Combined Reporting –
New York Becomes California’s Little Brother
Agenda

- Move to Combined Reporting
  - Overview
- New York State
  - Summary of Unitary Combined Reporting Regime
- Technical Issues
  - Composition of Group
    - Unity / Election
    - Additions / Holding Companies
    - Water’s-Edge
  - Joyce/Finnigan
  - NOLs
  - Dividends
  - Intercompany Gains / Sales
  - Statute of Limitation
Combined Reporting States - 2004

West of Mississippi
Alaska
Arizona
California
Hawaii
Idaho
Kansas
Minnesota
Montana
Nebraska
North Dakota
Oregon
Utah

East of Mississippi
Illinois
Maine
New Hampshire
Combined Reporting States - 2013

West of Mississippi
- Alaska
- Arizona
- California
- Hawaii
- Idaho
- Kansas
- Minnesota
- Montana
- Nebraska
- Oregon
- TEXAS (2008)
- Utah

East of Mississippi
- DISTRICT OF COLUMBIA (2011)
- Illinois
- Maine
- MASSACHUSETTS (2009)
- MICHIGAN (2009)
- New Hampshire
- NEW YORK STATE (2007; unitary eff. 2015)
- NEW YORK CITY (2009)
- VERMONT (2006)
- WEST VIRGINIA (2009)
- WISCONSIN (2009)
NEW YORK STATE
UNITARY COMBINED REPORTING REGIME
Unitary Combined Reporting

- The New York State Budget Bill ("Budget") shifts the Corporate Franchise Tax to a unitary combined reporting regime
  - Effective for tax years beginning January 1, 2015

- The Budget imposes Water’s-Edge Combined Reporting
  - Taxpayers must file a combined report including all unitary entities that are owned or controlled by the taxpayer
    - (50% ownership test)
  - Taxpayer election to include all members of a commonly-owned group in a combined report, regardless of unitary relationship
THE TECHNICAL ISSUES
Composition of Group: State Variations

- **New York**
  - Pre-2007: discretionary combination
  - 2007-2014: mandatory combination if “substantial intercorporate transactions” exist under 10-step process
  - Effective 2015: “substantial intercorporate transactions” replaced by more standard unitary inquiry

- **California case law**
  - *Tenneco* (not unitary despite strong centralized management)
  - *Dental Insurance* (dental insurance business unitary with farms)
  - *ComCon Production* (Comcast not unitary with its subsidiary, QVC)
Composition of Group – Unity

• Tests for determining unity:
  ▪ Unities of ownership, operation, and use
  ▪ Functional integration, economies of scale, and centralization of management
  ▪ Contribution or dependency
  ▪ MTC regulation defines unitary business as “single economic enterprise” of parts “sufficiently interdependent, integrated and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value….”
Composition of Group – Unity – New York State

  - ALJ determined that taxpayers did not operate a unitary business
  - The ALJ found that the centralized operations and services provided by the parent corporation were stewardship-activities not resulting from the parent’s “operational expertise”
    - The decision rejects many of the traditional indicia of functional integration, centralization of management, and economies of scale
  - Likely to see more “unitary” disputes now that New York shifted to unitary combined reporting effective for tax years beginning Jan. 1, 2015
Composition of Group – Group Additions

• What entities are included:
  ▪ Insurance companies?
  ▪ Financial institutions?
  ▪ REITs/RICs?
  ▪ Pass-through entities?

• Inclusion of different types of entities can raise questions with respect to meshing different apportionment methodology and/or with respect to different income or credit/loss carry forward rules
Composition of Group – Group Additions – New York State

• The Budget adds entities to the unitary combined group

  ▪ Combinable Captive Insurance Companies – previously known as “overcapitalized captive insurance companies”

  ▪ Alien Corporations with Effectively Connected Income

  ▪ Captive Real Estate Investment Trusts (REITs) and Regulated Investment Companies (RICs)

• Also includes provision to shift non-premium income from an “overcapitalized” admitted non-life insurance corporation to a parent company
Instant Unity

• When do the operations of a newly acquired subsidiary become sufficiently integrated to become unitary with the existing business?
  
  ▪ California generally requires some (indeterminate) amount of time to elapse (i.e., the rule should be called the “no instant unity” rule)
    ▪ How much time varies with the facts and circumstances
  
  ▪ New York (per audit group): “takes at least six months”
Holding Companies

- Holding companies as a subset of unitary group:
  - Are operations necessary to be combined?
    - In *Appeal of PBS Building Systems*, the SBE implied that shared tax benefits, loan guaranty, covenants, and overlap of officers and directors were sufficient for unity
    - See also FTB Legal Ruling 95-7 and 95-8
      - NYC Tax Tribunal determined that holding company was unitary with operating subsidiary
  - If not combined, consider dividend and interest issues
Affiliated Group Election – New York State

- New York will allow the taxpayer to make an election to include all commonly-controlled members
  - Must be filed on original return, 7-year term
  - An effective election automatically renews after the 7-year term for another seven years unless revoked
  - Includes all entities with 50% ownership, regardless of unitary relationship
Water’s-Edge – “Intercompany Inclusion”

• The parameters of water’s-edge group are hotly debated
• Issues in the debate include:
  ▪ Whether foreign entity should only include US source income (and does that include “effectively connected” income)
  ▪ Whether 80/20 rule should include domestic entities
  ▪ Proper interpretation of MTC model rule concerning intercompany transactions with members outside the group
  ▪ Issues concerning MTC tax haven provision – quasi-worldwide combination?
  ▪ Effect of US treaties that provide either that an item of income is not taxable federally or is to be subject to a reduced rate of federal tax
Water’s-Edge – New York State

• The Budget includes certain alien corporations:
  - Alien corporations with effectively connected income
  - Alien corporations that are treated as domestic corporations for IRC purposes (IRC 7701)

• If an alien corporation is included in the NYS group, it is included only to the extent of its effective connected income

• Effectively connected income is calculated without regard to any treaty protections (when the treaty does not prohibit state taxation of such income)
  - Alien corporations may have effectively connected income for New York corporate franchise tax purposes but not for federal income tax purposes
Joyce and Finnigan

• Is it the selling taxpayer? Or the group?
  - Finnigan states include:
    - New York
      - Pre-2015: Disney Enterprises
      - 2015-forward: Statutory
    - California
      - Mutual fund companies per Cal. Admin. Code, tit. 18, § 25137-14
      - 2011-forward: All Taxpayers

  - Should the rule be consistent with the rule for NOLs and credits?
Finnigan – New York State

• The Budget retains the Finnigan method for computing income and factors for members of the unitary combined group

  ▪ Each members’ income, apportionment, and attributes (i.e. NOL/PNOL) are aggregated and applied against the unitary combined group’s aggregate business income
Net Operating Loss Carryforwards

• Lack of uniformity in state rules
  ▪ California intrastate apportionment rules make clear each taxpayer has its own share of the group’s NOL
  ▪ Some states treat NOL as that of the group

• Transition rules can be a problem where losses only allowed to member that generated it:
  ▪ For example, a loss generated by a holding company may not be available where holding company intrastate apportionment percentage drops to zero, and it is not allocated a share of combined group income
Net Operating Losses – New York State

• The Budget changes the Corporate Franchise Tax Net Operating Loss (“NOL”) regime and establishes a transitional Prior Net Operating Loss (“PNOL”) deduction

• NOLs incurred prior to the Unitary combined reporting regime are recharacterized as a PNOL, with specific rules for application

• NOLs incurred after the unitary combined reporting regime have a separate set of rules
Net Operating Losses – New York State

- Taxpayers permitted to use PNOL deduction over 20 years (up to 10% per year)
  - Unused PNOLs may be carried forward through 2036
- The Budget provides an election to accelerate PNOLs, allowing up to 50% PNOL use
  - But if PNOL not exhausted by 2016, then it is lost forever
- Taxpayers calculates PNOL using its unabsorbed NOL from the last tax period prior to the implementation of the unitary combined reporting regime
Net Operating Losses – New York State

• NOLs incurred after the unitary combined reporting regime is implemented can be carried forward 20 years and carried back three years

• The Budget also eliminates some restrictions that historically applied to the use of NOLs
  
  ▪ NOLs are no longer limited by the amount of federal NOL deduction; and
  
  ▪ NOLs are used only to the extent the entire net income tax exceeds the capital or fixed tax bases
Dividends

- Dividends from unitary subsidiary:
  - Eliminated?
  - Eligible for dividends received deduction?

- Early California Safeway case holds dividends not eliminated, but legislature overrules in RTC 25106 so long as paid from unitary earnings

- Tracking of E&P is administratively burdensome

- Should the states allow for a pure elimination of dividends paid among members, with no limitations?
Dividends (cont’d)

• What of newly-formed subsidiary or holding company formed as part of reorganization, receiving dividend from E&P generated prior to its existence?
  - FTB sponsored legislation effective 1 January 2009 (RTC 25106(2)) that permits dividends received deduction (“elimination”) where recipient is newly formed, if part of unitary group from date of formation. FTB can disregard if done for tax evasion purposes.
  - What happens when the newly formed entity then dividends up to its parent?

• What has become of “Willson’s Rule”? 
Intercompany Gains

• Are intercompany sales eliminated or deferred?
  - Does it matter if the state begins with federal taxable income?
  - After an inconsistent history, California now follows federal “to the extent possible consistent with combined reporting principles”
  - In either case, transactions between group members as to the unitary business would apparently no longer implicate the states' add back laws
Intercompany Gains (cont’d)

- Assuming elimination, the correct application per unitary theory may lead to odd results:
  - Sub manufacturers goods at a cost of $40 in state M and sells to Parent for $75 in state N; Parent then sells to third party for $100 in state O
  - Where/when is profit recognized?
Intercompany Gains (cont’d)

• If state adopts federal deferral approach:
  - May match federal unless the ownership standard is less than 80%, or the group includes foreign members
  - What apportionment percentage applies, year of restoration or year of deferral?
  - Are intercompany sales eliminated from the apportionment factors?
  - How to treat deferred items before taxpayer entered the state, i.e., were there preexisting gains?
Intercompany Eliminations – New York State

• To compute combined business income:
  ▪ All intercorporate dividends must be eliminated; and
  ▪ All other intercorporate transactions must be deferred in a manner similar to the federal consolidated return rules under section 1502 of the Internal Revenue Code
Intercompany Sales

• Are intercompany sales eliminated from the sales factor?
  ▪ In *Chase Brass* the California court concluded that intercompany sales should be eliminated from the sales factor because no net income is created from the intercompany sale
Nonbusiness Items

• Nonbusiness losses
  ▪ Are generally trapped at the entity generating such losses, to be added to post-apportioned income

• Nonbusiness interest deduction
  ▪ *Robert Half Int’l* suggests that the debt must contribute materially to the production of business income
Capital Gains and Losses

- California has an elaborate regulation calling for separating and then netting various preferred items

- What to do in states with no clear rules?
Partnership Issues

• **Subject of recent FTB Interested Parties Meeting:**
  - How are distributive shares of items from **non**-unitary partnerships treated?
  - What about the indirect ownership of business assets (specifically, assets that are “nonbusiness” in the partnership’s hands but would be “business” in the partner’s hands)?
  - Possible expansion of rule eliminating sales between partner and partnership.
Statute of Limitations, Elections, Methods

• Does the group have a single, common statute of limitations?
  ▪ Assessments
  ▪ Refunds
  ▪ For combination itself (*Turbodyne Corp.* and *Panavision*)

• Does the group have a single, common set of elections? Must all be on same accounting method?

• Is tax liability individual or joint and several?
Questions?

Prentiss Willson, Of Counsel
916.241.0504
prentiss.willson@sutherland.com

Andrew Appleby, Associate
212.389.5042
andrew.appleby@sutherland.com
Connect with us!

The Sutherland SALT Shaker mobile app is now available in the iTunes App store and on Google Play for Android!

Visit us at www.stateandlocaltax.com

@Sutherland_SALT  Sutherland SALT Group
Cases Cited Above

- **ComCon Production Services I, Inc. v. Franchise Tax Bd.,** Case No. BC489779 (Los Angeles Super. Ct. Mar. 6, 2014)
- **Appeals of PBS Bldg. Sys., Inc., and PKH Bldg. Sys., Inc.,** No. 94-SBE-008 (Cal. State Bd. of Equalization Nov. 17, 1994)
- **Matter of American Banknote Corp.,** TAT (E) 03-31 (GC); TAT (E) 03-32 (GC); TAT (E) 03-33 (GC) (N.Y.C. Tax App. Trib., Nov. 2008)
- **Matter of Disney Enters., Inc.,** 888 N.E.2d 1029 (N.Y. 2008)
Cases Cited Above (cont’d)

- **Safeway Stores v. Franchise Tax Board**, 3 Cal.3d 745 (1970)
- **Chase Brass v. Franchise Tax Board**, 70 Cal.App.3d 457 (1977)