

An Evaluation of Combined Reporting in the Tennessee Corporate Franchise and Excise Taxes

William F. Fox, Director
LeAnn Luna, Associate Professor
Co-Project Directors

Contributors

Don Bruce, Associate Professor
Rebekah McCarty, Graduate Research Associate
Ann Watts, Graduate Research Associate
Zhou Yang, Graduate Research Associate

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716 Stokely Management Center
Knoxville, Tennessee 37996
Phone: (865) 974-5441
Fax: (865) 974-3100
<http://cber.bus.utk.edu>

Table of Contents

1. Overview of Tennessee Franchise and Excise Tax.....	2
1.1 Franchise Tax.....	3
1.2 Excise Tax.....	3
2. Overview of Multistate Taxation	5
2.1 Definitions.....	5
2.2 Separate, Consolidated, or Combined Reporting.....	6
3. Current Status of Reporting in U.S. States	9
3.1 Illustration of Combined Reporting vs. Separate Reporting.....	10
3.2 Tax Shelters and Tax Planning	12
4. Other Issues Relating to Combined Reporting	14
4.1 Voluntary vs. Required Combined Reporting	14
4.2 Definition of “Unitary”	14
4.3 Water’s Edge.....	15
4.4 Joyce vs. Finnigan.....	16
5. Transition Issues	21
5.1 Tax Attributes	21
5.2 Administration and Compliance	21
6. Evaluation of Combined Reporting	23
6.1 Measure Firm Liability Accurately.....	23
6.2 Economic Development and Tax Revenue.....	26
6.2.1 Tax Simulations	26
6.2.2 Statistical Analysis.....	29
6.2.3 Effects on Tax Revenues	30
6.2.4 Effects on State Gross Domestic Product	39
6.3 Compliance and Administration	42
6.3.1 Compliance	42
6.3.2 Administration	44
7. Summary	46
References.....	49
Appendix A – Additional Examples of Separate versus Combined Reporting	50
Appendix B - Meetings.....	52
Appendix C – Intangible Expense Disclosure Form.....	53

AN EVALUATION OF COMBINED REPORTING IN THE TENNESSEE CORPORATE FRANCHISE AND EXCISE TAXES

Tennessee Senate Resolution 292 urges the Comptroller of the Treasury with the cooperation of the Departments of Revenue and Economic and Community Development to complete a comprehensive study and analysis of converting to a combined reporting regime. This report fulfills that mandate and describes combined reporting and various issues related to a state combined reporting regime for the Tennessee franchise and excise taxes.

The question facing Tennessee is whether the current tax regime appropriately taxes the operations of multistate businesses operating in Tennessee. The tax regime should capture an appropriate measure of economic activity within the state. As such, the analysis that follows uses four criteria to examine the appropriateness of requiring all related firms to file combined set of franchise and excise tax returns versus the current requirement that each corporation file a separate return.¹ The four criteria include the effects on corporate tax revenue, economic development, administrative and compliance and base definition implications. Both the theoretical and practical dimensions of determining the appropriate tax base for the Tennessee business excise and franchise taxes are examined here. The report focuses primarily on the combined reporting and the excise tax, but also analyzes the effects of combined reporting on excise and franchise tax revenue.

Section 1 introduces the existing Tennessee franchise and excise tax regime. Section 2 provides an overview of multistate taxation and introduces combined reporting. Section 3 provides a description of the current reporting status of other states, applies combined reporting to a hypothetical example, and discusses some of the benefits of combined reporting. Sections 4 and 5 describe some pertinent issues that must be considered prior to adoption as well as other related details of a combined reporting statute, and Section 6 contains a broad evaluation of combined reporting versus separate reporting. Section 7 contains a summary.

1. OVERVIEW OF TENNESSEE FRANCHISE AND EXCISE TAX

Tennessee imposes two broad taxes on businesses operating in the state. The franchise tax is based on the greater of net worth or the value of real and tangible personal property owned or used in the state. The excise tax is based on net earnings or income for the tax year. The two taxes apply to virtually all businesses organized for profit including corporations, subchapter S corporations, limited partnerships, limited liability companies and limited liability partnerships. Only sole proprietorships and general partnerships are specifically exempt from the tax. With certain exceptions, related entities or entities by the same common parent are required to file *separate* tax returns. This analysis will

¹ A third option of allowing companies to file combined returns is not considered in detail because this simply permits firms to choose whichever option reduces their tax liability.

examine the separate filing requirement and consider the implications of allowing or requiring related (unitary) businesses to file combined tax returns.

1.1 Franchise Tax

The franchise tax is assessed at the rate of 25 cents per 100 dollars of a taxpayer's net worth at the end of the reporting period. The taxable base cannot be less than the book value (cost minus accumulated depreciation) of real and personal tangible property owned or used by the taxpayer. Property rented by the taxpayer is converted to a taxable value by multiplying the rents by a factor that varies from 8 for real property to 1 for mobile and delivery equipment, depending upon the type of property.

If a taxpayer is owned by another company doing business in Tennessee, the net worth of that taxpayer could be subject to a double tax. The net worth is taxed once at the firm level and again if the value of the firm is included in the net worth of another Tennessee taxpayer. To alleviate this potential double tax, affiliated entities can elect to calculate the franchise tax on a consolidated basis. Affiliates for this purpose are those that are greater than 50 percent owned by another related entity. The election once made is binding for at least five years.² The propensity for firms already to be filing combined franchise tax returns lowers the potential impact of a change to required combined reporting on the franchise tax, but the voluntary nature suggests that firms tend to file combined returns when it lowers their tax liability.

1.2 Excise Tax

The excise or income tax in Tennessee is assessed at a rate of 6.5 percent on the net earnings or income of all businesses engaged in a for profit activity, unless specifically exempt (e.g. sole proprietorships and general partnerships). Except in certain prescribed situations, each legal entity is required to file a separate return. Consolidated or combined returns are not allowed for Tennessee excise tax purposes, even if a consolidated return was filed for federal income tax purposes (unless authorized by the Commissioner of Revenue). In the case of merger or consolidation, carryover net operating losses are not available to the surviving corporation or entity. Tennessee begins its taxable income calculation with federal taxable income.

Earnings are classified as business or non-business using both transactional and functional tests. Multistate businesses apportion business income based on a three-factor formula of sales, property and payroll. The sales factor is double weighted in the Tennessee formula. Non-business earnings are generally allocated to Tennessee (as opposed to a share being apportioned) if the property giving rise to the non-business income was sited in Tennessee. Capital gains from intangible property are allocable to Tennessee if the taxpayer's domicile is in Tennessee.

² Tennessee provides for several exemptions and limitations of the franchise tax that are beyond the scope of this discussion.

2. OVERVIEW OF MULTISTATE TAXATION

2.1 Definitions

State tax regimes must consider three basic factors when assessing tax on business entities. The first is whether the entity or group of entities has *nexus*. Because of constitutional restrictions, states can only assess tax on businesses that meet some minimum connection or activity within the state's borders. While each state has its own specific definition and regulation, the general rule is a company must either have employees or rent or own property in a state to create nexus. Sales activity can also create nexus in many cases. However, Public Law 86-272 restricts states from imposing tax on a company if the business's only activity in a state is sales and/or solicitation of sales for tangible personal property. In other words, if a company has no employees and no property in a state but only makes destination sales to that state (and might have employees temporarily travel to the state for purposes of soliciting sales), then the company does not have nexus in the destination state. For example, before Dell moved operations into Tennessee, the income from sales of computers to Tennessee residents and businesses presumably was not subject to income tax by Tennessee because Dell did not have nexus within the state. The various state definitions of nexus can be complex, but a basic understanding of the concept is all that is required here for purposes of describing combined reporting.

The second issue is *which entities* are included in a return. There are three basic options. Under the separate entity concept of corporate accounting, a company is treated as distinct and completely separate from its owners or other affiliated companies. Under this concept, a company stands apart from other companies as a separate economic unit and records separate business transactions to distinguish it from its owners. Tennessee currently uses this concept and generally requires each separate entity to file its own tax return.³ However, other states consider the ownership structure of separate entities and require or allow separate entities with common ownership to file a return using either combined or consolidated reporting. These reporting options are discussed in more detail in section 2.2.

Finally, for multistate businesses operating in more than one state, states must determine how a business operating in more than one state allocates or apportions taxable income to each of the states in which it does business. Obviously, one way to do this is to maintain separate accounting records for each state. However, the costs of this method could be substantial, and even if revenues and expenses could be accurately assigned to particular states, the results would in many cases be undesirable. Shared costs and the benefits of economies of scale, for example, are more properly allocated to every state in which a company does business instead of the particular state in which the costs were incurred or the benefits produced. Accordingly, U.S. states employ an apportionment method where a company's income is apportioned or spread between the different states in which it has nexus based on a formulary approach.

³ In some circumstances, Tennessee will allow or require consolidated or combined reporting. This analysis ignores these special situations and assumes the general rules apply.

Typically the formula consists of some combination of three factors: sales, payroll, and property. The numerator of each factor would be the in-state amount of the factor, and the denominator is the total amount of the factor for the company. The result is that company income is taxed by each state on the basis of the company's percentage of factors that occur in that state. Some states use only a sales factor, some use all three factors equally weighted, and many use all three factors but weight the sales factor more than the other two. As discussed earlier, Tennessee uses a three-factor formula that double weights sales. For purposes of the examples in this report, we will always assume that states have the same apportionment formula so that we can compare differences related to the reporting regime and not related to apportionment.

The amount of income allocated to states will be less than total income both because of differences in states' apportionment formulas and the application of nexus rules. For example, if a business makes sales to a state in which it does not have nexus, the income from those sales will generally not be taxed by any state. Some states impose a throwback rule, which requires these "nowhere" sales to be "thrown-back" to the originating state and included in that state's sales factor. Other states impose a throwout rule where those sales that are untaxed by any state are removed from both the numerator and denominator of the apportionment formula. However, the practical reality is states occasionally devise apportionment rules that purposely create "nowhere" income. Single sales apportionment factors can create nowhere income for capital and labor-intensive manufacturing operations, for example. The main reason is that many states are more concerned about limiting the taxation of production in their state than they are in ensuring that the entire income of corporations is taxed in some state.

2.2 Separate, Consolidated, or Combined Reporting

The choice of filing method is an expression of the state's view on what is the appropriate measure of the taxable base for a multistate business that includes more than one filing entity. Businesses form separate entities for many legal and operational reasons. Each entity assumes a certain basket of responsibilities with varying prospects of profitability, risk, geographical reach, size, and other factors. For example, separate entities could be formed to isolate risk exposure to the entity that engages in risky business activities. Management activities could be located in a holding company, charging management fees to the operating entities. Activities within a vertically integrated operation are often separated by function, such as manufacturing versus sales. Tennessee must decide whether to dictate taxation based on these operational decisions or if a better measure of taxation is one that ignores separate entities and considers the profitability of the consolidated or unitary group as a whole. The decision about filing method must consider the method's effect on the state's taxable base and therefore tax revenues, but the question of what is appropriate must be considered in the ultimate outcome. The policy alternatives are examined in detail in Section 6 below.

Separate reporting requires that each individual company that has nexus in a state file a separate tax return that includes only the income of that individual company. This type

of reporting is based on the separate entity concept discussed above. The income for the company is then apportioned to the specific state based on that state's formula where the numerator represents the in-state activity of each factor for the company, and the denominator represents the total "everywhere" of each factor for the company. Under this type of reporting, the income and business activity of any related companies are disregarded.

Consolidated reporting generally looks for common ownership to determine the filing group. Typically, all companies that are included in a common ownership umbrella file one tax return that includes all the income of the group after inter-company transactions are eliminated. The income is then apportioned based on the entire group's percentage of in-state factors to total factors, and the entire consolidated group pays one tax amount. The definition of a consolidated group can vary by state but usually requires each member to meet a certain common ownership threshold, such as 80 percent. Typically, consolidated reporting for state purposes represents the same group of companies that file consolidated returns for federal income tax purposes and as such is a convenient option for many multistate businesses.

Combined reporting is, in a sense, a combination of both separate and consolidated reporting. Unlike consolidated return rules, combined reporting rules consider both ownership and the business relationship of related entities. Only entities engaged in a "unitary" business file a combined return.⁴

The theoretical underpinning of combined reporting rests on the assumption that an entity engaged in a cooperative business activity with related entities cannot be viewed in isolation from those related entities. Any number of business decisions can shift income between related entities, and a better measure of taxable income is to disregard separate entities if those entities are engaged in a combined business effort. In the same way investors will disregard entities to gauge the profitability of a strategic business line, states are justified in taking the same approach in determining taxable income of a "unitary business."

Under a combined reporting regime, each company files its own tax return and pays its own tax.⁵ However, to determine the amount of tax paid, the income (or loss) and apportionment factors of all members of the unitary group are combined as if they were a single entity. Similar to consolidated reporting, inter-company transactions are eliminated in the calculation of the group's taxable income. The combined income is apportioned to the state based on the total group's percentage of in-state factors. Then, the total combined taxable income of the group is allocated back to each of the specific companies based on its individual contributions to the factors of the group, and each company pays its respective tax.

In a separate reporting regime, one entity's losses are not available to offset the income of another entity. Under combined reporting, the losses of one entity in the group are

⁴ The factors determining the unitary group are discussed further in section 3.

⁵ For convenience, some states allow one company to file the entire combined report and pay tax on behalf of all of the members of the affiliated group.

immediately available to offset income from any other entity. Also, while combined reporting *does* require the combination of the group's income and elimination of inter-company transactions, the group *does not* remit one tax payment as a combined group nor file only one tax return.⁶ Instead, the taxable income and apportionment factors are calculated on a combined basis with each separate company then completing its own tax return and remitting its own tax payment.

Combined reporting requires member companies engaged in a unitary business to report combined income. This definition is different from the ownership percentages typically used to report for a consolidated group. Therefore, in many cases, the consolidated group for federal tax purposes will not be the same as the unitary group for combined reporting purposes. The definitions of "affiliated" and "consolidated" that are typically found in statutes for consolidated reporting states and found in the federal Internal Revenue Code are not the same as those for a combined group.

⁶ Occasionally, one tax return and payment is permitted as noted above in footnote 4.

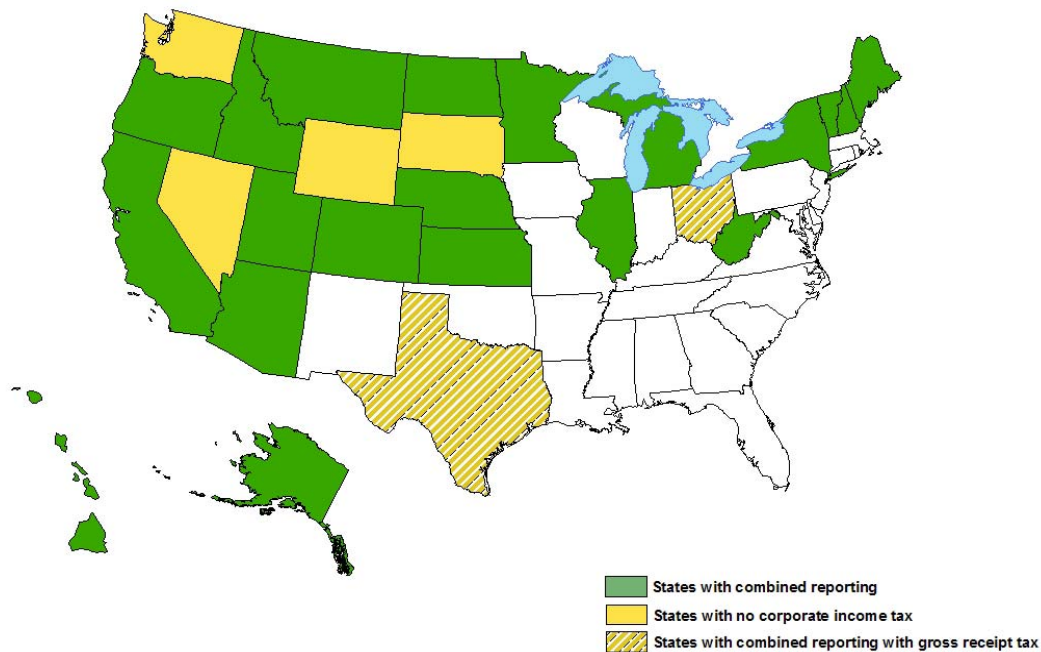
3. CURRENT STATUS OF REPORTING IN U.S. STATES

As shown below in Figure 1, 21 states currently require combined reporting of unitary businesses for business income taxes. Most of the others require separate reporting although some of these states allow combined reporting in special circumstances.

While 16 states have used combined reporting for decades, there had been little change until recently when five additional states enacted combined reporting (Vermont, West Virginia, New York, Massachusetts, and Michigan).⁷ Of these states enacting combined reporting, West Virginia, New York, and Michigan all enacted combined reporting in 2007. Most recently, Massachusetts instituted combined reporting in July 2008 as part of its reform to prevent highly profitable companies from shifting income out of the state to avoid taxation.⁸

The governors of three other states have also recommended combined reporting: Governor Michael Easley of North Carolina, Governor Chet Culver of Iowa, and Governor Edward Rendell of Pennsylvania. These governors all recommended combined reporting as a component of the FY08 tax and budget packages. Other states discussing or considering combined reporting in recent years include New Mexico, Florida, Ohio, and Maryland (Mazero, 2007).

**Figure 1: Combined Reporting for States with a Corporate Income Tax
(as of January 2009)**



⁷ Combined reporting has very different implications in states using a gross receipts tax, such as Texas and Michigan. Combined reporting with a gross receipts tax is intended to ensure that transactions between related companies remain untaxed rather than to ensure that taxable income is properly measured. Therefore, care must be exercised in comparing these states with corporate income taxing states such as Tennessee.

⁸ Combined reporting is effective in Vermont and New York for tax years beginning in 2007. It is effective in Michigan for tax years beginning in 2008 and in Massachusetts and West Virginia for 2009 tax years.

3.1 Illustration of Combined Reporting vs. Separate Reporting⁹

To illustrate the mechanics of the differences between combined reporting and separate reporting, examples are most effective. For the following example, we assume both that Company A and Company B operate only in the U.S. and are the only two members in a unitary group. The companies do not have any inter-company transactions and both have nexus in Tennessee, which uses a three-factor apportionment formula that double weights sales.

Table 1 outlines the pertinent facts including the apportionment factors and taxable income for each company. The first two columns calculate taxable income in Tennessee for each of the companies under a separate reporting regime. The apportionment factor for Company B is calculated as follows: $[(.48 (\text{sales}) + .48 (\text{sales}) + .24 (\text{property}) + .111(\text{payroll})]/4 = .328$. Company A's apportionment is calculated in a similar manner.

The third column combines both the in-state and U.S. totals for each of the three factors as well as the taxable incomes of the two companies and simulates a combined reporting regime. Although the income and apportionment calculations are combined, each company pays its own tax as previously explained. Therefore, the last two columns are shown to demonstrate how the two companies might calculate their individual tax liabilities based on the information contained in a combined report (Column 3). In these columns, each company's in-state factor is the same as if the company filed a separate return, but the denominator is the total factor for the *combined group*. The overall apportionment factor thus calculated is multiplied by the taxable income for the *combined group* to determine the taxable income allocated to the entity. In this example, we apportion 5.2 percent of the combined group's taxable income to Company A: $.052 \times \$8,100 = \423 .

For the example in Table 1, the total tax due to Tennessee is \$2,893 if the companies file separate returns and \$2,884 if they file a combined return. The difference is created when two companies with different apportionment factors combine, but the effect on Tennessee taxable income will vary depending on the size, apportionment factors, and income of each entity in the group. The system wide tax effect is not predictable in advance. Two additional examples in Appendix A (Tables 1 and 2) illustrate the other possible outcomes, with one increasing the tax liability with combined reporting and the other leaving the tax liability unchanged.¹⁰ The three examples together emphasize that combined reporting can increase, decrease, or leave tax liabilities unchanged for a particular business, depending on the specific characteristics of the related businesses.

Also, note that we assume a three-factor apportionment formula with double weighted sales. If, for example, Tennessee had a 100 percent sales apportionment factor, then the only determinant of whether combined reporting would result in different revenue than separate reporting would be the ratio of income to U.S. total sales.

⁹ These examples are adapted and revised from Cline (2008).

¹⁰ Note that these examples are intended to demonstrate how combined and separate reporting operate and how tax liabilities can be increased or decreased with adoption of combined reporting. They are not intended to evidence the effects of including a passive investment company in a combined return.

The examples presume that the same set of corporations is taxable in Tennessee with separate accounting and combined reporting. Tax revenues could also rise or fall if companies that are not remitting taxes under the current separate reporting standards are included in the combined group. We include two additional tables following the discussion of the Joyce and Finnigan rules in Section 4.4 that illustrate this point.

Table 1: Separate vs. Combined Reporting
Revenue Impact – Combined Reporting Decreases Revenue

	A- Separate	B- Separate	Combined	A's Return	B's Return
Apportionment:					
<i>Sales Factor:</i>					
In-State Sales	<u>800</u>	<u>6,000</u>	<u>6,800</u>	<u>800</u>	<u>6,000</u>
Total U.S. Sales	1,000	12,500	13,500	13,500	13,500
In-State Sales %	80.0%	48.0%	50.4%	5.9%	44.4%
<i>Property Factor:</i>					
In-State Property	<u>800</u>	<u>3,000</u>	<u>3,800</u>	<u>800</u>	<u>3,000</u>
Total U.S. Property	1,000	12,500	13,500	13,500	13,500
In-State Property %	80.0%	24.0%	28.1%	5.9%	22.2%
<i>Payroll Factor:</i>					
In-State Payroll	<u>300</u>	<u>1,000</u>	<u>1,300</u>	<u>300</u>	<u>1,000</u>
Total U.S. Payroll	600	9,000	9,600	9,600	9,600
In-State Payroll %	50.0%	11.1%	13.5%	3.1%	10.4%
Total Weighted Apportionment % (Double-Weighted Sales)*	72.5%	32.8%	35.6%	5.2%	30.4%
Taxable Income Total	600	7,500	8,100	8,100	8,100
In-State Taxable Income	435	2,458	2,884	423	2,461
Total Taxable Income to State	<u>2,893</u>		<u>2,884</u>	<u>2,884</u>	
Ratio of Income to U.S. Sales	0.60	0.60			
Ratio of Income to U.S. Property	0.60	0.60			
Ratio of income to U.S. Payroll	1.00	0.83			

* Calculated as a weighted average of the three factors, with 25 percent weight on payroll and property and 50 percent weight on sales.

3.2 Tax Shelters and Tax Planning

Some states enact combined reporting to combat several common but aggressive tax planning techniques. The most common type of tax shelter that proponents of combined reporting seek to alleviate is known as the “Delaware Holding Company” or “Passive Investment Company” (PIC).¹¹ A company that is required to file and pay taxes in a separate reporting state may put intangible property such as trademarks, patents, etc. into a holding company incorporated in Delaware, or another state that does not tax income from these types of properties. The operating entity in a separate reporting state such as Tennessee can normally deduct royalty payments to the PIC for use of the intangible property. The income, however, is not taxable in Delaware and is in fact “nowhere income” that is not taxed in any state. However, if the taxing state were a combined reporting state instead of a separate reporting state, the PIC is effectively disregarded for Tennessee income tax purposes. Some of the combined group’s taxable income will be apportioned to Delaware, but only an amount commensurate with Delaware’s share of the combined entity’s property, payroll and sales. In the typical PIC transaction, such factors will be minimal. All income of the unitary business, including the income of the PIC, would have to be reported to Tennessee. Then, the company that has nexus in Tennessee will calculate its taxable income as a percentage of the total company’s apportionment factors (Mazero, 2007).

Perhaps the most famous example of this type of tax planning is the Toys “R” Us case. Toys “R” Us operated retail stores in South Carolina, a separate reporting state. Geoffrey Inc. is a holding company in Delaware that owns the Toys “R” Us trademark. The corporation operating Toys “R” Us retail outlets located in South Carolina paid significant royalties to Geoffrey for the use of the trademark. These royalties were deductible on Toys “R” Us’s South Carolina tax return and were not taxable to Geoffrey in Delaware.¹²

States have taken differing approaches to dealing with this type of tax planning. Some have written legislation directly aimed at this particular plan. For example, many states requiring separate reporting have enacted addback provisions for related-party royalty or intangible expenses and interest expenses. Under these provisions, certain types of inter-company payments that have been deducted from the income of the paying company are required to be added back to the company’s taxable income. The downside of these provisions is they require the addback of deductions from both aggressive tax planning strategies as well as legitimate business expenses. Also, some states have asserted nexus over the holding companies (such as South Carolina) and some have questioned the business purpose of the PICs (such as Maryland). However, other states have simply enacted combined reporting as a means to alleviate some of these loopholes.

¹¹ Multistate corporations can achieve similar results by siting profits through transfer pricing into a combined reporting state. For example, companies could locate their PIC in California, a combined reporting state. The firm’s liability in California is unchanged because the PIC is already included in the combined group, while income in separate reporting states would still be sheltered.

¹² *Geoffrey Inc. v. South Carolina Tax Commission*, 437 S.E. 2d 13 (South Carolina S. Ct., 1993), *cert. denied*, 114 S. Ct. 50 (1993).

Another form of tax planning involves transfer pricing, or the pricing of assets or services transferred within a company. The movement of goods and services between entities engaged in a unitary business require many transfer pricing decisions. If the goods or services transferred have independent reference points, as might be the case with raw materials, the transfer pricing is straightforward and uncontroversial for companies and tax authorities. However, more often, there is no direct independent reference point for a good or service. This uncertainty creates an opportunity for companies to site taxable income in low taxing jurisdictions by manipulating transfer prices since the amount of the transfer price will determine the allocation of total profit between related companies.

States can address the transfer pricing issue by auditing the price itself. However, even in the absence of any profit shifting motive, determining the “correct” transfer price for a unique product or service is extremely difficult, creating uncertainty for both state taxing authorities and businesses. This is described in some detail in Section 6. Combined reporting is a better solution to transfer pricing issues because the price itself is largely irrelevant to taxing authorities—the inter-company transaction is eliminated on the combined report. However, it is important to note that transfer pricing issues are still present in combined reporting states for transactions between members of the unitary group and non-member, affiliated companies.

4. OTHER ISSUES RELATING TO COMBINED REPORTING

4.1 Voluntary vs. Required Combined Reporting

Many states require combined reporting only in specific cases or allow companies to elect to use combined or consolidated reporting in place of separate reporting. Allowing companies to choose between separate and combined reporting nullifies the usual intended effect of combined reporting, which is that a state taxes the income of a unitary business, unaffected by manipulations for tax purposes. Given an election, each company will simply choose the method that allows it to pay the least amount of tax, resulting in less tax collections for the state. However, some states have a provision in the law that allows the state tax director to permit separate reporting for special situations. This approach is more advisable if combined reporting is not required because special treatment is usually only given in circumstances where the effect of combined reporting on a specific company causes its taxable income to be substantially different from its true economic income in the state. Maintaining elective combined reporting simply allows for more tax planning opportunities.

4.2 Definition of “Unitary”

Combined reporting requires that the income of all members of a unitary group be included in a combined report. The term “unitary” is defined in a number of different ways by the various states that require combined reporting. The general idea is that companies that are engaged in business together, and are commonly owned and controlled, should report their income as combined on the state combined report.

The U.S. Supreme Court has upheld the unitary business principle in general.¹³ Many variations on the unitary business concept exist and many are logically consistent with the underlying principles.¹⁴ However, the Court has identified the following general indicators of a unitary business (McIntyre et al., 2001):

- Unity of use and management;¹⁵
- A concrete relationship between the out-of-state and the in-state activities that is established by the existence of a unitary business;¹⁶
- Functional integration, centralization of management, economies of scale;¹⁷
- Substantial mutual interdependence;¹⁸ and
- Some sharing or exchange of value not capable of precise identification or measurement.¹⁹

¹³ *Mobile Oil Corp. v. Comm’r of Taxes of Vermont*, 445 U.S. 425, 439, 100 S. Ct. 1223, 1232 (1980).

¹⁴ *Container Corp. of America v. Franchise Tax Bd. Of California*, 463 U.S. 159, 167, 103 S. Ct. 2983, 2941 (1983).

¹⁵ *Butler Bros. v. McColgan, Franchise Tax Commissioner of California*, 315 U.S. 501, 508, 62 S. Ct. 701, 704 (1942).

¹⁶ *Container*, 463 U.S. at 166, 103 S. Ct. at 2940.

¹⁷ *Mobile*, 445 U.S. at 438, 100 S. Ct. at 1232.

¹⁸ *F. W. Woolworth Co. v. Taxation and Revenue Dept. of New Mexico*, 458 U.S. 354, 371, 102 S. Ct. 3128, 3139 (1982).

The application of the general rules outlined by the Court, and the state-specific guidelines are difficult in practice. Companies frequently cite uncertainty about the definition of a unitary group as a primary complaint about combined reporting. Indeed, the issue is heavily litigated, and is the area that is most often contested by companies. Therefore, it becomes important that a state defines this term clearly and uses prior court cases to determine the best way to define a unitary business.

Fundamentally, a state can only tax a company that has nexus in the state, meaning the company has some sort of taxable presence, depending on how the statutes for nexus are defined in the particular state. However, through the concept of a unitary business, states are able to tax the income of all members of a unitary group if that unitary business is conducted within the state. Of course, the state can still only tax that part of the income that is apportioned to it. However, because of the unitary principle, more companies will have nexus in a state than without this principle, which allows for combination of the member companies (McIntyre et al., 2001).²⁰

4.3 Water's Edge

Until this point, we have assumed that all members of a unitary group exist and operate only within the U.S. Clearly this assumption is not realistic, and so states must address how to administer combined reporting in the face of foreign operations and/or foreign entities that are members of a unitary group.

Although worldwide combined reporting would be consistent with the principle of a unitary group that reports its combined income, many states have enacted legislation to exempt some foreign income and/or entities from inclusion in the combined report. Typically, if a company makes a water's edge election, the company can exclude certain foreign entities from both the calculation of combined income and the formulary apportionment factors. In addition, some states allow a water's edge election to allow exclusion of certain foreign source income of domestic members of a unitary group.

Administratively, the allowance of this type of election could decrease costs for the combined reporting state since the state will be able to avoid auditing the accounting records of foreign companies. On the other hand, this type of allowance also reduces the effectiveness of combined reporting on preventing certain types of tax shelters as explained above. Similar to the PIC tax shelter, under a water's edge election, companies could move their intangible assets to foreign holding companies in low or no-tax foreign jurisdictions. Because the foreign entity would not be required to be included in the combined report, any royalty income from the domestic members will be excluded from taxation in the U.S. state. Transfer pricing between the domestic members of the unitary group and the foreign members represents another area of tax planning that companies can take advantage of when a state allows a water's edge election.

¹⁹ *Container*, 463 U.S. at 166, 103 S. Ct. at 2940.

²⁰ The extent of taxation depends on whether a Joyce or Finnegan approach is taken. See Section 4.4.

To alleviate some of these potential tax planning strategies, some states require the inclusion of certain foreign entity income even in the case where a water's edge election has been made. These rules are similar to U.S. Federal Subpart F rules where the income from foreign holding companies and controlled foreign corporations (CFC's) with passive income is required to be included in the combined report to the extent of their tax-haven income (McIntyre et al., 2001).

California, for example, has a rule that is known as the "80-20" rule. Under this exception to the water's edge election, any foreign member of the unitary group that has twenty percent or more of its apportionment factors within the U.S. is treated as a U.S. company and therefore included in the combined report. This rule prevents foreign corporations that have substantial U.S. operations from avoiding state tax (McIntyre et al., 2001).

The Multistate Tax Commission's proposed model statute for combined reporting includes a water's edge election that addresses all of the previously mentioned exceptions. The statute also requires a water's edge election to be binding for 10 years so that companies cannot decide from year to year which foreign subsidiaries to include based on the relative profits and losses each year. The statute also gives the state tax director the power to disregard any particular company's water's edge election if tax-avoidance is the purpose (Multistate Tax Commission, 2006).

Of the 21 states that currently require combined reporting, almost all of them have either a water's edge election or some other statute that allows for exclusion of certain foreign entity income (Commerce Clearing House, 2007).

4.4 Joyce vs. Finnigan

Another important consideration relates to the previously mentioned P.L. 86-272 that prevents a state from taxing a company whose only activity within a state is the solicitation of sales of tangible personal property. However, as mentioned in Section 4.2, the concept of a unitary business actually allows a state to require combined reporting that includes the income and apportionment factors of all members of a unitary group, including those that do not have nexus in the state. This concept has become the subject of debate among state legislators and business taxpayers. Some argue that members of a unitary group should be taxed as one taxpayer and therefore all apportionment and income from all members should be included in the taxable income for the group. Others cite P.L. 86-272 and believe that regardless of combined reporting or unitary rules, a state is not allowed to tax any individual company that is protected under the statute. Although P.L. 86-272 is a federal law, the U.S. Courts have yet to make any decision on this issue, and so the state courts have made their own determinations.

Those who would argue that P.L. 86-272 protects the non-nexus members of a unitary group would follow what is called the "*Joyce Rule*."²¹ This rule is derived from a

²¹ *Appeal of Joyce Inc.*, No.66-SBE-070, California Board of Equalization (1966).

California State Board of Equalization (BOE) case in which it was determined that the in-state sales of a member of a unitary group should not be included in the numerator of the group's sales factor if that member is protected under P.L. 86-272. Traditionally, under the concept of a unitary group, the group's income and all apportionment factors are combined. However, the California state BOE argued that including the sales factor of a non-nexus entity would essentially result in taxing an entity that should have been protected from in-state taxation by P.L. 86-272.

Twenty years after the *Joyce* decision, the California BOE decided the *Finnigan*²² case. In this case, one of the member companies of the unitary group had sales to customers in states other than California. Although the unitary group was taxable in some of those other states, the particular member under consideration did not have nexus in the other states. Essentially, then, this company had "nowhere sales" as discussed in section 2.1. Therefore, California required that these "nowhere sales" be "thrown back" for taxation in the state of California. This treatment would have followed the *Joyce* decision, because it implies that although the businesses are members of a unitary group, they are treated as individual taxpayers for purposes of apportionment. However, the California BOE decided instead that the sales were improperly "thrown back," implying that the unitary group should be treated as one taxpayer for purposes of apportionment. The BOE also reversed the *Joyce* decision based on the results of the *Finnigan* case. Although the facts are different in the two cases, the question of how to treat separate members of a unitary group for purposes of apportionment remained the same (Carr and Cara, 2006).

The specifics of the issue are best illustrated with an example. Table 2 contains the basic example from Table 1 except that now we have an additional company, Company C. Company C does not have nexus in Tennessee because its only activity in this state is sales, as evidenced by the apportionment factors shown. Because Company C is part of the unitary group, its taxable income is included in the combined report; however, its treatment of sales to Tennessee for purposes of apportioning income depends on whether the state uses the *Joyce* or *Finnigan* rule. Whether this increases or decreases the group's taxable income in Tennessee depends on the ratio of C's taxable income to the various apportionment factors. Table 3 contains the same example from Table 2, with the exception being income for Company C is \$3,000 instead of \$6,000. In Table 2, combined reporting increases Tennessee taxable income, but in Table 3, the dilutive effect of adding Company C reduces income taxable by Tennessee.

Under the *Joyce* rule, the numerator of the combined sales apportionment factor includes only the sales of Company A and Company B, even though the denominator includes the entire U.S. sales of all three companies. Although Company C has in-state sales, *Joyce* proponents would argue that these sales should be exempt from taxation in Tennessee because Company C does not have nexus under P.L. 86-272. Note that Company C's income is still combined with the other two companies, but this income is apportioned based on only the sales of Company A and Company B (as well as the property and payroll factors). Also, it is important to note that the result using *Joyce* is the same as our separate reporting result (assuming equal ratios of income to total U.S. factors for all

²² *Appeal of Finnigan*, No. 88-SBE-022, California Board of Equalization (1988).

three factors). This result occurs because under *Joyce* Company C's sales are not taxed, and under separate reporting Company C would also pay no tax since it is considered to be without nexus.²³

The next column shows the result using the "*Finnigan* Rule." Under this method, the combined sales factor numerator includes the sales of all three companies. So, under *Finnigan*, Company C is taxed as if it had nexus in Tennessee.

Since the *Finnigan* ruling, the California BOE has gone back and forth between the *Joyce* rule and the *Finnigan* rule.²⁴ The most recent California ruling relevant to the debate of these two treatments came in 1999 when the BOE decided a case²⁵ that put California back in conformance with the *Joyce* rule.

Although the debate has not been settled, most states adhere to the *Joyce* Rule. However, recently the New York State Tax Appeals Tribunal issued an opinion consistent with a *Finnigan* approach.²⁶

²³ Note that if the ratios of income to U.S. factors were not equal for both companies, the separate reporting result would be different from the combined reporting result in both the *Joyce* and *Finnigan* cases.

²⁴ *Appeal of Finnigan*, No. 88-SBE-022-A, California Board of Equalization (1990);
Appeal of NutraSweet Co., No. 92-SBE-024, California State Board of Equalization (1992).

²⁵ *Appeal of Huffy Corp.*, No. 99-SBE-005, California Board of Equalization (1999)

²⁶ *Matter of Disney Enterprise Inc.*, DTA No. 818378, New York State Tax Appeals Tribunal (2005).

Table 2: Joyce vs. Finnigan
Revenue Impact – Combined Reporting Increases Revenue

	A- Separate	B- Separate	C- Separate	Combined- Joyce	Combined- Finnigan
Nexus	yes	yes	no		
Apportionment:					
<u><i>Sales Factor:</i></u>					
In-State Sales	<u>800</u>	<u>6,000</u>	<u>2,000</u>	<u>6,800</u>	<u>8,800</u>
Total U.S. Sales	1,000	12,500	10,000	23,500	23,500
Sales %	80.0%	48.0%	20.0%	28.9%	37.4%
<u><i>Property Factor:</i></u>					
In-State Property	<u>800</u>	<u>3,000</u>	<u>0</u>	<u>3,800</u>	<u>3,800</u>
Total U.S. Property	1,000	12,500	10,000	23,500	23,500
Property %	80.0%	24.0%	0.0%	16.2%	16.2%
<u><i>Payroll Factor:</i></u>					
In-State Payroll	<u>300</u>	<u>1,000</u>	<u>0</u>	<u>1,300</u>	<u>1,300</u>
Total U.S. Payroll	600	9,000	6,000	15,600	15,600
Payroll %	50.0%	11.1%	0.0%	8.3%	8.3%
Total Weighted Apportionment % (Double-Weighted Sales)	72.5%	32.8%	10.0%	20.6%	24.8%
Taxable Income Total	600	7,500	6,000	14,100	14,100
In-State Taxable Income	435	2,458	0	2,904	3,504
Total Taxable Income to State		<u>2,893</u>		<u>2,904</u>	<u>3,504</u>
Ratio of Income to U.S. Sales	0.60	0.60	0.60		
Ratio of Income to U.S. Property	0.60	0.60	0.60		
Ratio of income to U.S. Payroll	1.00	0.83	1.00		

Table 3: Joyce vs. Finnigan
Revenue Impact – Combined Reporting Reduces Income

	A- Separate	B- Separate	C- Separate	Combined- Joyce	Combined- Finnigan
Nexus	yes	yes	no		
Apportionment:					
<u><i>Sales Factor:</i></u>					
In-State Sales	<u>800</u>	<u>6,000</u>	<u>2,000</u>	<u>6,800</u>	<u>8,800</u>
Total U.S. Sales	1,000	12,500	10,000	23,500	23,500
Sales %	80.0%	48.0%	20.0%	28.9%	37.4%
<u><i>Property Factor:</i></u>					
In-State Property	<u>800</u>	<u>3,000</u>	<u>0</u>	<u>3,800</u>	<u>3,800</u>
Total U.S. Property	1,000	12,500	10,000	23,500	23,500
Property %	80.0%	24.0%	0.0%	16.2%	16.2%
<u><i>Payroll Factor:</i></u>					
In-State Payroll	<u>300</u>	<u>1,000</u>	<u>0</u>	<u>1,300</u>	<u>1,300</u>
Total U.S. Payroll	600	9,000	6,000	15,600	15,600
Payroll %	50.0%	11.1%	0.0%	8.3%	8.3%
Total Weighted Apportionment % (Double-Weighted Sales)	72.5%	32.8%	10.0%	20.6%	24.8%
Taxable Income Total	600	7,500	3,000	11,100	11,100
In-State Taxable Income	435	2,458	0	2,286	2,758
Total Taxable Income to State		<u>2,893</u>		<u>2,286</u>	<u>2,758</u>
Ratio of Income to U.S. Sales	0.60	0.60	0.30		
Ratio of Income to U.S. Property	0.60	0.60	0.30		
Ratio of income to U.S. Payroll	1.00	0.83	0.50		

5. TRANSITION ISSUES

5.1 Tax Attributes

Most states allow a carry forward of net operating losses (NOLs) and certain tax credits. In a separate reporting state, each individual company is allowed a reduction to its taxable income or to its tax liability only for NOLs and credits that originated with that company. The state has a choice regarding utilizing the NOL carryforward if combined reporting is implemented. Under one option, the NOLs of one company could offset income of another since the combined report will include both income and losses from all members of the unitary group. If some members of the group have NOLs applicable to the state in question that have remained unused from the separate reporting regime, the transition to combined reporting will allow these companies to use the NOLs against the income of the other members of the group. Depending on the state's carry forward period and the amounts of NOLs available, this transition effect could continue for some time (Cline, 2008).

A second option available to state policy makers is to allow NOLs from one member to offset income from other members only when the NOLs were generated from activities of the unitary business. If, for example, one entity has NOLs that were generated as a part of its business that was not considered part of the unitary business, then that NOL would be allowable as an offset only to that individual company's income.

A similar effect may occur with certain state tax credits depending on the specific provisions in the state tax law for carrying forward the credits. A state transitioning to combined reporting would have to delineate in its statute how to deal with any combinations of carry forwards. It would go against the underlying concept of combined reporting and unitary groups to deny combinations of net operating losses; however, state tax credit laws are so varied that a discussion of the proper treatment of tax credits after adopting combined reporting is beyond the scope of this study.

5.2 Administration and Compliance

As mentioned throughout this report, a combined reporting statute requires consideration of many issues. Combined reporting adoption requires changes to other areas of a tax law as well as new definitions and concepts. In addition, adopters must design new tax forms and will probably require additional audit effort surrounding the determination of unitary groups. However, some auditing around transfer prices between affiliated companies can be decreased since combined reporting alleviates some issues with transfer pricing between members of the unitary group.

Compliance for individual companies may be more or less difficult depending on each company's situation. Many companies already file several combined reports, and so their tax departments or tax preparers already have some idea of which members to include in the unitary group, although the exact specification may vary by state. In addition, some companies have a federal consolidated group that is the same as their state unitary group.

However, for other companies, the costs of making the determination of which companies to include in a unitary group, and the costs of gathering the required information to combine the income of these groups, can be significant. In addition, this determination must be revisited each year for companies that are involved in frequent restructurings, mergers, divestitures, etc.

6. EVALUATION OF COMBINED REPORTING

State policy decisions on whether to adopt combined reporting should be made after considering a number of criteria. In order to inform Tennessee's consideration of combined reporting, we examine combined reporting in terms of four criteria: (1) distribution of the tax burden across firms (proper relative measures of the tax base), (2) economic development consequences, (3) revenues generated, and (4) administration and compliance effects. Of course, these factors are not independent but are interrelated. Economic development effects and revenue effects are particularly connected, because to the extent that undesirable economic effects arise, they do so because the tax burden on firms has risen.

The discussion below presumes that Tennessee wants to measure as accurately as possible the taxable activity that corporations have in the state, use limited resources for tax administration, keep compliance costs low, and enhance the state's economy. The role of tax revenues is more complicated because some may want to increase the amount of tax incident on business and others may not. So, we examine how combined reporting affects revenue but do not seek to interpret the result as either a positive or negative attribute.

We do not seek to reach a conclusion about whether combined reporting should be adopted because that decision must be made in the policy setting arena where the different criteria are examined and weighted according to the state's preferences. Instead, we describe each criterion and how our criteria would be affected by adoption of combined reporting.

6.1 Measure Firm Liability Accurately

The intent of any tax is to spread the burden across taxpayers according to their share of the tax base. For example, the sales tax is intended to share the burden across taxpayers according to their proportion of goods and services purchased or used in Tennessee. The property tax is to distribute the burden among taxpayers according to their proportion of real and tangible personal property in the local jurisdiction. A similar argument holds for the corporate franchise and excise taxes. The intent is to share the taxes among taxable entities according to their proportion of the bases in Tennessee. With each of these taxes, the General Assembly has developed very specific rules for defining the taxable base and therefore the appropriate share to be paid by each firm. Still, principles can be used to determine whether the definitions are consistent with spreading the burden according to good tax policy.

The tax base for a business income tax is corporate profits, and states have a great amount of discretion in determining what is meant by taxable profits, both by defining items includible in income and allowable deductions. For example, allowable depreciation expense is a common item subject to frequent legislative changes. The method of filing (separate or combined reporting) is another variable that can affect the amount of profits subject to tax. An ideal income tax system achieves what economists

describe as “neutrality.” This simply means that the tax should impose the same relative burden on investments in corporations across firms and industries. Non-neutral tax burdens provide tax incentives (or disincentives) to invest in favored (disfavored) industries.

The corporate tax base must be designed using an accurate measure of corporate profits if the relative tax burdens are to be even or neutral. Accurate in this sense means reflective of the underlying economic reality as opposed to numerical accuracy. This requires that the definition of profits be selected so that the burden is distributed properly across firms and industries. This report does not broadly investigate whether the definition of profits is consistent with neutral taxation but only whether the choice between combined reporting and separate reporting results in a more or less accurate measure of corporate profits.

Neutrality requires that Tennessee tax the range of different multistate firms similarly and tax multistate firms similarly to firms that operate exclusively in Tennessee. Separate versus combined reporting is an important dimension of this decision. The performance of separate accounting versus combined reporting can be evaluated by considering the tax treatment of a set of related, unitary corporations under the two approaches. If all related businesses operate within a single state, earn a profit, and are taxable entities, the total tax liability of the related businesses is the same regardless of whether tax returns are filed for each individual firm or together as a combined group.

The tax liability differs if one (or more) of the related companies operates at a loss as others earn a profit because separate accounting does not allow the combined entity to offset profits in one firm with losses in another, but combined reporting does. Combined reporting would lower the tax liability of the total business relative to that paid by the sum of the individual corporations and results in a more accurate liability for the total corporate body.

The story can be very different if separately incorporated entities operate in states besides Tennessee because some members of the group may not pay taxes in Tennessee as a separate corporation but would be taxable if part of a unitary business.²⁷ The result is that a different share of the total firm’s activity is taxable in Tennessee with separate accounting than with combined reporting. The share is often smaller under separate accounting. However, smaller does not necessarily mean that the distribution is not neutral because the goal is to determine the profits earned in Tennessee and not to maximize the tax burden for individual firms.

Separate accounting may not fairly represent the amount of profits that the overall company actually earns in Tennessee for three reasons. The share could be too large or too small, but these reasons give the parent corporation considerable discretion (for example by altering the corporate structure) in determining how much is taxable in Tennessee and it has the incentive to make these decisions to lessen its tax liability. First, transfer prices must be set for transactions between related companies with separate

²⁷ Taxability also depends on whether Tennessee adopted a Finnegan or Joyce structure.

accounting²⁸ and this can be very difficult, particularly if the goods and services that are exchanged are not also sold to unrelated parties. This can occur if one subsidiary of the related businesses produces an input solely for use by another of the related businesses and does not sell to any other buyers. And, the problem becomes even more difficult to address if the input is very specialized and not produced by unrelated businesses for other purposes. Firms have the incentive to determine the transfer price that minimizes taxes and not the one that represents the economic price of a willing buying and a willing seller.²⁹

Second, related corporations often are commonly owned because economies of scope can arise when entities produce a number of different products, and economies of vertical integration can exist when entities produce at several levels in the production chain. For example, economies of scope exist if a parent can lower costs (or raise revenues) by owning both an oil corporation and a coal corporation. Economies of vertical integration exist if a parent has a corporation that produces auto parts, another that assembles automobiles and a third that finances auto sales, and the overall cost of delivering these components of the production process is lower because the same parent controls them. No economics or accounting methodology allows the benefits of the economies to be definitively split between the contributing companies since there is no reliable means of determining which firm is responsible for the additional profits (and indeed, no individual firm may be responsible). As a result the parent corporation has considerable discretion over which firms to attribute the additional profits and likely where the income is attributed.

Third, shared costs, such as for the parent corporation's management, finance, and computer functions should be allocated across the member firms, but there are no clear means of making the allocations. Under separate accounting the costs could be borne entirely by the parent corporation or distributed to the member firms using some type of transfer pricing. Combined reporting with apportionment assigns the costs to states based on where the factors are located without trying to measure where the specific benefits of the parent functions are received.

The basic conclusion reached here is that combined reporting is more likely to result in reasonable measures of the relative tax burden across firms (more neutral treatment across firms) that are less controllable by decisions on corporate structure and transfer prices. Therefore, combined reporting is more likely to limit the potential for tax planning. With separate accounting, those firms that are best able to use tax planning, such as many multistate/multi-firm corporations, are able to lower their tax liability relative to firms that are less able to engage in tax planning, such as many firms that only

²⁸ With combined reporting, transfer prices must be set between members of the combined group and other members owned by the parent and potentially between the combined group and foreign subsidiaries.

²⁹ Tax planning using Delaware holding companies is an example of transfer prices set to lower the tax burden by shifting income to states, such as Delaware, where it is not taxed. But, there is no misstatement of income if transfer prices are properly set for the services provided by the intangible holding company. Of course, the tax advantage of siting intangibles in Delaware persists even if the transfer prices are properly set because Delaware chooses not to tax the income.

operate in Tennessee.³⁰ Ensuring that transfer prices are properly set can deal with several, but not all of the problems. Further, there may be no reliable means of setting transfer prices for some transactions (such as in the allocation of economies of scope and shared costs), and the costs of auditing the transfer prices is very high.

6.2 Economic Development and Tax Revenue

Measuring the economic development and tax revenue implications of combined reporting are both the most difficult tasks and the most important tasks in informing the decision on whether combined reporting would be good policy for Tennessee. The argument for combined reporting is often focused on the ability to reduce abusive tax planning, as described in the previous section, but with the expectation that it generates more tax revenues. The issue in this section is whether the strategy results in additional tax revenue. The tax revenue and economic development effects are closely linked because the effects of combined reporting on economic development, to the extent that they exist, arise because firms attach a perception (which is presumably negative) to states that use combined reporting that influences their willingness to produce in a state. Also, if the policy generates additional revenue then it means that the effective corporate tax rate is higher, which raises the costs of operating in Tennessee and could affect the willingness to produce in the state.

Two basic options exist for evaluating the revenue consequences of combined reporting. The first is to use some form of simulations based on taxpayer data, which in Tennessee would need to be enhanced with data from another state to estimate how combined reporting would affect specific businesses. The second is to use statistical/econometric techniques to measure the effect of combined reporting. The following evaluates these alternatives and describes the findings that exist using each approach. We conclude that the statistical approach is preferred and place greater weight on the findings using this approach.

6.2.1 Tax Simulations

The Tennessee Department of Revenue (TDOR) does not have the requisite information using existing tax return data to calculate the tax liabilities that would exist if combined reporting were adopted. As described below, the use of such data to estimate effects of combined reporting is very suspect even if the data existed. TDOR does not have data on related firms to calculate the tax liabilities that would be due to Tennessee if the state imposed combined reporting and it is not possible for the state to have data on how taxes would be filed if Tennessee imposed combined reporting because firms have not been required to file in this fashion. Firms are not required to report data to the Department of Revenue on the related businesses that would form a combined group for Tennessee or to provide information on the tax characteristics and apportionment factors of the related

³⁰ Of course, single state firms can often buy tax planning services that allow them to also use tax planning strategies.

businesses. Firms are only required to file separate returns, which do not include information on which firms would file a combined return, which firms would be in the combined group, and other necessary information to approximate combined returns. Further, no information is available for firms that are not currently filing in Tennessee, but would file as part of a combined group. As a result, Tennessee tax return data cannot be used directly to measure the effects of combined reporting.

Tennessee requires firms to file an “Intangible Expense Disclosure Form” for intangible payments made to related businesses as defined by TCA Section 67-4-2004. This form provides some data (see Appendix C for copy of the return) on the recipients of intangible payments made to related firms such as whether they file income and franchise tax returns for Tennessee, location of the principle business activities, types of intangible property for which expenses were incurred, the number of full time employees and the value of real and tangible personal property. But the form does not require firms to determine whether the recipient of the intangible revenue would be part of a unitary group, nor to report the apportionment factors for Tennessee for the intangible recipient, income of the firm, and so forth.

Several separate reporting states have sought to approximate the potential revenues from adopting combined reporting by working with actual firm tax records. Iowa is a separate reporting state that *allows* but does not require firms to file a combined return. The Iowa Department of Revenue sought to determine the effects of combined reporting on revenues by matching firms filing Iowa returns with federal returns using data for 2000-2003.³¹ The study describes the match rate as “not good” at least in part because the state was only able to match about 51.5 percent of firms that file separately in Iowa but consolidate their returns for federal tax purposes. The low match rate raises considerable question about the reliability of the results. The study finds that the tax liability of affected firms (for which matching data could be found) would be nearly doubled. For example, in 2002 the firms paid \$82.7 million in taxes and would have owed \$182.1 million, though the additional revenues would have been smaller in 2003. The study must make a number of assumptions, which likely impact the results, including that all firms filing a consolidated return would be part of a unitary group. Further, banks, insurance companies and foreign firms are included in the combined groups for the study, but would not be included in the combined group under Iowa law.

Pennsylvania is a separate reporting state that sought to determine the effects of combined reporting by simulating the taxable income of potential combined reporting firms.³² Pennsylvania has 138,000 C corporations and determined that 63,500 were single filers at both the state and federal levels and would not be affected by combined reporting because their federal and Pennsylvania incomes were the same. The remaining 74,500 C corporations potentially could be affected by combined reporting. Minnesota, a combined reporting state, provided relevant data to Pennsylvania for the 6,472 firms where the taxpayer identification numbers could be matched for the two states. Pennsylvania chose

³¹ Iowa Department of Revenue, “Combined Reporting: An Option for Apportioning Iowa Corporate Income Tax,” March 2007.

³² Pennsylvania Department of Revenue, “The Impact of Combined Reporting on the Corporate Net Income Tax,” February 25, 2005.

to evaluate the 107 combined groups where the income reported for the combined group in Minnesota exceeded the income reported to Pennsylvania by at least \$1 billion. An additional sample of 123 combined groups where differences between state and federal reported income were smaller was also analyzed. The state used painstaking methods to parallel the companies in Pennsylvania so that combined returns could be estimated for Pennsylvania. The tax liability for the simulated combined returns for the small sample of firms was then compared with the liability measured using the separate returns that were currently filed in Pennsylvania. The study found that tax revenues for the small sample of combined groups would be increased by 24 percent with combined reporting. The Pennsylvania Business Tax Reform Commission, for which the study was performed, concluded that the tax rate should be lowered to offset the revenue gain if combined reporting is adopted.

Rhode Island recently completed a study using a methodology similar to Pennsylvania's.³³ The state began by asking New Hampshire, a combined reporting state, to provide matching combined reporting data for the 200 largest taxpayers in Rhode Island (which are not necessarily the 200 largest firms). The result was 35 matches. Rhode Island also sought to develop combined returns for the 30 largest Rhode Island firms³⁴ based on gross receipts so that a sample of 65 firms was developed. These 65 firms provide less than five percent of total tax liabilities and are taken from more than 44,000 corporate income tax filers. The state found that six firms would see a tax decrease and 18 would see a tax increase. In total, the tax liability would rise from \$5.9 million to \$14.4 million for the 65 firms. But, this result cannot be extrapolated to the entire taxpaying population because the sample is not randomly drawn.

Similar methodologies of analyzing tax return data could be adopted to examine the effects on Tennessee, but we do not believe that either of these approaches (or a related one) is a reliable means to approximate the revenue implications for the state. The estimated revenue gains in these studies vary widely, ranging from 24 percent in Pennsylvania to 144 percent in Rhode Island. We also believe that the approaches used by Iowa, Rhode Island and Pennsylvania overstate the potential revenues from combined reporting. First, as previously observed, the combined group can differ across states both because of state specific statutes (e.g., how foreign firms are treated) and the particular characteristics of firm operations. As a result, it is not reasonable to expect the combined groups for Pennsylvania to be the same as for Minnesota. The problem would be further complicated for Tennessee because no southeastern states require combined reporting, so the state would likely need to obtain the matching data from a state with a different tax structure and a very different economic base. A related point for the Pennsylvania and Rhode Island studies is that the sample sizes are very small and the samples are not random for any of the studies. For example, the Pennsylvania sample only contains firms where a match existed between Pennsylvania and Minnesota and a small group of other firms. The Rhode Island study included some firms that did not match with New Hampshire, but did not randomly select the sample. For example, the large taxpayers that have been selected for these studies may be large because they use tax planning less

³³ Rhode Island Department of Revenue, Division of Taxation, "Report to the General Assembly on Combined Reporting of the Corporate Income Tax," December 2008.

³⁴ It is not clear how combined returns were developed for these 30 firms.

aggressively than other firms in the states. The studies do not try to examine the effects of combined reporting using a random sample, nor do they seek to correct the results for the lack of randomness.

Second, the greatest problem with using taxpayer data to measure effects of combined reporting is that firms are presumed to accept higher tax liabilities with no adjustment in their production and real economic activity or in their tax planning. The approaches assume that firms do not alter their corporate structure or use other means for *tax planning* once combined reporting is adopted, which are likely not good assumptions. For example, firms may set up intangible holding companies outside the US and have their Tennessee corporations make payments to the foreign companies rather than domestic companies. In principle Tennessee could, but probably would not, choose to have worldwide combined reporting so that the foreign recipient of intangible payments would not be part of the combined group. Alternatively, firms could change their transactions between related companies to prevent some firms from having nexus in Tennessee. The data that Pennsylvania obtained from Minnesota presumably reflected some adjustments made by firms filing in Minnesota so it should have accounted for some tax planning in a state with combined reporting. However, more than one-half of the sample was firms for which the data were not matched.

Also, firms could choose to reduce their production in states that require combined reporting and this would lower the tax liability, as well as reduce economic activity in the state. We address this issue in the economic development section above.

6.2.2 Statistical Analysis

We believe that statistically based regression analysis of the revenue collected by states with and without combined reporting is the best means to measure revenue effects. The methodology involves “holding constant” the effects of all other influences on state corporate tax revenues and then measuring whether states with combined reporting raise more revenues than states without combined reporting. The analysis uses actual tax revenue data from all states to examine whether states with combined reporting actually raise more revenue than states without combined reporting. This method allows us to examine the effects of combined reporting on revenues after all of the business responses to the presence of combined reporting, such as tax planning and movements of economic activity, have occurred. It also allows us to deal with statistical problems, such as the lack of randomness that was described above. Analysts generally prefer the regression-based methods to simulation methods for examining the effects of complicated policy changes because it is possible to separate the effects of other economic and tax policy effects from the policy in question, which in this case is combined reporting. Regression methods are used frequently in academic, policy and government analyses.

We know of no prior statistical analysis of how combined reporting affects tax liabilities so we undertake the statistical analysis for this project. First we review related findings from several academic studies. Two related papers written by authors of the present study consider combined reporting as one part of their research, though neither was focused on

the effects of combined reporting. Bruce, Deskins and Fox (2005) examined whether state corporate tax bases are becoming increasingly mobile. Combined reporting was included in their analysis, but some states may have been misreported as requiring combined reporting in the databases. They find that the tax base³⁵ is unaffected by the simple direct presence of combined reporting but that the tax base is higher with combined reporting when the effects of combined reporting are interacted with various state policies such as sales apportionment, throwback rule, and tax rate. Fox and Luna (2005) find evidence that combined reporting offsets some, though less than one-half, of the narrowing of the corporate tax base that occurred in the late 1990s. A more recent study by Gramlich et al. (2008) finds that combined reporting increases the effective tax rate on corporations but does not increase corporate tax revenues.

6.2.3 Effects on Tax Revenues

This section describes the empirical analysis that we undertook for this study and the results of how combined reporting affects state tax revenues. The first step of the analysis was to examine annual corporate tax revenues for two states that have recently enacted combined reporting, Vermont and New York, to determine whether there is any visual evidence demonstrating that tax revenues rose in these states in the years following adoption of combined reporting. Table 4 provides national average growth rates for the state corporate income and corporate license taxes (including taxes such as the Tennessee Franchise Tax) for purposes of comparison. Exhibits 1 and 2 describe the revenue experience for both New York and Vermont for FY 2007 and 2008. As can be seen in Exhibit 1, Vermont experienced no increase in corporate income tax revenues after adopting combined reporting, but a series of other policy changes, including a rate decrease, were enacted with combined reporting. New York also had other policy changes concurrent with adopting combined reporting, and experienced very strong corporate income tax revenue growth in 2007 but lost about one-half of the revenue growth in 2008 (see Exhibit 2). New York exaggerated the national pattern in each year. New York's and Vermont's experience of enacting combined reporting with other policy changes illustrates the necessity of evaluating the revenue consequences in a multiple regression context where all changes can be taken into account.

Table 4: Average State Revenue Growth by Tax Source, FY 2007 and 2008

Revenue Source	FY 2007	FY 2008
Corporate Income Tax	12.5	-6.5
Corporate License Taxes	9.6	17.2
Total Corporate Taxes	12.1	-3.3

Source: Authors' calculations based on U.S. Census data.

We now proceed to describe our more technical analysis. The statistical analysis uses the characteristics of state tax structures and the size of the state economy to explain the

³⁵ Tax base is estimated as tax revenue divided by tax rate, which the authors recognize is only approximately true given the timing of payments, late fees, and other factors.

amount of corporate tax collections received by each state.³⁶ Combined reporting versus separate reporting is one of these characteristics and we are seeking to determine whether the evidence demonstrates that states with combined reporting raise more tax revenues than other states, given the other aspects of their economy and tax structure.

A wide range of data on state economies, tax collections, and tax structures was collected for 1994 through 2008³⁷ to estimate the effects of combined reporting.³⁸ Specifically, an equation was estimated for state tax revenues as a function of the following corporate tax structure characteristics:³⁹

- Corporate income tax rate
- Sales factor percent of apportionment
- Throwback rule
- Deductibility of federal corporate income taxes
- Required combined reporting

In addition, revenues are allowed to depend on the extent of tax and non-tax incentives used by states, the presence of laws allowing limited liability companies, and the maximum personal income tax rate and sales tax rate.⁴⁰ Finally, tax revenues are presumed to depend on the level of the state economy as measured by state Gross Domestic Product in the private sector.⁴¹ A listing of all explanatory variables is contained in Table 5.

A second version of the equation was structured to examine how the interaction between the various tax structure characteristics affects revenues. Specifically, we examine whether the effects of combined reporting on revenues depends on the level of the corporate income tax rate, reliance on the sales factor in the apportionment formula, and

³⁶ The analysis is conducted using a two-stage panel model with fixed effects for states and a non-linear time trend. State GDP is estimated in the first stage and is described in the economic development section below.

³⁷ U.S. Census Bureau state corporate tax revenue data were used in order to have the greatest consistency in state tax revenues. Census provides two state tax series, one based on quarterly reports and the other on fiscal year reports. We generally judge the annual data to be more reliable because they are more likely to be based on a consistent set of final accounts and are more likely to include any changes or corrections. However, fiscal year data are only available through 2007, while quarterly data are available through 2008. We wanted to include 2008 in the analysis because Vermont and New York enacted combined reporting that was first effective for tax years beginning in 2007 and we wanted to include any possible effects from these new states (much of the revenue effects may not be felt until fiscal 2008 because of the timing of corporate tax payments). Thus, analyses are done both through 2007 and through 2008, where the latter includes the annual data for 1994-2007 and the annualized quarterly data for 2008. The Tennessee quarterly and annual data as reported by the Census Bureau are essentially the same for 2007, and the combined F&E totals are about \$10 million lower than Tennessee currently reports as the accrual numbers for the year.

³⁸ Alaska and Hawaii were excluded from the analysis.

³⁹ The explanatory variables are lagged one year because of the differences between fiscal and calendar years in the data and because some data are not available for 2007 or 2008. State GDP and corporate tax revenues are entered in natural log form in the regression analysis.

⁴⁰ The model also includes fixed effects for states to account for unexplained unique characteristics of individual states and a time trend to account for any unexplained time varying factors.

⁴¹ A separate set of equations was estimated using population rather than state GDP to measure the size of the state economy. The results were qualitatively the same.

presence of a throwback rule. Similarly, the effects of the tax rate were allowed to depend on the other tax structure characteristics, sales apportionment and throwback rules.

Results of the statistical analysis are reported in Table 6 for the corporate income tax collections and in Table 7 for corporate and franchise tax revenues combined. A qualitative summary of the results is provided in Table 8 for those wanting to skip the detailed analysis. Table 8 only evidences the direction of effect on tax revenues for statistically significant variables. The statistical analysis was conducted with numerous robustness checks in an attempt to find any evidence that combined reporting affects revenues, and we believe the reported equations are the most statistically reliable of the analyses performed. The column for Model 1 in each table evidences the analysis of combined reporting without considering how it interacts with other policies, and the column for Model 2 evidences the analysis of combined reporting, both on its own and as it interacts with other state tax policies. In all cases, we are looking for evidence that the presence of combined reporting has a “statistically significant” effect on the amount of tax revenue that is collected.

Exhibit 1

Vermont

Combined reporting was adopted effective for tax years beginning in 2006 and later. Corporate income tax collection decreased by about \$2.7 million (in nominal dollars) from 2006 to 2007, and then increased the following year by \$1.4 million. Effective for 2006, Vermont also switched from an equally weighted three-factor apportionment formula to a double-weighted sales factor. The highest bracket tax rate decreased from 9.75 in 2005 to 8.9 in 2006 and then 8.5 in 2007. Effective beginning in 2007, the top bracket was collapsed into the second highest bracket. Previously the top bracket included income from \$250,001 and higher. For 2007 and later years, the top bracket now includes income over \$25,001.

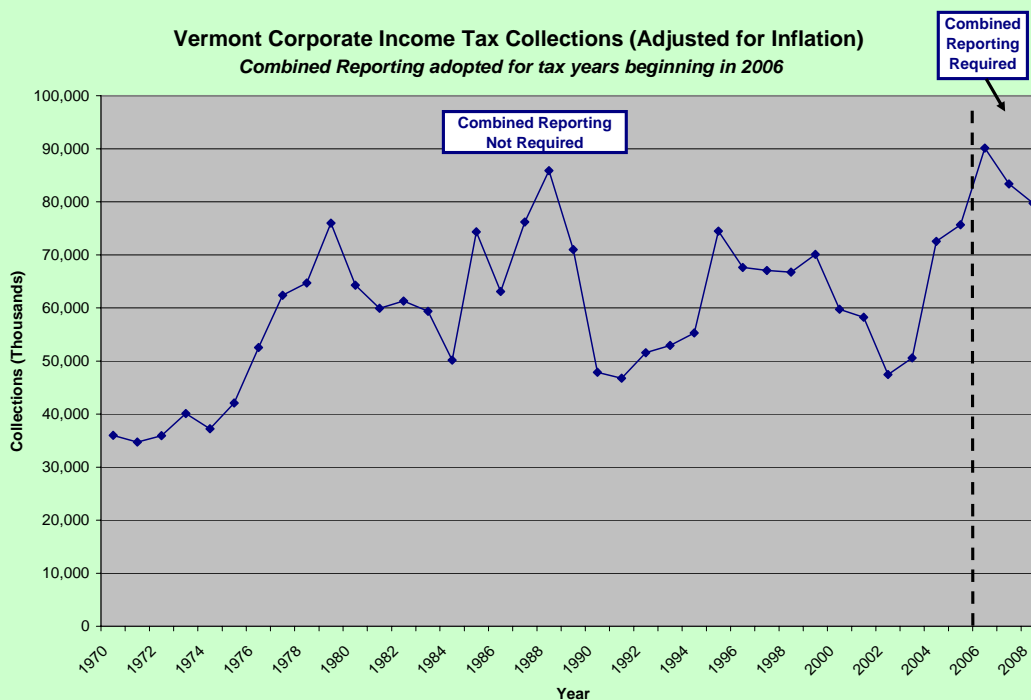
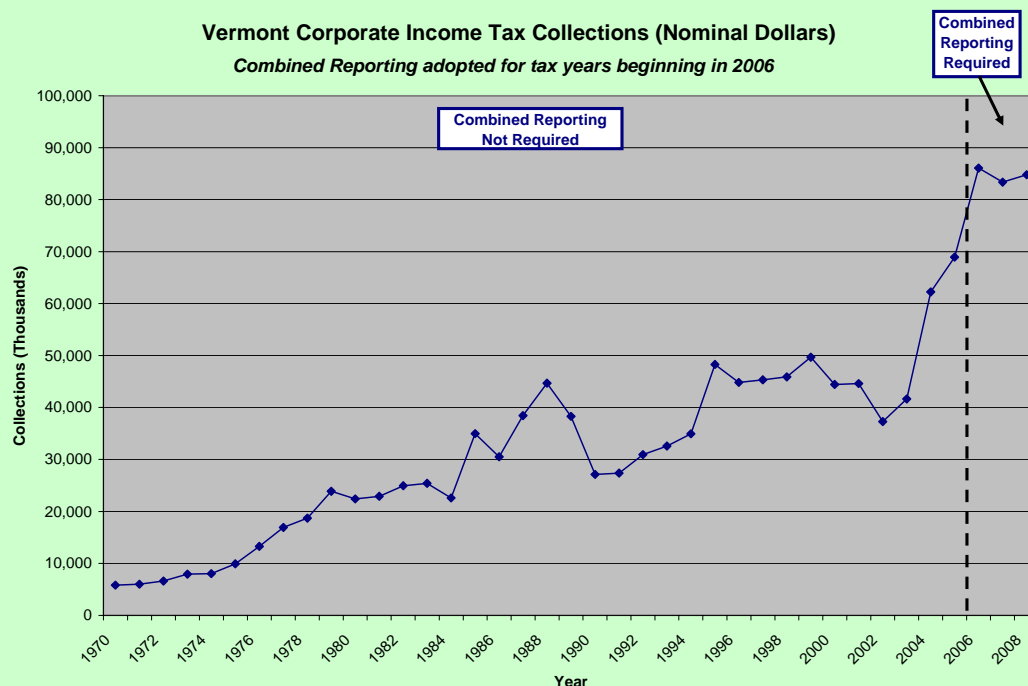


Exhibit 2

New York

Combined reporting was adopted effective for tax years beginning in 2007 for companies with substantial inter-company transactions. Corporate income tax collection decreased by about \$680 million (in nominal dollars) from 2007 to 2008. Effective for 2006, New York switched from a double weighted sales factor apportionment formula to a 60 percent weighted sales factor. Then, for 2007 a 100% sales factor apportionment formula was adopted.

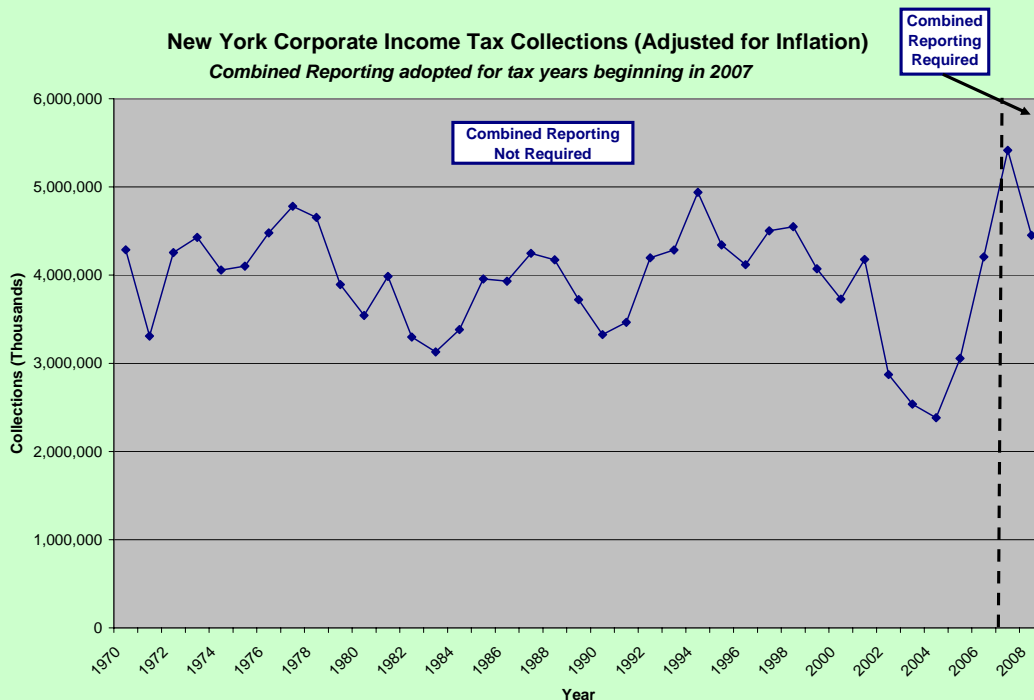
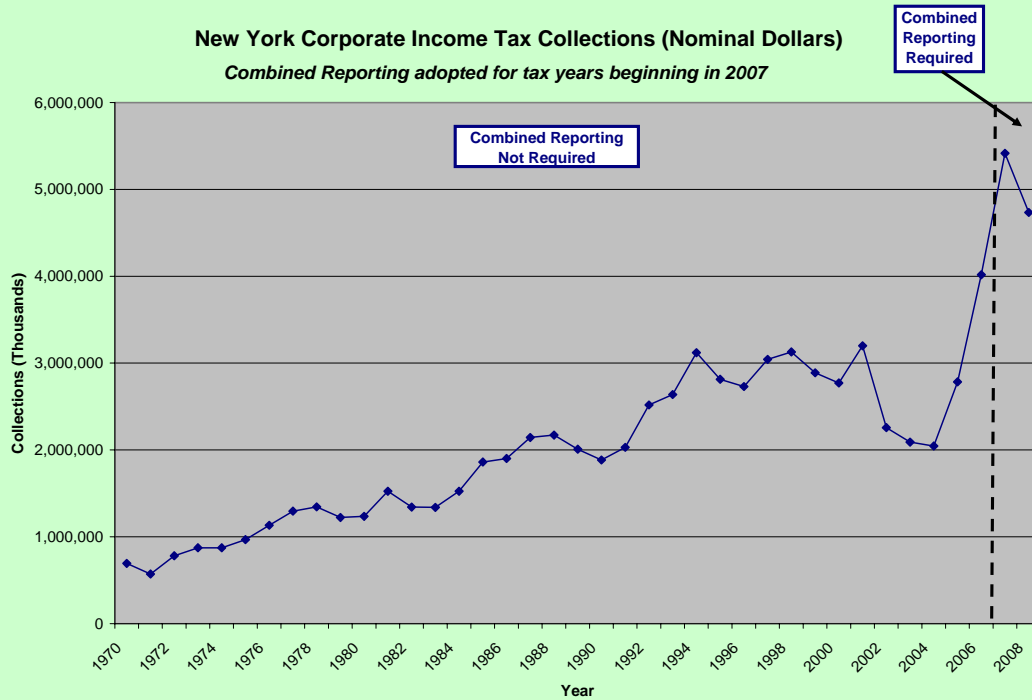


Table 5: Variable Names and Acronyms

State private gross domestic product	GDP
Corporate income tax rate	CIT rate
Personal income tax rate	PIT rate
Sales tax rate	Sales tax rate
Sales apportionment percentage	Sales apportionment
Combined reporting	Combined reporting
Allow limited liability companies	LLC
Enforce throwback rules	Throwback rule
Allow deductibility of federal tax	Federal deductibility
Number of tax incentive programs	Tax incentives
Number of non-tax incentive programs	Non-tax incentives
Time since 1994	Trend
Time since 1994 squared	Trend ²

As reported in Table 6, we find no evidence in the statistical analysis that adopting combined reporting has affected state corporate income tax revenues, either by increasing them or decreasing them. The measured effect is very small, sometimes negative, and never statistically significant at any level normally used for analysis. This result is consistent regardless of the time period analyzed, the other variables included in the equation and the way in which we measured combined reporting. In other words, we find no evidence that states with combined reporting collect more revenue than states using separate accounting given the other elements of their tax system and their economy. The result is similar when combined reporting is interacted with other elements of state corporate tax policy.⁴²

⁴² Neither the t-test of significance for the combined reporting term, nor an f-test of significance of the set of variables containing combined reporting is statistically significant at conventional levels.

Table 6: Determinants of Corporate Excise (Income) Tax Revenue

Variable	Model 1	Model 2
GDP	2.217***	2.188***
CIT rate	0.071***	-0.046
PIT rate	0.013	0.009
Sales tax rate	0.009	0.015
Sales apportionment	-0.002	-0.022**
Combined reporting	0.069	-0.158
LLC	0.279***	0.458*
Throwback rule	-0.029	0.458
Federal deductibility	-0.114	-0.079
Tax incentives	-0.010*	-0.010
Non-tax incentives	0.001	-0.002
Year2008	-0.135***	-0.140***
Trend	-0.230***	-0.230***
Trend ²	0.010***	0.010***
CIT*Sales apportionment		0.003**
CIT*Combined reporting		0.068
CIT*LLC		-0.021
CIT*Throwback rule		-0.036
Combined reporting*Sales appt		-0.005
Throwback rule*Sales appt		0.001
Combined reporting*Throwback		-0.311
Constant	-27.724***	-26.552***
Observations	630	630
Adjusted R-squared	0.863	0.848

Note: Corporate revenue and GDP are in natural logs.

*significant at 10% level of confidence.

** significant at 5% level of confidence.

***significant at 1% level of confidence

Table 7: Determinants of Corporate Excise and Franchise Tax Revenue

Variable	Model 1	Model 2
GDP	2.125***	2.079***
CIT rate	0.070***	-0.041
PIT rate	0.012	0.009
Sales tax rate	0.008	0.014
Sales apportionment	-0.002	-0.022**
Combined reporting	0.068	-0.150
LLC	0.277***	0.461**
Throwback rule	-0.027	0.493
Federal deductibility	-0.113	-0.078
Tax incentives	-0.011*	-0.010*
Non-tax incentives	0.001	-0.002
Year2008	-0.134***	-0.140***
Trend	-0.224***	-0.223***
Trend ²	0.010***	0.010***
CIT*Sales apportionment		0.003**
CIT*Combined reporting		0.067
CIT*LLC		-0.022
CIT*Throwback rule		-0.040
Combined reporting*Sales appt		-0.005
Throwback rule*Sales appt		0.001
Combined reporting*Throwback		-0.316
Constant	-26.053***	-24.619***
Observations	630	630
Adjusted R-squared	0.865	0.848

Note: Corporate revenue and GDP are in natural logs.

*significant at 10% level of confidence.

** significant at 5% level of confidence.

***significant at 1% level of confidence

Table 8: Factors Affecting State Corporate Excise Income Tax Revenue

Variable	Income	Income and Franchise
GDP	+	+
CIT rate	+	+
PIT rate		
Sales tax rate		
Sales apportionment	-	
Combined reporting		
LLC	+	+
Throwback rule		
Federal deductibility	-	
Tax incentives	-	-
Non-tax incentives		
Trend	U - shaped	U - shaped
CIT*Sales apportionment	+	
CIT*Combined reporting		
CIT*LLC		
CIT*Throwback rule		
Combined reporting*Sales appt	+	+
Throwback rule*Sales appt		
Combined reporting*Throwback		

The equation demonstrates that state corporate tax revenues rise with the size of the state economy and the state corporate income tax rate and surprisingly with adoption of LLC legislation. Revenues fall with greater use of tax incentives, which is not surprising because the incentives erode the base. The time trend also evidences that corporate tax revenues across the country were falling in the years after 1994 but have been rising more recently (during the end of the economic expansion).⁴³

The analysis was extended to examine the effects of combined reporting on corporate income and franchise tax collections (Table 7). For this purpose, franchise taxes include any corporate tax that is defined by the Bureau of the Census as a “license tax.” Combined reporting is again found to have no direct or indirect effect on tax revenues. That is, the coefficients related to combined reporting are not statistically significant in either of the columns.⁴⁴

The findings differ to some extent from those obtained by Bruce, Deskins and Fox and Fox and Luna. Several factors could contribute to the difference. First, all studies started by using data from Commerce Clearinghouse (CCH) to determine whether states have required combined reporting during each year. The data have been reported inconsistently over the years, and our earlier studies, which were not focused on combined reporting,

⁴³ The negative sign on the time trend dominates in the early years and the positive effect of the time trend squared dominates in the latter years.

⁴⁴ An F-test of the combined effects of all terms involving combined reporting is statistically insignificant in both Tables 7 and 8.

did not seek to deal with these inconsistencies. For the current study, we spent considerable effort to ensure that combined reporting was properly measured for each state and this changed the combined reporting status for some of the states compared to the CCH data. Second, the time period studied differs. Earlier studies examine data through 2002, and the current study includes data through 2008. The earlier studies also examine some earlier years, but we have less confidence in the data from the earlier years. The current analysis that finds no effect of combined reporting suggests that its effects may be diminishing as firms are better able to plan their tax liabilities in the face of the policy. Third, the Bruce, Deskins, Fox study examined tax base, not tax revenue. The tax base measure could result in a different conclusion from tax revenue. Finally, a study by Bruce and Deskins (2008) finds that self employment rates and other measures of entrepreneurial activity rise in states with combined reporting, which suggests the use of tax planning to avoid additional tax liabilities that might arise with combined reporting.

Where do these findings leave us? It is very unlikely that substantial additional tax revenue is being raised by states with combined reporting given our inability to find evidence in a careful statistical analysis that is focused on its effects. Perhaps states that require combined reporting systematically alter some other policy that is not accounted for here, such as reducing their auditing resources. Earlier empirical studies found a minimal effect of combined reporting but our current analysis finds almost no evidence that additional revenues would result. We conclude that combined reporting may increase tax revenues (even though we find no empirical evidence this is occurring), but by a relatively small amount and probably only for a short period as firms develop alternative planning arrangements or further change their operating behavior. We reach this conclusion based on our qualitative judgment that if combined reporting has an effect on revenues, it would be to increase them. Thus, we would not forecast that Tennessee would collect significant additional tax revenue if combined reporting were adopted.

6.2.4 Effects on State Gross Domestic Product

Previous Research

Combined reporting could affect the economic performance of a state by altering the willingness of firms to startup, locate, expand, or produce in Tennessee. These effects could occur either because firms pay higher tax liabilities with combined reporting and this discourages business activity or because the presence of combined reporting alters firms' perceptions of the state economy and thereby their willingness to operate in the state. If we presume that combined reporting results in somewhat higher tax burdens, then consideration of the first point should focus on how firms respond to higher effective tax rates. The perception issue is more difficult to examine because combined reporting is only one factor in determining business climate, but combined reporting surely diminishes perceptions of the environment, even if not enough to hurt the economy.

The effects of taxes on the location of economic activity have been widely studied. Previous research has demonstrated that higher state business taxes diminish state economic activity, though the effects are generally modest (see Wasylenko, 1997 for a

summary of the literature). Thus, the small increase in the effective tax rate that might be resulting from combined reporting is expected to slightly diminish the Tennessee economy. And, combined reporting has its effects on the effective tax rate of multistate firms that are more likely to be economically mobile than Tennessee only firms.

Statistical Analysis

No study has sought to directly address the degree to which combined reporting influences the economy. Our analysis of how combined reporting affects tax revenues was undertaken while simultaneously examining whether the state economy, as measured by state Gross Domestic Product, is affected by combined reporting. This is examined by estimating an equation to determine Gross Domestic Product as a function of a number of factors including whether the state imposes combined reporting. The equation is the first stage of the results reported in Tables 6 and 7. The analysis accounts for effects that combined reporting would have by possibly raising the effective tax rate and by altering perceptions of the state business climate.

An equation to examine determinants of state GDP was used in the first stage of the revenue regression. Then, the predicted state GDP is used as one factor, explaining the amount of tax revenue raised in states. Combined reporting is one of the policy variables included in the equation to estimate GDP to determine whether economic activity is larger or smaller in states that require combined reporting as opposed to separate accounting. Other policy variables used in the equation include the corporate income tax rate, allowance of the LLC structure and others in the revenue equation. In addition, factors affecting the cost of doing business in a state are included, such as wages and energy prices. The results of factors affecting state GDP are shown in Table 9, and qualitative analysis of the direction is reported in Table 11. As in Tables 6 and 7, the column for Model 1 examines combined reporting without the various interaction results and the column for Model 2 allows tax policies to be interacted. These results have been merged in Table 10.

The equations reported in Table 9 find no evidence that the existence of combined reporting affects GDP. This is not a surprising result since we also find no statistical evidence that combined reporting affects tax revenues. The results provided in Table 9 and 11 are based on all 48 continental states. A separate analysis of combined reporting was undertaken using the 42 states that impose a corporate income tax. These regressions provide evidence that combined reporting lowers state GDP in cases where the corporate tax rate exceeds 8 percent. Though Tennessee's excise tax rate is lower than 8 percent, the effective rate when combined with the franchise tax is higher than 8 percent, suggesting that combined reporting might have a small negative effect on the economy.

Table 9: Determinants of State Gross Domestic Product

Variable	Model 1	Model 2
CIT rate	-0.007*	0.053***
PIT rate	-0.006**	-0.004*
Sales tax rate	-0.009*	-0.011*
Sales apportionment	0.000	0.004**
Combined reporting	-0.020	0.113
LLC	-0.058***	0.001
Throwback rule	0.027*	0.272***
CIT*Sales apportionment		-0.001**
CIT*Combined reporting		-0.015
CIT*LLC		-0.007
CIT*Throwback rule		-0.026***
Combined reporting*Sales appt		0.001
Throwback rule*Sales appt		0.000
Combined reporting*Throwback		-0.045
Federal deductibility	-0.007	-0.005
Tax incentives	-0.003***	-0.002
Non-tax incentives	-0.004***	-0.002***
Population	0.000***	0.000***
Median Income	0.002***	0.003***
Population density	0.000	0.000
State expenditure per capita	0.002	0.004
Average wage	-0.013***	-0.012***
Energy price	0.002	0.002
constant	18.762***	18.264***
Observations	720	720
Adjusted R-squared	0.961	0.963

Note: All models include fixed effects for state and year.

*significant at 10% level of confidence.

** significant at 5% level of confidence.

***significant at 1% level of confidence.

Table10: Factors Affecting State Gross Domestic Product

Variable	
Population	+
CIT rate	+
PIT rate	-
Sales tax rate	
Sales apportionment	
Combined reporting	
LLC	-
Throwback rule	+
Federal deductibility	
Tax incentives	-
Non-tax incentives	-
Time	
CIT*Sales apportionment	-
CIT*Combined reporting	
CIT*LLC	
CIT*Throwback rule	-
Combined reporting*Sales appt	
Throwback rule*Sales appt	
Combined reporting*Throwback	
Median income	+
Per capita state government expenditures	-
Average wages	-
Energy prices	+

6.3 Compliance and Administration

Analysts generally expect combined reporting to create complexities in the corporate tax system. However, the reality may depend on the type of taxpayer and the particular issues facing the state. Much of the compliance problem for businesses arises from the differences in tax structure that have been imposed by the states. Just as with any change implemented in a tax system, both winners and losers will surface. In this section, our report describes the costs and perhaps benefits associated with taxpayer compliance and state administrative issues.

6.3.1 Compliance

Tax planning can be complex and costly to undertake, so combined reporting could lower compliance costs if it prevents tax planning. Further, Tennessee expends considerable resources as it seeks to audit and limit tax planning. But, the failure to find a revenue effect suggests that other forms of planning are found, and the compliance costs could be greater. The remainder of the section addresses the specific compliance effects that are expected from combined reporting.

Determining the Group

One of the most challenging issues of combined reporting is determining how to define the unitary group. The process of defining the unitary group involves examining the economic relationships and understanding the interactions between and among all entities, whether these entities are comprised of single corporations with divisions, affiliated corporations, or nonaffiliated corporations. The U.S. Constitution and Supreme Court rulings provide a general framework for defining the unitary group. Unfortunately, most state statutes and regulations provide little practical guidance as to the parameters of what constitutes a unitary group. The resulting uncertainty, and the conflicting incentives for the state and taxpayers in defining the unitary group introduce controversy resulting in more complex audits, appeals, and litigation between taxpayers and the states. The task is made more difficult by differences in state statutes and business operations, which means that the combined groups can differ across states. Accounting firms and business groups interviewed for this project indicate that an increase in litigation costs regarding the definition of the unitary group accompanies combined reporting regimes. Furthermore, the uncertainty about the definition of *unitary* is a frequent complaint by business groups to combined reporting proposals.

Calculating and Apportioning Income

After determining the members of the unitary group, the taxpayer must determine the income of the unitary group. Due to different ownership tests for inclusion and the concept of unitary in operation for inclusion, state combined income often differs from the consolidated federal taxable income and differs by state. Further, though nearly every state begins with federal corporate income in calculation of the tax liability, the states differ in the adjustments to the income, which causes additional compliance problems. Determining state combined income also requires identification of income that is apportionable *business* income versus allocable *non-business* income. In addition to identifying the income, expenses must also be attributed to business and non-business income.

The taxpayer must next calculate the apportionment percentage to be applied to the combined income of the unitary group to determine the state's share of the income. The apportionment formula calculations are further complicated by the variation in the states' methods to calculate the apportionment factors as well as the various weighting schemes of the factors. For example, a state may choose to include or exclude in the numerator of the apportionment factors the dollar amounts of the factors for members of the unitary group that do not have nexus in the state.⁴⁵ States also vary in the treatment of factors from foreign subsidiaries that have foreign income and the process of including pass-through entities in the combined apportionment factors. The variations in calculating and apportioning the combined income result in complexities that increase the compliance costs.

Adopting states must decide how to deal with pre-combined reporting net operating losses. The issue is whether or not to allow pre-enactment net operating losses (NOLs) to

⁴⁵ This refers to the Finnegan versus Joyce approach.

be available to the combined group or only to the entity that generated the NOL. Credit carryforwards are subject to the same question. Most states treat NOL and credit carryforwards as an attribute of each member, and therefore not available to the unitary group as a whole.

Preparing the Report

Finally, the actual tax return must be prepared. Determining the group, calculating the income, and apportioning the income are all integral parts of the tax return required for a combined reporting state. Some companies may elect to file a consolidated tax return in a combined reporting state where this option is available. Multistate firms that already have state activity in other combined reporting states may incur little additional cost when another state adopts combined reporting because they are already familiar with the basic process, though they must work through the detailed differences in the new state requirements versus those for other combined reporting states. But, smaller or regional firms, particularly firms primarily located in the southeastern United States where states predominately require separate reporting, may incur substantial additional compliance costs as these firms are unfamiliar with the process of determining the group as well as calculating and apportioning income on a combined reporting basis. These firms may require more time to understand the rules and requirements associated with combined reporting and more resources including additional tax preparation software and/or personnel.

6.3.2 Administration

This section addresses the ongoing administrative costs of combined reporting versus separate reporting. The following three sections consider setup costs associated with moving to combined reporting.

Auditing the Group

The administrative costs to audit a taxpayer's unitary relationship are substantial with combined reporting. Rather than focusing on accounting and tax return substantiation when auditing a separate entity, the state must focus efforts on understanding and auditing the determination of the unitary group through examining organizational charts, management processes, ownership percentages, changes in corporate structure, types of intercompany transactions, and financial flows. Therefore, auditors must be equipped to understand how a taxpayer and its affiliates operate at a detailed level to determine whether the affiliates classified as the unitary group are appropriate. The problem is complicated because the state auditors may have very little information about the companies owned by the same parent corporation that the firm has not deemed to be unitary. As changes are continually occurring in a taxpayer's structure and in the types of transactions, the determination of the unitary group is a dynamic one that must be continually evaluated.

While there are substantial administrative costs associated with combined reporting, some of the administrative costs associated with separate entity reporting may be reduced. For example, separate entity reporting allows taxpayers to tax plan and use

transfer pricing to shield income from state taxation. Auditors must request documents and determine that the transfer price set between affiliated corporations is appropriate under separate entity reporting. Because combined reporting effectively disregards intercompany transactions between members of the unitary group, administrative costs associated with determining appropriate transfer prices could be significantly reduced. Nevertheless, transfer pricing issues continue to exist under combined reporting; however, they only remain relevant between unitary group members and affiliated companies not in the unitary group.

Designing the Form

The state will incur costs of developing a new set of combined reporting forms and the related software that would need to be used instead of the current form for preparing the Tennessee corporate income tax return that is based on a single entity approach. If combined reporting is adopted, the forms must be adjusted to allow multiple entities to file on a single form. A form is usually added that details the structural listing of the entities in the unitary group. In general, the forms would need to be updated to allow individual subsidiary level details related to apportionment percentage components and income. In addition to the form changing, the instructions to the form will also need to be updated to provide detailed guidance to taxpayers. Furthermore, software changes to mirror the form revisions would require significant programming costs.

Educating the Staff

The changes related to combined reporting might reflect new concepts to the Department of Revenue staff. Therefore, a plan needs to be developed to provide training for both the state auditors and for those people responding to taxpayer questions, as these changes will create uncertainties. The auditing of combined returns and the appropriate unitary groups can be highly sophisticated and require very well trained auditors so the extent of this training responsibility should not be minimized.

7. SUMMARY

Tennessee imposes an income (excise) tax on all corporations doing business in the state of Tennessee. With certain exceptions, related entities or entities under the same ownership umbrella are currently required to file *separate* tax returns. This analysis considers the implications of requiring related (unitary) businesses to file combined tax returns.

Under a combined reporting regime, each company files its own tax return and pays its own tax.⁴⁶ However, to determine the amount of tax paid, the combined income (or loss) and apportionment factors of all members of the unitary group are combined as if they were a single entity. Similar to consolidated reporting, inter-company transactions are eliminated in the calculation of the group's taxable income. The combined income is apportioned to the state based on the total group's percentage of in-state factors. Then, the total combined taxable income of the group is allocated back to each of the specific companies based on its individual contributions to the factors of the group, and each company pays its respective tax.

Defining the "unitary" group is a contentious issue for both businesses and Departments of Revenue. Although the Supreme Court provides a general framework for defining the unitary group, the details, and therefore the entities comprising the unitary group, can vary from state to state. The resulting uncertainty and the conflicting incentives for the state and taxpayers in defining the unitary group introduce controversy resulting in more complex audits, appeals, and litigation between taxpayers and the states. The Multistate Tax Commission has standardized proposed regulations defining the unitary group and could be used as a starting point for Tennessee.

Combined reporting is arguably a more accurate method of taxing a multi-entity business. If two or more entities engage in a coordinated business activity (e.g. the manufacture and sale of automobiles), the appropriate tax base is the combined profits of that coordinated business activity rather than the separate profits of the entities. In the same way investors will disregard entities to gauge the profitability of a strategic business line, states are justified in taking the same approach in determining taxable income of a "unitary business." Combined reporting limits the potential for firms to engage in tax planning, through the choice of corporate structure, use of Passive Investment Companies (PICs) or location of activity to take advantage of differences in tax structures across states, and thereby their potential to manipulate their tax burden. Combined reporting allows losses in some affiliated members of a group to be offset against profits of other affiliated members, which does not occur with separate accounting. This results in a better measure of the overall profits of a parent corporation and its affiliates. Further, combined reporting provides a mechanism for distributing shared costs and the gains from vertical integration and economies of scope, decisions that are largely left in the companies' hands with separate accounting. Tennessee also can impose a more neutral or even corporate tax structure using combined reporting than separate accounting. Neutral

⁴⁶ For convenience, some states allow one company to file the entire combined report and pay tax on behalf of all of the members of the affiliated group.

or even corporate taxation means that industries and firms are taxed consistently so that none are subsidized or penalized relative to others, though non-taxed structures, such as partnerships and sole proprietorships are advantaged since they remain untaxed. Currently 21 states require combined reporting, however, none of Tennessee's neighbors are included in that list.

For individual firms, the revenue impact of combined reporting depends on the specific characteristics of the combined businesses. Combining multistate firms with different apportionment factors can either increase or decrease Tennessee taxable income. Furthermore, unlike with separate reporting, losses in one entity are available to offset income of other members of the unitary group. However, combined reporting will likely curtail several common and effective aggressive tax planning techniques used by multistate businesses to reduce state income taxes. The PIC strategy, which uses royalty payments to a tax shelter to lower state taxable income, and manipulating transfer prices to site income in low tax states are two of the most often cited targets of combined reporting.

When examined across the aggregate of state corporate tax revenues, we find no statistical evidence that states enforcing combined reporting collect more tax revenues than states that employ separate accounting, given the other characteristics of the tax structure (such as the rate) and the state economy. It is likely that additional tax revenue is collected from some firms, such as when a PIC that was established for tax planning purposes is combined with other companies in Tennessee under a combined reporting regime. But, the statistical analysis evidences that these gains are offset by lower revenues that result in other cases such as when loss making and profit making companies are combined, when affiliates with different factors are combined, and when companies find alternative means to tax plan (such as using foreign PICs). States may collect some additional revenue when combined reporting is initially enacted, but the failure to find any evidence that the 18 states (plus the effects of two new entrants during our study period) that have employed combined reporting raised more revenue across the 1994 to 2008 time period than other states suggests that states are unable to raise greater tax revenue for a sustained time period by employing combined reporting. Thus, we would not forecast that Tennessee would raise significant new revenue if it adopted combined reporting.

Statistical evidence finds no effect of combined reporting on state economies. The economies in combined reporting states are neither more nor less vibrant than in other states, given other characteristics of the state tax structures and economic determinants. This is not surprising since the tax burden is not higher for firms in combined reporting states.

Combined reporting alters the compliance and administrative functions relative to separate accounting. For example, much of the emphasis moves to identifying the unitary group rather than the focus on ensuring that profits are properly measured through appropriate transfer prices. The effects on firms' compliance is likely to differ, with those already operating in combined reporting states being less affected because they understand the tax filing requirements. Firms with no experience in filing combined

returns must learn the process anew. There may also be additional costs of tax planning to lessen the burdens that otherwise would be imposed by combined reporting. Similarly, the Tennessee Department of Revenue would need to educate auditors and others on how to file and audit combined returns. The process can be complex and would require a group of highly skilled auditors.

Any significant changes in tax structures, including moving to combined reporting, entail a series of transition costs. New costs include educating both administrative staff and taxpayers, developing new forms, and modifying computer systems.

States adopting combined reporting face a number of implementation options. Net operating loss and tax credit carryovers can be made available to the unitary group as a whole or restricted to the company that created the carryforwards. Foreign operations could be included in the unitary group, but most states allow for a water's edge election, which effectively ignores international operations in the combined report.

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APPENDIX A – ADDITIONAL EXAMPLES OF SEPARATE VERSUS COMBINED REPORTING

Appendix A Table 1: Separate vs. Combined Reporting
Revenue Impact: Combined Reporting Has No Effect on Income

	A- Separate	B- Separate	Combined	A's Return	B's Return
Apportionment:					
<i>Sales Factor:</i>					
In-State Sales	800	6,000	6,800	800	6,000
Total U.S. Sales	1,000	12,500	13,500	13,500	13,500
Sales %	80.0%	48.0%	50.4%	5.9%	44.4%
<i>Property Factor:</i>					
In-State Property	800	3,000	3,800	800	3,000
Total U.S. Property	1,000	12,500	13,500	13,500	13,500
Property %	80.0%	24.0%	28.1%	5.9%	22.2%
<i>Payroll Factor:</i>					
In-State Payroll	300	1,000	1,300	300	1,000
Total U.S. Payroll	600	7,500	8,100	8,100	8,100
Payroll %	50.0%	13.3%	16.0%	3.7%	12.3%
Total Weighted Apportionment % (Double-Weighted Sales)	72.50%	33.33%	36.23%	5.37%	30.86%
Taxable Income Total	600	7,500	8,100	8,100	8,100
In-State Taxable Income	435	2,500	2,935	435	2,500
Total Taxable Income to State	<u>2,935</u>		<u>2,935</u>	<u>2,935</u>	
Ratio of Income to U.S. Sales	0.60	0.60			
Ratio of Income to U.S. Property	0.60	0.60			
Ratio of income to U.S. Payroll	1.00	1.00			

The table above contains the same example from Appendix A Table 1 in the text, with one exception. In this example, Company B's U.S. total payroll is \$7,500; where as, it was \$9,000 in Example 1. The total tax under both reporting regimes, separate and combined reporting, is identical.

Appendix A Table 2: Separate vs. Combined Reporting
Revenue Impact: Combined Reporting Increases Revenue

	A- Separate	B- Separate	Combined	A's Return	B's Return
Apportionment:					
<i><u>Sales Factor:</u></i>					
In-State Sales	<u>800</u>	<u>6,000</u>	<u>6,800</u>	<u>800</u>	<u>6,000</u>
Total U.S. Sales	1,000	12,500	13,500	13,500	13,500
Sales %	80.0%	48.0%	50.4%	5.9%	44.4%
<i><u>Property Factor:</u></i>					
In-State Property	<u>800</u>	<u>3,000</u>	<u>3,800</u>	<u>800</u>	<u>3,000</u>
Total U.S. Property	1,000	12,500	13,500	13,500	13,500
Property %	80.0%	24.0%	28.1%	5.9%	22.2%
<i><u>Payroll Factor:</u></i>					
In-State Payroll	<u>300</u>	<u>1,000</u>	<u>1,300</u>	<u>300</u>	<u>1,000</u>
Total U.S. Payroll	600	6,000	6,600	6,600	6,600
Payroll %	50.0%	16.7%	19.7%	4.5%	15.2%
Total Weighted Apportionment % (Double-Weighted Sales)	72.5%	34.2%	37.1%	5.6%	31.6%
Taxable Income Total	600	7,500	8,100	8,100	8,100
In-State Taxable Income	435	2,563	3,009	452	2,557
Total Taxable Income to State	<u>2,998</u>		<u>3,009</u>	<u>3,009</u>	
Ratio of Income to U.S. Sales	0.60	0.60			
Ratio of Income to U.S. Property	0.60	0.60			
Ratio of income to U.S. Payroll	1.00	1.25			

Appendix A Table 2 contains the same example from Table 1 in the text, with the exception being this time that the total U.S. payroll for Company B is \$6,000 instead of the \$9,000 in Example 1. The total tax is higher under combined reporting than that for separate reporting.

APPENDIX B - MEETINGS

1. Billy D. Cook, Institute for Professionals in Taxation, Atlanta, GA
2. Harley Duncan, KPMG, Washington DC
3. Reagan Farr, Tennessee Department of Revenue, Nashville, TN
4. Matthew Kisber, Tennessee Department of Economic and Community Development, Nashville, TN
5. Doug Lindholm, Council on State Taxation, Washington, DC
6. Bob Cline, Ernst and Young, Washington, DC
7. Michael Mazerov, Center for Budget and Policy Priorities, Washington DC
8. Lin Smith and Bryan Mayster, Price Waterhouse Coopers, Washington DC
9. John Stewart, Tennesseans for Fair Taxation, Knoxville TN

APPENDIX C – INTANGIBLE EXPENSE DISCLOSURE FORM



Tennessee Department of Revenue

Franchise and Excise Tax Intangible Expense Disclosure Form

Name of taxpayer _____ FEIN _____
Tax period _____ Federal form type _____
Type of expense _____ Amount _____ Deducted on federal form line _____
Has taxpayer requested and received a letter ruling on this issue? Yes ___ No ___ If yes, please attach a copy.

QUESTIONNAIRE:

1. Name and FEIN of affiliate, as the recipient of income, in the affiliated intangible expense transaction. _____ FEIN _____
2. Date and state of incorporation or formation of affiliate. Date _____ State _____
3. Business activity of affiliate. _____
4. Number of full-time employees of affiliate at year-end _____
5. Dollar-value (on a cost basis) of all real and tangible property of affiliate at year-end _____
6. Does affiliate file franchise and excise tax returns? (If so, provide closing date of first tax return filed.) _____

7. Location of where principle business activities of the affiliate take place such as; accounting, policy decisions, contracts and financial operations? _____
8. List the type of "Intangible property" for which the expense is incurred? _____

9. Does the expense occur on an annual or regular basis or is it a one-time or special event? _____
10. By what method is the intangible expense measured or determined? (Please mark all that apply)
____ a) solely a reimbursement-of-costs?
____ b) reimbursement-of-costs plus a percentage?
____ c) percentage of sales?
____ d) arm's length pricing?
____ e) other: _____
Please attach a detailed explanation of the method used to measure or determine the intangible expense.
11. If the answer to the prior question is anything other than (a), has the rate or pricing method been subject to a third party examination or opinion? Yes ___ No ___ Explain _____

12. Does the affiliate use the proceeds from the expense transaction to: (Please mark all that apply)
____ a) Pay dividends?
____ b) Loan the proceeds back to a member of the affiliated group?
____ c) Used directly in the affiliate's business operations?
____ d) Used by the affiliate to invest in publicly-traded securities?
____ e) Other: _____
Please attach a detailed explanation of how the affiliate uses the proceeds from the transaction.
13. When the affiliate has to support, legally defend, or authorize use of "Intangible property", does it use;
____ a) Its own employees
____ b) Employees of an affiliate group member
____ c) Contract 'labor'
____ d) Outside professional legal counsel
____ e) Other: _____
Please attach a detailed explanation of how the affiliate supports, legally defends, and/or authorizes use of "Intangible property."

Instructions to Intangible Expense Disclosure Form

This form must be completed and filed with your Franchise and Excise tax return for tax years beginning on or after January 1, 2004, in order to comply with the disclosure requirements of an "Intangible expense" as defined by Tenn. Code Ann. Section 67-4-2004.

- Only disclose those expenses with an "Affiliated business entity" as defined by Tenn. Code Ann. Section 67-4-2004.
- A separate Intangible Expense Disclosure form must be completed for each affiliated business entity which an affiliated intangible expense is disclosed.
- If you determine additional explanation and information would be helpful in the disclosure, please submit as an attachment to this form.
- The disclosed expense will be reported on the Franchise and Excise tax return by adding it back in reporting federal taxable income and then taking a deduction on Line 23, Schedule J.
- If an intangible expense does not meet the requirements of a properly disclosed expense, then the deduction available in accordance with Tenn. Code Ann. Section 67-4-2006(b)(2)(N) will be disallowed.
- If it is determined an affiliated intangible expense does not meet the disclosure requirements, the taxpayer will be notified and will have the rights available under Tenn. Code Ann. Section 67-1-1801, et seq.