is recommended that the effective date of combined reporting be January 1, 2010 to allow the Division of Taxation the ability to perform outreach to inform taxpayers and practitioners of the changes.
- If the General Assembly wishes to adopt combined reporting, it is recommended a review of the Rhode Island Passive Investment Companies statue (RIGL §44-11-1(2)(vii)) be undertaken prior to the effective date of combined reporting to outline any adverse affects.

Appendix A: Multi-State Tax Commission's Model Statue

Multistate Tax Commission
Proposed Model Statute for Combined Reporting
As approved by the Multistate Tax Commission August 17, 2006

Section 1. Definitions.

A. "Person" means any individual, firm, partnership, general partner of a partnership, limited liability company, registered limited liability partnership, foreign limited liability partnership, association, corporation (whether or not the corporation is, or would be if doing business in this state, subject to [state income tax act]), company, syndicate, estate, trust, business trust, trustee, trustee in bankruptcy, receiver, executor, administrator, assignee or organization of any kind.

B. "Taxpayer" means any person subject to the tax imposed by [State Corporate income tax act].

C. "Corporation" means any corporation as defined by the laws of this state or organization of any kind treated as a corporation for tax purposes under the laws of this state, wherever located, which if it were doing business in this state would be a "taxpayer." The business conducted by a partnership which is directly or indirectly held by a corporation shall be considered the business of the corporation to the extent of the corporation's distributive share of the partnership income, inclusive of guaranteed payments to the extent prescribed by regulation.

D. "Partnership" means a general or limited partnership, or organization of any kind treated as a partnership for tax purposes under the laws of this state.

E. "Internal Revenue Code" means Title 26 of the United States Code of [date] [and amendments thereto] without regard to application of federal treaties unless expressly made applicable to states of the United States.

F. "Unitary business" means [a single economic enterprise that is made up either of separate parts of a single business entity or of a commonly controlled group of business entities that are sufficiently interdependent, integrated and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts.] Drafter's note: This portion of the definition is drafted to follow MTC Reg. IV(b), defining a "unitary business." A state that does not wish to define unitary business in this manner should consider alternative language. In addition, this MTC Regulation defining unitary business includes a requirement of common ownership or control. A state which treats ownership or control requirements separately from the unitary business requirement will need to make additional amendments to the statutory language. Any business conducted by a partnership shall be treated as conducted by its partners, whether directly held or indirectly held through a series of partnerships, to the extent of the partner's distributive share of the partnership's income, regardless of the percentage of the partner's ownership interest or its distributive or any other share of partnership income. A business conducted directly or indirectly by one corporation is unitary with that portion of a business conducted by another corporation through its direct or indirect interest in a partnership if the conditions of the first sentence of this section 1.F. are satisfied, to wit: there is a synergy, and exchange and flow of value between the two parts of the business and the two corporations are members of the same commonly controlled group.

G. "Combined group" means the group of all persons whose income and apportionment factors are required to be taken into account pursuant to Section 2.A. or 2.B. in determining the taxpayer's share of the net business income or loss apportionable to this State.

H. "United States" means the 50 states of the United States, the District of Columbia, and United State's territories and possessions.

I. "Tax haven" means a jurisdiction that, during the tax year in question:

i. is identified by the Organization for Economic Co-operation and Development (OECD) as a tax haven or as having a harmful preferential tax regime, or
ii. exhibits the following characteristics established by the OECD in its 1998 report entitled Harmful Tax Competition: An Emerging Global Issue as indicative of a tax haven or as a jurisdiction having a harmful preferential tax regime, regardless of whether it is listed by the OECD as an un-cooperative tax haven:

(a) has no or nominal effective tax on the relevant income; and
(b) (1) has laws or practices that prevent effective exchange of information for tax purposes with other governments on taxpayers benefiting from the tax regime;
(2) has tax regime which lacks transparency. A tax regime lacks transparency if the details of legislative, legal or administrative provisions are not open and apparent or are not consistently applied among similarly situated taxpayers, or if the information needed by tax authorities to determine a taxpayer's correct tax liability, such as accounting records and underlying documentation, is not adequately available;
(3) facilitates the establishment of foreign-owned entities without the need for a local substantive presence or prohibits these entities from having any commercial impact on the local economy;
(4) explicitly or implicitly excludes the jurisdiction's resident taxpayers from taking advantage of the tax regime's benefits or prohibits enterprises that benefit from the regime from operating in the jurisdiction's domestic market; or
(5) has created a tax regime which is favorable for tax avoidance, based upon an overall assessment of relevant factors, including whether the jurisdiction has a significant untaxed offshore financial/other services sector relative to its overall economy.

Section 2. Combined reporting required, when; discretionary under certain circumstances.

A. Combined reporting required, when. A taxpayer engaged in a unitary business with one or more other corporations shall file a combined report which includes the income, determined under Section 3.C. of this act, and apportionment factors, determined under [provisions on apportionment factors and Section 3.B. of this act], of all corporations that are members of the unitary business, and such other information as required by the Director.

B. Combined reporting at Director's discretion, when. The Director may, by regulation, require the combined report include the income and associated apportionment factors of any persons that are not included pursuant to Section 2.A., but that are members of a unitary business, in order to reflect proper apportionment of income of entire unitary businesses. Authority to require combination by regulation under this Section 2.B. includes authority to require combination of persons that are not, or would not be if doing business in this state, subject to the [State income tax Act].
In addition, if the Director determines that the reported income or loss of a taxpayer engaged in a unitary business with any person not included pursuant to Section 2.A. represents an avoidance or evasion of tax by such taxpayer, the Director may, on a case by case basis, require all or any part of the income and associated apportionment factors of such person be included in the taxpayer's combined report.
With respect to inclusion of associated apportionment factors pursuant to Section 2.B., the Director may require the exclusion of any one or more of the factors, the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this State, or the

employment of any other method to effectuate a proper reflection of the total amount of income subject to apportionment and an equitable allocation and apportionment of the taxpayer's income.

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

The use of a combined report does not disregard the separate identities of the taxpayer members of the combined group. Each taxpayer member is responsible for tax based on its taxable income or loss apportioned or allocated to this state, which shall include, in addition to other types of income, the taxpayer member's apportioned share of business income of the combined group, where business income of the combined group is calculated as a summation of the individual net business incomes of all members of the combined group. A member's net business income is determined by removing all but business income, expense and loss from that member's total income, as provided in detail below.

A. Components of income subject to tax in this state; application of tax credits and post apportionment deductions.

i. Each taxpayer member is responsible for tax based on its taxable income or loss apportioned or allocated to this state, which shall include:
(a) its share of any business income apportionable to this State of each of the combined groups of which it is a member, determined under Section 3.B.,
(b) its share of any business income apportionable to this State of a distinct business activity conducted within and without the state wholly by the taxpayer member, determined under [provisions for apportionment of business income],
(c) its income from a business conducted wholly by the taxpayer member entirely within the state,
(d) its income sourced to this state from the sale or exchange of capital or assets, and from involuntary conversions, as determined under Section 3.C.ii.(g), below,
(e) its nonbusiness income or loss allocable to this State, determined under [provisions for allocation of non-business income],
(f) its income or loss allocated or apportioned in an earlier year, required to be taken into account as state source income during the income year, other than a net operating loss, and
(g) its net operating loss carryover or carryback. If the taxable income computed pursuant to Section 3 results in a loss for a taxpayer member of the combined group, that taxpayer member has a [state] net operating loss (NOL), subject to the net operating loss limitations, carryforward and carryback provisions of [provisions on NOLs]. Such NOL is applied as a deduction in a prior or subsequent year only if that taxpayer has [State] source positive net income, whether or not the taxpayer is or was a member of a combined reporting group in the prior or subsequent year.
ii. Except where otherwise provided, no tax credit or post-apportionment deduction earned by one member of the group, but not fully used by or allowed to that member, may be used in whole or in part by another member of the group or applied in whole or in part against the total income of the combined group; and a post-apportionment deduction carried over into a subsequent year as to the member that incurred it, and available as a deduction to that member in a subsequent year, will be considered in the computation of the income of that member in the subsequent year, regardless of the composition of that income as apportioned, allocated or wholly within this state.

B. Determination of taxpayer's share of the business income of a combined group apportionable to this State.

The taxpayer's share of the business income apportionable to this State of each combined group of which it is a member shall be the product of:

i. the business income of the combined group, determined under Section 3.C., and
ii. the taxpayer member's apportionment percentage, determined under [provisions on apportionment factors], including in the [property, payroll and sales factor]numerators the taxpayer's [property, payroll and sales, respectively,] associated with the combined group's unitary business in this state, and including in the denominator the [property, payroll and sales] of all members of the combined group, including the taxpayer, which property, payroll and sales are associated with the combined group's unitary business wherever located. The [property, payroll, and sales] of a partnership shall be included in the determination of the partner's apportionment percentage in proportion to a ratio the numerator of which is the amount of the partner's distributive share of partnership's unitary income included in the income of the combined group in accordance with Section 3.C.ii.(c). and the denominator of which is the amount of the partnership's total unitary income.

C. Determination of the business income of the combined group.

The business income of a combined group is determined as follows:

i. From the total income of the combined group, determined under Section 3.C.ii., subtract any income, and add any expense or loss, other than the business income, expense or loss of the combined group.
ii. Except as otherwise provided, the total income of the combined group is the sum of the income of each member of the combined group determined under federal income tax laws, as adjusted for state purposes, as if the member were not consolidated for federal purposes. The income of each member of the combined group shall be determined as follows:
(a) For any member incorporated in the United States, or included in a consolidated federal corporate income tax return, the income to be included in the total income of the combined group shall be the taxable income for the corporation after making appropriate adjustments under [state tax code provisions for adjustments to taxable income].
(b) (1) For any member not included in Section 3.C.ii.(a), the income to be included in the total income of the combined group shall be determined as follows:

(A) A profit and loss statement shall be prepared for each foreign branch or corporation in the currency in which the books of account of the branch or corporation are regularly maintained.
(B) Adjustments shall be made to the profit and loss statement to conform it to the accounting principles generally accepted in the United States for the preparation of such statements except as modified by this regulation.
(C) Adjustments shall be made to the profit and loss statement to conform it to the tax accounting standards required by the [state tax code]
(D) Except as otherwise provided by regulation, the profit and loss statement of each member of the combined group, and the apportionment factors related thereto, whether United States or foreign, shall be translated into the currency in which the parent company maintains its books and records.
(E) Income apportioned to this state shall be expressed in United States dollars.

(2) In lieu of the procedures set forth in Section 3.C.ii.(b)(1), above, and subject to the determination of the Director that it reasonably approximates income as determined under [the State tax code], any member not included in Section 3.C.ii.(a) may determine its income on the basis of the consolidated profit and loss statement which includes the member and which is prepared for filing with the Securities and Exchange Commission by related corporations. If the member is not required to file with the Securities and Exchange Commission, the Director may allow the use of the consolidated profit and loss statement prepared for reporting to shareholders and subject to review by an independent auditor. If above statements do not reasonably approximate income as determined under

[the State tax code] the Director may accept those statements with appropriate adjustments to approximate that income.

(c) If a unitary business includes income from a partnership, the income to be included in the total income of the combined group shall be the member of the combined group's direct and indirect distributive share of the partnership's unitary business income.

(d) All dividends paid by one to another of the members of the combined group 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 a part of the combined group.

(e) Except as otherwise provided by regulation, business income from an intercompany transaction between members of the same combined group shall be deferred in a manner similar to 26 CFR 1.1502-13. Upon the occurrence of any of the following events, deferred business income resulting from an intercompany transaction between members of a combined group shall be restored to the income of the seller, and shall be apportioned as business income earned immediately before the event:

(1) the object of a deferred intercompany transaction is

(A) re-sold by the buyer to an entity that is not a member of the combined group,

(B) re-sold by the buyer to an entity that is a member of the combined group for use outside the unitary business in which the buyer and seller are engaged, or

(C) converted by the buyer to a use outside the unitary business in which the buyer and seller are engaged, or

(2) the buyer and seller are no longer members of the same combined group, regardless of whether the members remain unitary.

(f) A charitable expense incurred by a member of a combined group shall, to the extent allowable as a deduction pursuant to Internal Revenue Code Section 170, be subtracted first from the business income of the combined group (subject to the income limitations of that section applied to the entire business income of the group), and any remaining amount shall then be treated as a nonbusiness expense allocable to the member that incurred the expense (subject to the income limitations of that section applied to the nonbusiness income of that specific member). Any charitable deduction disallowed under the foregoing rule, but allowed as a carryover deduction in a subsequent year, shall be treated as originally incurred in the subsequent year by the same member, and the rules of this section shall apply in the subsequent year in determining the allowable deduction in that year.

(g) Gain or loss from the sale or exchange of capital assets, property described by Internal Revenue Code Section 1231(a)(3), and property subject to an involuntary conversion, shall be removed from the total separate net income of each member of a combined group and shall be apportioned and allocated as follows.

(1) For each class of gain or loss (short term capital, long term capital, Internal Revenue Code Section 1231, and involuntary conversions) all members' business gain and loss for the class shall be combined (without netting between such classes), and each class of net business gain or loss separately apportioned to each member using the member's apportionment percentage determined under Section 3.B., above.

(2) Each taxpayer member shall then net its apportioned business gain or loss for all classes, including any such apportioned business gain and loss from other combined groups, against the taxpayer member's nonbusiness gain and loss for all classes allocated to this State, using the rules of Internal Revenue Code Sections 1231 and 1222, without regard to any of the taxpayer member's gains or losses from the sale or exchange of

capital assets, Section 1231 property, and involuntary conversions which are nonbusiness items allocated to another state.

(3) Any resulting state source income (or loss, if the loss is not subject to the limitations of Internal Revenue Code Section 1211) of a taxpayer member produced by the application of the preceding subsections shall then be applied to all other state source income or loss of that member.

(4) Any resulting state source loss of a member that is subject to the limitations of Section 1211 shall be carried forward [or carried back] by that member, and shall be treated as state source short-term capital loss incurred by that member for the year for which the carryover [or carryback] applies.

(h) 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 4. Designation of surety.

As a filing convenience, and without changing the respective liability of the group members, members of a combined reporting group may annually elect to designate one taxpayer member of the combined group to file a single return in the form and manner prescribed by the department, in lieu of filing their own respective returns, provided that the taxpayer designated to file the single return consents to act as surety with respect to the tax liability of all other taxpayers properly included in the combined report, and agrees to act as agent on behalf of those taxpayers for the year of the election for tax matters relating to the combined report for that year. If for any reason the surety is unwilling or unable to perform its responsibilities, tax liability may be assessed against the taxpayer members.

Section 5. Water's-edge election; initiation and withdrawal.

A. Water's-edge election.

Taxpayer members of a unitary group that meet the requirements of Section 5.B. may elect to determine each of their apportioned shares of the net business income or loss of the combined group pursuant to a water's-edge election. Under such election, taxpayer members shall take into account all or a portion of the income and apportionment factors of only the following members otherwise included in the combined group pursuant to Section 2, as described below:

i. the entire income and apportionment factors of any member incorporated in the United States or formed under the laws of any state, the District of Columbia, or any territory or possession of the United States;

ii. the entire income and apportionment factors of any member, regardless of the place incorporated or formed, if the average of its property, payroll, and sales factors within the United States is 20 percent or more;

iii. the entire income and apportionment factors of any member which is a domestic international sales corporations as described in Internal Revenue Code Sections 991 to 994, inclusive; a foreign sales corporation as described in Internal Revenue Code Sections 921 to 927, inclusive; or any member which is an export trade corporation, as described in Internal Revenue Code Sections 970 to 971, inclusive;

iv. any member not described in [Section 5.A.i.] to [Section 5.A.iii.], inclusive, shall include the portion of its income derived from or attributable to sources within the United States, as determined under the Internal Revenue Code without regard to federal treaties, and its apportionment factors related thereto;

v. any member that is a "controlled foreign corporation," as defined in Internal Revenue Code Section 957, to the extent of the income of that member that is defined in Section 952 of Subpart F of the Internal Revenue Code ("Subpart F income") not excluding lower-tier subsidiaries' distributions of such income which were previously taxed,

determined without regard to federal treaties, and the apportionment factors related to that income; any item of income received by a controlled foreign corporation shall be excluded if such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in Internal Revenue Code Section 11;
vi. any member that earns more than 20 percent of its income, directly or indirectly, from intangible property or service related activities that are deductible against the business income of other members of the combined group, to the extent of that income and the apportionment factors related thereto; and
vii. the entire income and apportionment factors of any member that is doing business in a tax haven, where "doing business in a tax haven" is defined as being engaged in activity sufficient for that tax haven jurisdiction to impose a tax under United States constitutional standards. If the member's business activity within a tax haven is entirely outside the scope of the laws, provisions and practices that cause the jurisdiction to meet the criteria established in Section 1.I., the activity of the member shall be treated as not having been conducted in a tax haven.

B. Initiation and withdrawal of election

i. A water's-edge election is effective only if made on a timely-filed, original return for a tax year by every member of the unitary business subject to tax under [state income tax code]. The Director shall develop rules and regulations governing the impact, if any, on the scope or application of a water's-edge election, including termination or deemed election, resulting from a change in the composition of the unitary group, the combined group, the taxpayer members, and any other similar change.
ii. Such election shall constitute consent to the reasonable production of documents and taking of depositions in accordance with [state statute on discovery].
iii. In the discretion of the Director, a water's-edge election may be disregarded in part or in whole, and the income and apportionment factors of any member of the taxpayer's unitary group may be included in the combined report without regard to the provisions of this section, if any member of the unitary group fails to comply with any provision of [this act] or if a person otherwise not included in the water's-edge combined group was availed of with a substantial objective of avoiding state income tax.
iv. A water's-edge election is binding for and applicable to the tax year it is made and all tax years thereafter for a period of 10 years. It may be withdrawn or reinstituted after withdrawal, prior to the expiration of the 10 year period, only upon written request for reasonable cause based on extraordinary hardship due to unforeseen changes in state tax statutes, law, or policy, and only with the written permission of the Director. If the Director grants a withdrawal of election, he or she shall impose reasonable conditions as necessary to prevent the evasion of tax or to clearly reflect income for the election period prior to or after the withdrawal. Upon the expiration of the 10 year period, a taxpayer may withdraw from the water's edge election. Such withdrawal must be made in writing within one year of the expiration of the election, and is binding for a period of 10 years, subject to the same conditions as applied to the original election. If no withdrawal is properly made, the water's edge election shall be in place for an additional 10 year period, subject to the same conditions as applied to the original election.