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# Combined Reporting -- Department of Revenue Authority To Disallow Commonly Controlled Group Election (General Fund Taxes -- Income and Franchise Taxes)

[LFB 2011-13 Budget Summary: Page 191, #14]

## CURRENT LAW

A commonly controlled group of corporations may elect to file a combined state income/franchise tax return, regardless of whether each corporation in the group is in the same unitary business. The election must be made for 10 years. The Department of Revenue (DOR) is required to disregard the tax effect of such an election, or to disallow the election, with respect to any controlled group member or members for any year of the election period, if the Department determines that the election has the effect of tax avoidance.

## GOVERNOR

Delete the current requirement that DOR must disregard the tax effect of an election to include a commonly controlled business in a combined group, or disallow the election, for any year of the election period if the Department determines that the election has the effect of tax avoidance. Instead, prohibit DOR from disregarding the tax effect of an election to include a controlled business in a combined group, or from disallowing the election. This provision would apply retroactively to tax years beginning on or after January 1, 2009.

## DISCUSSION POINTS

1. Wisconsin's combined reporting law requires a corporation to use combined reporting if it satisfies all of the following conditions: (a) the corporation is a member of a "commonly controlled group"; (b) the corporation is engaged in a "unitary business" with one or more other corporations in its commonly controlled group; and (c) the corporation is not excluded from the combined group under "water's edge" rules.

2. In general, a "unitary business" is a group of commonly controlled companies, divisions, or branches that operates as a unit. "Unitary" operations are integrated, and each company, division, or branch is dependent upon and contributory to the operation of the business as a whole. However, each component of the "unitary" business does not have to contribute to all the other components of the business. The Wisconsin statutes and administrative code establish two analytical concepts for identifying a unitary business.

*Sharing, Exchange, Flow of Value.* Participants in a commonly controlled economic enterprise have sharing or exchange of value among them, and a significant flow of value to the separate parts of the group, and thus are a unitary business, if any of the following are true: (a) the companies in the enterprise contribute, or are expected to contribute in a nontrivial way to each other's profitability; (b) the companies are dependent on each other for achieving nontrivial business objectives; (c) the group offers one or more participants some economies of scale, or economies of scope that benefit the group's enterprise; or (d) the prices charged on transactions between participants in the enterprise are inconsistent with the arms-length principle. (Existence of arms-length pricing does not, in any way, negate the existence of a unitary business.)

Activities between group members that evidence a flow of value between them include any of the following: (a) assisting in the acquisition of assets; (b) assisting with filling personnel needs; (c) lending funds, guaranteeing loans, or pledging assets; (d) common future planning, or development of the enterprise; (e) providing technical assistance, general operational guidance, or overall operational strategic advice; (f) supervising; or (g) sharing use of trade names, patents, or other intellectual property.

*Unity of Operation and Use.* Participants in a commonly controlled economic enterprise are also engaged in a unitary business if they have both unity of operation and unity of use. Unity of operation means that there is functional integration among corporations, and is evidenced by shared support functions such as: (a) centralized purchasing, marketing, advertising, accounting, or research and development; (b) intercorporate sales or leases, including equipment and real estate; (c) intercorporate services, including administrative, data, management, computer support, employee benefits, human resources, insurance, tax compliance, legal, financial, and cash management services; (d) intercorporate debts; and (e) intercorporate use of proprietary materials, including trade names, trademarks, service marks, patents, copyrights, and trade secrets. Unity of use is evidenced by centralized management or use of centralized policies including: (a) centralized executive force; (b) interlocking directorates or corporate officers; (c) intercompany employee transfers; (d) common employee and executive training programs; (e) common hiring and personnel policies; (f) common recruiting programs; (g) common employee handbooks; and (h) common employee benefit programs.

Case law provides further guidance to determine whether a unitary business exists. Factors that have been considered by the U.S. Supreme Court to be determinative of a unitary business include; (a) unity of use and management [*Butler Bros. v. McColgan, 1942]*; (b) a concrete relationship between the out-of-state and the in-state activities that is established by the existence of the unitary business [*Container Corp. of America v. Franchise Tax Bd. Of California, 1983*]; (c) functional integration, centralization of management, and economies of scale [*Mobil Oil Corp. v. Comm'r of Taxes of Vermont, 1908*]; (d) substantial mutual interdependence [*F.W. Woolworth Co. v. Taxation and Revenue dept. of New Mexico, 1982*]; and (e) some sharing or exchange of value not

capable of precise identification or measurement -- beyond the flow of funds arising out of a passive investment or a distinct business operation [*Container, 1983]*.

Administrative rules specify certain presumptions that apply in determining whether participants in a commonly controlled group of corporations are considered a unitary business. The rules include the following presumptions:

*Horizontal Integration.* An entity or commonly controlled group of entities is presumed to be engaged in a unitary business when all of its activities are in the same general line of business.

*Vertical Integration.* An entity or commonly controlled group of entities is presumed to be engaged in a unitary business when its various divisions, segments, branches, or affiliates are engaged in different steps of a vertically structured enterprise.

*Centralized Management.* An entity or commonly controlled group of entities is presumed to be engaged in a unitary business when there is strong central management coupled with the existence of centralized departments or affiliates for such functions as financing, advertising, research and development, or purchasing.

*Different Business Segments.* An entity that has different business segments within the organizational structure of the single business entity is presumed to be engaged in the same unitary business throughout the entity.

3. A "commonly controlled group" can be any one or combination of four types of arrangements, based on ownership of stock that represents more than 50% of voting power. Specifically, there must be common ownership of stock representing more than 50% of the voting power of the corporations in any commonly controlled group. A corporation owns stock representing more than 50% of voting power if it owns or controls more than 50% of all classes of stock entitled to vote.

*Parent-Subsidiary Chain.* A group in which a parent corporation directly or indirectly owns stock representing more than 50% of the voting power of one or more corporations, or chains of corporations, in the group, or if the parent corporation or any of the corporations in the group owns stock that cumulatively represents more than 50% of the voting power of each of the corporations in the group.

*Single Common Owner Brother-Sister Corporations.* A group in which a common owner directly or indirectly owns stock representing more than 50% of the voting power of the corporations in the group.

*Family Owned/Controlled Brother-Sister Corporations.* A group in which stock representing more than 50% of the voting power of each corporation is directly owned by, or for the benefit of, members of the same family, to the third degree of kinship. Under the third degree of kinship, an individual is considered to be in the same family with his or her: parents; grandparents; great-grandparents; children; great-grandchildren; siblings; nieces and nephews; and aunts and uncles.

*Stapled Entities.* A group in which there is an arrangement where stock representing more than 50% of the voting power of each corporation cannot be separately transferred, even if there is

not actual common ownership of the stock. If a group of corporations would be considered "stapled entities" under the Internal Revenue Code, without regard to whether the corporations are foreign or domestic, then the corporations would be in a commonly controlled group.

4. The controlled group election is binding and applicable to all members of the commonly controlled group for the tax year for which the election is made, and for the next nine tax years (10 years total). The election is also binding on any corporations that join the commonly controlled group during the period the election is in effect. Any corporation that departs the commonly controlled group is not bound by the election, unless reorganization provisions apply, or the corporation rejoins the group. Generally, when a merger or acquisition occurs between two combined groups, if the acquiring group (or both the acquiring and target groups) has made the controlled group election, all corporations in the commonly controlled group, after considering the effect of the merger or acquisition, are bound by the acquirer's controlled group election. Conversely, if the acquiring group has not made the controlled group election, but the target group has, the controlled group election of the target group terminates on the date of the transaction. When a commonly controlled group that has made the controlled group election divests stock of one or more of the subgroups of members, so that the subgroups are no longer in the commonly controlled group, then those subgroups are no longer bound by the controlled group election. However, if the book value of total assets of a subgroup and its total fair market value are greater than those of the divesting group, then the subgroup is bound by the controlled group election, and the controlled group election of the divesting group terminates on the date of the transaction.

5. Combined reporting "water's edge" rules provide that corporations that are either foreign corporations, or that have a substantial amount of business conducted outside the U.S. do not include certain income, loss, and apportionment factors in the combined report. Factors that determine a corporation's status under water's edge rules include: (a) whether it is a foreign or domestic corporation; (b) whether it qualifies as an 80/20 corporation (80% of worldwide gross income is active foreign business income); and (c) whether its income is sourced to U.S. or foreign sources.

6. When the states tax the income of corporations generated by activities carried on across state lines, they are required by the due process and commerce clauses of the U.S. Constitution to tax only income that is fairly attributable to activities carried on within the state. There must be a definite link or "nexus" between the state and the corporation's income that the state seeks to tax. Through a number of judicial decisions, the U.S. Supreme Court has established the constitutionality of the use of formula apportionment of the income of a unitary business to allocate income to a state for tax purposes. Consistent with these judicial decisions, states can only use combined reporting to tax the income of a unitary group.

7. The Supreme Court has never attempted a rigorous, systematic definition of unitary business. The Court has developed tests and criteria, such as unity of operation, ownership, and use, and functional integration, centralized management, and economies of scale within an affiliated group. States and the Multistate Tax Commission (MTC) have developed more specific definitions of what constitutes a "unitary" business. The MTC is an intergovernmental state tax agency that works on behalf of state tax agencies and taxpayers to administer state tax laws that apply to multistate and multinational enterprises. The MTC has promulgated a model statute for the implementation of combined reporting, and a model regulation detailing the corporate subsidiaries

of a "unitary business" that should be included in a combined report. MTC auditors are also familiar with auditing combined returns. Wisconsin has enacted specific statutory provisions and administrative rules (Discussion Point 2 above) that are used to determine unitary business subject to combined reporting.

8. However, determining a unitary group's composition can be difficult and costly. Constitutional and statutory guidelines make determination of whether a particular entity is unitary with another entity inherently fact-specific. The process can involve examining entities that do not necessarily have nexus with the taxing state, and annually reexamining the unitary relationships to reflect structural changes in the business. Tax administrators must examine how parent and subsidiary corporations operate at a fairly detailed level. The process of identifying members of a unitary business group can result in disagreements between taxpayers and tax administrators. These disagreements can cost individual taxpayer and state resources in the form of audits, appeals, and litigation.

9. The controlled group election eliminates the need to individually determine members of a unitary business group. Under the election, the combined group includes all corporations in the commonly controlled group that have taxable income (or loss) that meets the "water's edge" standard. Both commonly controlled groups and "water's edge" income are determined by objective "bright-line" tests, which increases administrative certainty and reduces costs. In addition, the election does not permit a combined group to exclude corporations that would otherwise be included in the combined group. The combined group must include all corporations that are more than 50% commonly controlled, and the election applies to any corporation that joins the commonly controlled group during the period of the election.

10. Currently, 23 of 45 states with corporate income or similar business taxes have implemented some form of combined reporting. Eleven of those states provide an election to include members of a commonly controlled group in the combined group. The chart lists the combined reporting states that allow and do not allow the commonly controlled group election.

| States That Allow Commonly Controlled Group Election | States That Do Not Allow Commonly Controlled Group Election |
|---|---|
| Alaska | Hawaii |
| Arizona | Illinois |
| California | Michigan |
| Colorado | Minnesota |
| Idaho | Nebraska |
| Kansas | New Hampshire |
| Maine | New York |
| Massachusetts | North Dakota |
| Montana | Oregon |
| Vermont | Texas |
| Wisconsin | Utah |
| | West Virginia |

11. Through May 6, 2011, a total of 40,818 regular (C) corporate income and franchise tax returns have been processed for tax year 2009. Of the total, 3,466 were combined returns, of which 588 claimed the controlled group election. The net tax reported by controlled groups was

$60.9 million. It should be noted, that all returns for tax year 2009 have not been processed. DOR will receive tax year 2009 returns through October of 2011. However, tax year 2009 returns provide the only actual data for combined returns. DOR indicates that through May 6 of last year, approximately 89% of tax year 2008 returns had been processed. Because combined reporting first applied to tax year 2009, the Department cannot determine if the same percentage of tax year 2009 returns have been processed.

12. As noted, the current statutory provision (anti-abuse provision) requires DOR to disallow the commonly controlled group election if the Department determines that the election is used for tax avoidance. The administrative rules governing the provision provide that a controlled group election may be disregarded by the Department if the facts demonstrate that the election has the primary effect of tax avoidance, rather than its intended purpose of simplifying the determination of items includable in a combined report. The rules specify that a controlled group election may be considered to have the primary effect of tax avoidance if, from the facts available to any corporation in the commonly controlled group at the time of the election, the election will not have meaningful continuing application. The rule notes that one example of tax avoidance would be the effect of a controlled group election made in anticipation of a sale of a business, if by making the election, the seller incurred a significantly lower tax liability on the transaction, and after the sale, all other corporations in the combined group would be included in the group, even if the controlled group election were not in effect. The anti-abuse provision is designed to provide authority to DOR to allow the Department to prevent combined groups from using the controlled group election to include members in the group primarily for the purpose of reducing state corporate income/franchise tax liability.

13. Under the administrative rule, if DOR finds it necessary to disregard the tax effect of the controlled group election or disallow the election, the Department is required to revoke the election for the entire commonly controlled group for all the tax years open to adjustment. If the election is revoked, the controlled group may not make another election for three years. DOR is also required to recompute the tax liability for each member of the commonly controlled group in the manner the liability would have been computed had the controlled group election not been in place, and issue notices of assessment and refund within the statute of limitations (generally four years), including extensions.

14. Since the anti-abuse provision was adopted in 2009 Wisconsin Act 28, taxpayers have expressed concern that the provision created a level of uncertainty in determining annual tax liabilities. The initial emergency administrative rules authorized DOR to remove from the group individual corporations that the Department identified as being included solely to avoid taxes. Businesses were concerned that DOR would eliminate individual corporations from the group to generate the highest tax liability. As noted, the current rule requires the Department to revoke the election for the entire group. However, this change only partially addressed business concerns. The commonly controlled group election applies for ten years. Each year during that period DOR could revoke the election and determine each member's tax liability individually, which could affect the annual cash flow of each individual firm, and the unitary business group. From the taxpayers' perspective, repealing the anti-abuse provision would address a concern about the certainty of the annual process of determining a controlled group's tax liability.

15. According to information provided by DOR, of the eleven combined reporting states

that provide the commonly controlled group election, Wisconsin and Massachusetts have anti-abuse provisions.

16. DOR indicates that it has not used its authority to revoke a commonly controlled group election. In part, this is due to the relatively recent enactment of the combined reporting provisions. The law first applied to tax years beginning on or after January 1, 2009. Since corporate income/franchise tax returns are typically filed on extension, most returns were not due until October 15, 2010. Returns for tax year 2009 will be received through October of 2011. The Department has had limited opportunity to audit the returns. However, to date, no commonly controlled group election has been disallowed.

17. A separate provision of state law authorizes DOR to reallocate income, deductions, and tax credits between two or more businesses if the DOR Secretary determines that it is necessary in order to prevent tax evasion or clearly to reflect their income. Specifically, in any case of two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the U.S., whether or not affiliated, and whether or not unitary) owned or controlled directly or indirectly by the same interests, the DOR Secretary or his or her delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such entities, if he or she determines that the adjustments are necessary in order to prevent evasion of taxes or clearly to reflect their income.

Current law also specifies that if any person, directly or indirectly, engages in a transaction or series of transactions without economic substance to create a loss or to reduce taxable income or to increase credits allowed in determining Wisconsin tax, DOR must determine the amount of a taxpayer's taxable income or tax so as to reflect what would have been the taxpayer's taxable income or tax if not for the transaction or transactions without economic substance causing the reduction in taxable income or tax. In order for a transaction to have economic substance, the taxpayer must show that: (a) the transaction changes the taxpayer's economic position in a meaningful way, apart from tax effects; and (b) the taxpayer has a substantial nontax purpose for entering into the transaction and the transaction is a reasonable means of accomplishing the substantial nontax purpose. A transaction has a substantial nontax purpose if it has substantial potential for profit, disregarding any tax effects. Transactions between members of a controlled group are presumed to lack economic substance and the taxpayer has the burden of establishing by clear and convincing evidence that a transaction or a series of transactions between the taxpayer and one or more members of the controlled group has economic substance. The bill would not amend these provisions.

18. The bill does not include a fiscal estimate for repealing the anti-abuse provisions. As noted, DOR has not used its authority to revoke a commonly controlled election. DOR processing data for tax year 2009 indicate that through May 6, 2011, controlled groups reported net tax liability of $60.9 million. To the extent repealing the anti-abuse provision would prevent DOR from disallowing tax avoidance practices in future years, there could be an unknown decrease in corporate income/franchise tax revenues. However, as noted in the preceding paragraphs, DOR would still have statutory authority to adjust corporate tax returns to prevent tax evasion.

**ALTERNATIVES**

1. Adopt the Governor's recommendation to delete the current requirement that DOR must disregard the tax effect of an election to include a commonly controlled business in a combined group, or disallow the election, for any year of the election period if the Department determines that the election has the effect of tax avoidance, for tax years beginning on or after January 1, 2009.

2. Delete the Governor's recommendation.

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