BATC

Business Associations' Tax Coalition

7265 Halcyon Summit Drive
Montgomery, AL 36117
334/263-5757

The Honorable Mike Hubbard
Alabama State House
11 South Union Street, Suite 519-A
Montgomery, AL 36130

Dear Speaker Hubbard,

The Business Associations' Tax Coalition (BATC), a coalition of business and trade associations representing every major classification of business in our state (see full list on next page), stands in opposition to **HB142**, the combined reporting bill by Rep. Mike Hill, R-Columbiana.

A detailed analysis of the legislation and its context, prepared by BATC's chief legal counsel, follows this letter. Many BATC members have long-standing positions in opposition to combined reporting for basic and obvious reasons. Primary among those are, that combined reporting:

- **Hinders economic development and retention:** No Southeastern state has adopted mandatory unitary combined reporting because of its detrimental effect on attracting businesses. (See map that follows showing the current status of combined reporting in our country). Georgia studied the issue and determined that it would have a negative effect on job creation.
- **Creates confusion rather than consistency in the tax code:** HB 142 gives broad authority to Alabama's revenue commissioner to unilaterally determine tax policy and creates a bureaucratic nightmare resulting in delays and confusion for the taxpayer.
- **Is costly for businesses and the state:** This is not the closing of "loopholes" as suggested; instead, it is the adoption of an entirely new taxing scheme that our competing states have rejected. Complying with the provisions of this bill will be extremely costly for both the government and businesses.

The business groups that follow respectfully ask you to reject combined reporting. We stand ready to discuss this issue further with you at your convenience.

Sincerely,

Rick Brown
Chairman
Business Associations' Tax Coalition

Members of the

Business Associations' Tax Coalition

Alabama Association of Life Companies
Alabama Association of REALTORS®, Inc.
Alabama Bankers Association
Alabama Beverage Association
Alabama Cable Telecommunications Association
Alabama Concrete Industries Association
Alabama Farmers Federation
Alabama Hospital Association
Alabama Independent Insurance Agents, Inc.
Alabama Manufactured Housing Association
Alabama Nursing Home Association
Alabama Poultry & Egg Association
Alabama Retail Association
Alabama Road Builders' Association
Alabama Rural Electric Association
Alabama Society of CPA's
Alabama Trucking Association
American Council of Engineering Cos. of Alabama
Associated Builders and Contractors of Alabama
Associated General Contractors of Alabama
Automobile Dealers Association of Alabama
Business Council of Alabama
Home Builders Association of Alabama
Manufacture Alabama
Petroleum & Convenience Marketers of Alabama
Subcontractors Association of Alabama

Combined Reporting Adoption

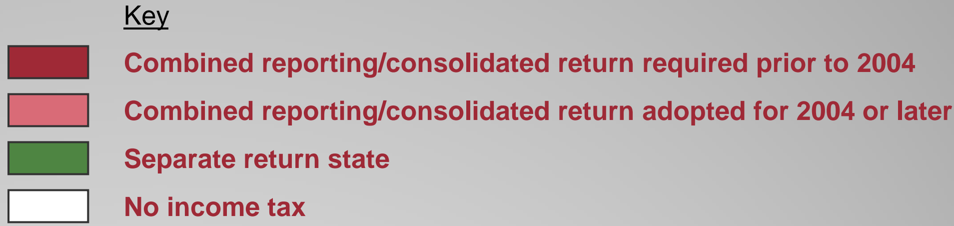
As of March 2015

[1] NY state and city requires combined reporting when there are substantial intercorporate transactions

[2] Combined reporting for a tax based on gross receipts

[3] Combined reporting required for certain "big box" retailers, for tax years beginning after 31 December 2013

[4] RI switched to combined reporting effective tax year 2015



Business Associations' Tax Coalition

The following is an analysis of HB142 – the combined reporting bill introduced by Rep. Mike Hill – prepared by Jeff Patterson, chief legal counsel for the Alabama Business Associations' Tax Coalition. To better understand HB142, it is important to understand the context in which it was introduced.

The Current State of Corporate Income Tax Reporting In Alabama

Currently, corporations that are subject to Alabama's corporate income tax file their returns on a "separate-entity" basis, i.e., each corporate taxpayer reports its items of gross income, deductions, credits, etc., and pays Alabama income tax on the result of the calculations concerning those items. Alabama law does not force corporate taxpayers to include the income of other corporations in those calculations. See, generally, Ala. Code § 40-18-39(a).

Alabama law allows one exception to separate reporting, however, and that is known as "consolidated reporting." Alabama corporate taxpayers that are members of a defined group of corporations (known as an "Alabama affiliated group") may elect to file an Alabama consolidated return, as a group, if the group files a consolidated return for federal income tax purposes. Alabama law is clear, however, that the filing of a consolidated return is at the election of the taxpayers, and that the ADOR is prohibited from forcing such a filing. § 40-18-39(b) through (k). And the section in the Alabama Revenue Code that authorizes consolidated reporting states that "nothing in this section shall be construed as allowing or requiring the filing of a combined income tax return under the unitary business concept." § 40-18-39(i).

When a corporation that operates in Alabama and in other states files a separate-entity income tax return here, it does not pay Alabama tax on 100 percent of its total business income. In fact, the U.S. Constitution forbids such taxation, because it could result in each state in which the corporation does business taxing 100 percent of the corporation's multistate income. Instead, the corporation uses a mathematical formula to source – or apportion – to Alabama less than 100 percent of its business income. The remaining business income is attributable to the other states in which the corporation does business.

Alabama's apportionment formula contains three factors – property, payroll, and sales. These factors represent the value of the corporation's property in Alabama compared to the value of its property everywhere; the amount of the corporation's payroll in Alabama compared to its payroll everywhere; and the amount of its sales in Alabama compared to its sales everywhere. The calculation of each factor is a matter of basic division, i.e., the Alabama value/amount for each category is divided by the total value/amount for that category. Once each factor is determined, the three percentages are added together, except the sales factor is counted twice (double-weighted). The sum is then divided by four, and that percentage is used to apportion the corporation's business income to Alabama for income tax purposes. For example, if a multistate corporation operating also in Alabama had a

property factor of 10 percent, a payroll factor of 20 percent, and a sales factor of 25 percent, its Alabama apportionment ratio would be 20 percent (10 percent +20 percent +25 percent +25 percent = 80 percent, and 80 percent ÷ 4 = 20 percent). If that corporation had $1 million in business income, its Alabama apportionment ratio of 20 percent would mean that the corporation would apportion $200,000 of business income to Alabama for tax purposes.

Introduction to Combined Reporting

Some states require a corporate taxpayer to combine its income and apportionment data with the income and apportionment data of other corporations to determine the taxpayer's income that is subject to the state's corporate income tax. Combination involves the taxpayer and other corporations that are engaged in a "unitary business," which is a single business enterprise that is commonly controlled (owned) and that theoretically produces a mutual economic benefit for all members of the group. As an example, consider a family of corporations involved in the oil business. One corporation, XYZ Oil Exploration, Inc., searches for oil reserves. A sister company, XYZ Oil Extraction, Inc., drills for and removes oil from the reserves discovered by the exploration company. Another sister company, XYZ Oil Refining, Inc., turns the oil into a sellable product. Yet another related company, XYZ Oil Marketing, Inc., sells the product. And XYZ Oil Distribution, Inc., delivers the product to customers. These corporations most likely would be engaged in a unitary business. If only one of these companies was operating in a combined reporting state, that state would require its taxpayer to include the income and apportionment data from the other companies in that taxpayer's income tax calculations.

The application of combined reporting is not limited to separate corporate entities. It also applies to separate divisions within one corporate entity, if those divisions are considered unitary with each other. So, in the oil companies' example, if those companies were merely different divisions within only one corporate entity, the principles of combined reporting still could be applied, even though only one of those divisions operated in the combined reporting state.

Generally, the combined reporting calculation would be made as follows: The corporate taxpayer determines the total amount of its business income. Then, the taxpayer adds to that amount the business income of all other members of the unitary group. This sum represents the amount (or pool) of income that is subject to apportionment in the combined reporting state. The next step would be to determine the taxpayer's apportionment ratio, which is the percentage that the taxpayer multiplies by the pool of apportionable income to determine how much business income to report to the state. To do so, the taxpayer uses that state's apportionment method, such as the property, payroll, and sales factor formula discussed previously. The numerator of each factor would include **the taxpayer's** value/amount of property, payroll, and sales in the taxing state that is associated with the combined group's unitary business conducted in the state. But, the denominator of each factor would include the values/amounts of property, payroll, and sales of the taxpayer **plus all other members of the unitary group**, concerning the unitary business conducted in the taxing state and elsewhere. Once

each factor is calculated as a percentage, the factor percentages are added to each other and then divided by the number of factors (such as three), or by some other number (such as four in a state where the sales factor percentage is counted twice). That percentage is then multiplied by the taxpayer's pool of apportionable income. (There are other calculations that are made in this process. This explanation is for general illustration only.)

The determination of the taxpayer's income on a combined basis is then reported to the taxing state by the taxpayer on what is known as a "combined report." These characteristics and requirements produce the phrase "unitary combined reporting." If a taxpayer is required to report on a combined basis, instead of merely having the option to do so, the reporting method is referred to as "mandatory unitary combined reporting."

HB142

Rep. Hill's bill is almost identical to the Multistate Tax Commission's combined reporting bill that it proposed in 2006 (amended in 2011). The Multistate Tax Commission describes itself as "an intergovernmental state tax agency," of which Alabama and many other states are members. The main deviation by HB142 from the Commission's proposed bill is that HB142 includes a section that addresses a filing method referred to as an "affiliated group election."

Lawmakers should be aware of the following points concerning HB142.

1. The synopsis and preamble of HB142 incorrectly state that the bill requires the filing of one return.

In both the synopsis and preamble, it is stated that the bill would "require" the filing of "one corporate income tax return." In fact, the bill allows the filing of a return by each taxpayer of the group, once calculations concerning combination have been made. The bill would allow the filing of one return for the entire group, but such a filing is at the election of the group and is not a requirement. *HB142, page 34*. Thus, the introductory language fails to accurately describe the bill's filing provisions.

2. Within the discretion of the Revenue Commissioner, a taxpayer may be required to include in its combined report the income and apportionment data of entities such as financial institutions and insurance companies, even though those entities are not subject to Alabama's corporate income tax.

In HB142, page 16, a taxpayer's combined report would not include the income or apportionment data of organizations that are exempt from Alabama's corporate income tax under § 40-18-32. That section (§ 40-18-32) includes certain insurance companies, financial institutions, and other entities. However, the next subparagraph in HB142 would authorize the Alabama Department of Revenue Commissioner to do just the opposite, i.e., to require a taxpayer to include in its combined report the

income and apportionment data of such entities, if those entities are involved with the taxpayer in a unitary business.

At the least, such a reporting requirement could create significant issues concerning the manner in which an entity's income is determined, for corporate income tax reporting purposes, when that entity is not subject to Alabama's corporate income tax and may not account for income in the same manner as a corporate income taxpayer. Also, the Legislature's delegation of this authority to the commissioner comes with no statutory guidance, other than a vague, undefined phrase that the commissioner may do so "in order to reflect proper apportionment of income of entire unitary businesses." In short, taxpayers would be subjected to situations in which they must await a discretionary decision from a non-legislative agency as to their tax status and calculations.

The bill's next paragraph (*page 17*) gives the Commissioner additional authority to require such combination, if the commissioner determines that a taxpayer's reporting of income or loss from a unitary business "represents an avoidance or evasion of tax by such taxpayer." Again, taxpayers are given no statutory guidance as to the meaning of "avoidance" of tax (which has always been legal), much less "evasion of tax" (which could constitute a criminal offense). More specifically, concerning the phrase "evasion of tax," the bill not only would allow the commissioner to assert what would amount to a criminal charge against the taxpayer, but apparently would allow the commissioner to determine the elements or parameters of the offense. And the implementation of this requirement would be at the discretion of the commissioner "on a case by case basis."

3. If a partnership is held directly or indirectly by a corporation, HB142 considers the business conducted by the partnership to be the business of the corporation.

On pages 4-5, the bill includes in the definition of "corporation" the following: "The business conducted by a partnership which is directly or indirectly held by a corporation shall be considered the business of the corporation to the extent of the corporation's distributive share of the partnership income, inclusive of guaranteed payments to the extent prescribed by regulation." That concept is repeated in the bill's definition of "unitary business" on page 13. Corporations, or those entities taxable as a corporation, should be aware that any business it conducts through a partnership will be considered business of the corporation for combined reporting purposes.

4. Although HB142 would require the combining of income and apportionment data of separate members of the unitary group, the bill would not allow members of the unitary group to use another member's tax credits or certain deductions.

HB142 defines "unitary business" as "a single economic enterprise …" HB142, page 12. The bill proceeds to require members of a unitary business to combine their income and apportionment data for income tax reporting purposes. However, as to the claiming of tax credits and post-apportionment deductions, the bill limits those to the particular member of the group that earned those credits or deductions. HB142, page 19. Thus, HB142 treats entities as a single enterprise for one purpose – the

combining of income and apportionment data – but treats entities separately for another purpose – the claiming of credits and deductions. The bill seems to want it both ways.

5. The legality of Alabama's current apportionment method, which would be utilized in HB142, is in question in other states.

HB142 would utilize Alabama's current apportionment methodology – the property, payroll, and double-weighted sales factor formula – to determine the amount of income a taxpayer would report to this state (page 20), as discussed in detail previously. However, that formula, with the sales factor being double-weighted, has been challenged and declared invalid by a state appeals court in California in Gillette v. Franchise Tax Board. The case currently is under review by the California Supreme Court. Like California, Alabama adopted the original three-factor apportionment formula (with the sales factor being only single-weighted) as part of the Multistate Tax Compact, which was entered into by several states. That original three-factor formula was referred to by the U.S. Supreme Court as the "benchmark" for fair apportionment. However, also like California, Alabama unilaterally altered its original apportionment formula by double-weighting the sales factor (in 2011). Gillette challenged this action in California, by claiming that the state lacked authority to unilaterally alter a multistate compact. The California appellate court agreed. Therefore, it is questionable whether Alabama's alteration of its original apportionment formula was legal. Yet Alabama now considers imposing an entirely new and different taxing regime that is predicated, in part, upon an apportionment formula of questionable legality.

6. The "water's-edge" election contained in HB142, which can be made by taxpayers, may be illusory.

Generally, combined reporting statutes may allow taxpayers to limit the members of its combined group to those entities located within the United States; hence the phrase "water's-edge." The lack of such a limitation is referred to as "worldwide combined reporting." HB142 would allow taxpayers to make a water's-edge election, but other provisions in the bill seem to quickly undo the election. HB142, pages 26-28. For example, the entire income and apportionment data of an overseas company is included in the combined group, despite the election, if the apportionment ratio of the overseas company is 20 percent or more. *HB142, page 27*. The same is true for an overseas company that earns more than 20 percent of its income from intangible property or from service activities that are deductible against the business income of the other members of the combined group. *HB142, page 28*. This 20 percent threshold seems to be arbitrarily low, so as to turn waters-edge combined reporting into worldwide combined reporting.

7. HB142's terms concerning "tax havens" are too broad and too vague.

The bill would disregard a taxpayer's water's-edge election as to a member "that is doing business in a 'tax haven'." *HB142, page 28*. In such a situation, the taxpayer would include all income and apportionment data of that member. One problem here, however, is that the bill's definitions of tax

haven are very subjective. *HB142, pages 11-12*. For example, one provision defines the phrase as a jurisdiction that "has created a tax regime which is favorable for tax avoidance, based upon an overall assessment of relevant factors, including whether the jurisdiction has a significant untaxed offshore financial/other services sector relative to its overall economy." *HB142, page 12*. Presumably, the "overall assessment of relevant factors" would be performed by the Revenue Commissioner, although the bill is silent on the matter. Also, the bill offers no other factors that the Commissioner is supposed to assess, besides a significant financial services sector, and the bill offers no guidance as to the meaning of the term "significant." Further, entrusting the Revenue Commissioner with the task of determining which overseas jurisdictions constitute tax havens may encroach upon the authority of the U.S. government in such matters, and may violate the U.S. Constitution's Foreign Commerce Clause, which reserves to Congress the power to regulate commerce among foreign nations.

Also, the bill offers no explanation as to why an overseas member would be included in a water's-edge election merely because that member conducted business in a tax haven. One might expect the bill to include in the combined group a member of the unitary business that was incorporated or organized in a tax haven, but it seems punitive to include in the group a member that simply performs some level of business activity in a particular jurisdiction.

8. A waters-edge election comes with a price.

One of the few elections granted to taxpayers in HB142 requires certain concessions by the taxpayer. Specifically, the bill states that "such [water's-edge] election shall constitute consent to the reasonable production of documents and taking of depositions…" HB142, page 29. And, the election can be disregarded altogether if a person not included in the water's-edge group had a substantial objective of avoiding state income tax. Again, the key phrase here is undefined in the bill, and the determination of tax avoidance is left to the discretion of the Revenue Commissioner. These concessions, coupled with the uncertainty concerning the election, could deter a taxpayer from making the election in the first place.

9. HB142 is a retroactive tax increase.

According to Section 9 of the bill (page 42), HB142 would apply to all tax years beginning after December 31, 2014. This retroactivity to the beginning of the year is for the obvious purpose of raising revenue, which constitutes a tax increase that ultimately will be borne by consumers. If such a major change in tax reporting were going to be implemented by the state of Alabama, it would be more appropriate to give the bill an effective date far enough into the future to allow the ADOR and taxpayers time to prepare for such a significant change.

10. HB142 could have a detrimental effect on Alabama's business recruitment and economic development.

When the Multistate Tax Commission was considering its proposed combined reporting bill – the one which is the blueprint for HB142 – the Commission held public hearings on the proposal, and received several comments from the tax community. One set of comments came from a group called the Organization for International Investment, which described itself as "the leading association representing the interests of U.S. subsidiaries of international companies." The Organization stated: "The members of OFII also are very concerned with the adverse impact on the ability of any state that adopts this draft statute to attract "insourcing," or inbound investment by foreign entities. OFII believes that such states will be at a competitive disadvantage vis-à-vis other states that do not adopt this draft statute. An additional general concern is that the compliance burden and expense imposed by the statute on OFII's membership will be significant." It is ironic that the same Alabama Legislature that has quickly begun passing economic development legislation also would consider combined-reporting legislation.

Conclusion

HB142 raises many significant questions and issues and, as explained, would constitute a drastic change from Alabama's current corporate income tax reporting laws. These facts, coupled with the retroactive application of the bill for the purpose of raising taxes, causes the Business Associations' Tax Coalition to oppose HB142.